Working with borrowers who are experiencing financial difficulties may involve formally restructuring their loans and taking other measures to conform the repayment terms to the borrowers' ability to repay. Such actions, if done in a way that is consistent with prudent lending principles and supervisory practices, can improve the prospects for collection. Generally accepted accounting principles (GAAP) and regulatory reporting requirements provide a framework for reporting that may alleviate certain concerns that lenders may have about working constructively with borrowers who are having financial difficulties.

Interagency policy statements and guidance, issued on March 1, 1991; March 10, 1993; and June 10, 1993, clarified supervisory policies regarding nonaccrual assets, restructured loans, and collateral valuation (additional clarification guidance may be found in SR-95-38 and in the glossary of the reporting instructions for the bank call report and the FR-Y-9C, the consolidated bank holding company report). When certain criteria[1] are met, (1) interest payments on nonaccrual assets can be recognized as income on a cash basis without first recovering any prior partial charge-offs; (2) nonaccrual assets can be restored to accrual status when subject to formal restructurings, according to Financial Accounting Standards Board (FASB) Statement Nos. 15 and 114, ''Accounting by Debtors and Creditors for Troubled Debt Restructurings'' (FAS 15) and ''Accounting by Creditors for Impairment of a Loan'' (FAS 114); and (3) restructurings that specify a market rate of interest would not have to be included in restructured loan amounts reported in the years after the year of the restructuring. These supervisory policies apply to federally supervised financial institutions. The board of directors and management of bank holding companies should therefore incorporate these policies into the supervision of their federally supervised financial institution subsidiaries.

2065.1.1 CASH-BASIS INCOME RECOGNITION ON NONACCRUAL ASSETS

Current regulatory reporting requirements do not preclude the cash-basis recognition of income on nonaccrual assets (including loans that have been partially charged off), if the remaining book balance of the loan is deemed fully collectible. Interest income recognized on a cash basis should be limited to that which would have been accrued on the recorded balance at the contractual rate. Any cash interest received over this limit should be recorded as recoveries of prior charge-offs until these charge-offs have been fully recovered.

2065.1.2 NONACCRUAL ASSETS SUBJECT TO FAS 15 AND FAS 114 RESTRUCTURINGS

A loan or other debt instrument that has been formally restructured to ensure repayment and performance need not be maintained in nonaccrual status. When the asset is returned to accrual status, payment performance that had been sustained for a reasonable time before the restructuring may be considered. For example, a loan may have been restructured, in part, to reduce the amount of the borrower's contractual payments. It may be that the amount and frequency of payments under the restructured terms do not exceed those of the payments that the borrower had made over a sustained period, within a reasonable time before the restructuring. In this situation, if the lender is reasonably assured of repayment and performance according to the modified terms, the loan can be immediately restored to accrual status.

Clearly, a period of sustained performance, whether before or after the date of the restructuring, is very important in determining whether there is reasonable assurance of repayment and performance. In certain circumstances, other information may be sufficient to demonstrate an improvement in the borrower's condition or in economic conditions that may affect the borrower's ability to repay. Such information may reduce the need to rely on the borrower's performance to date in assessing repayment prospects. For example, if the borrower has obtained substantial and reliable sales, lease, or rental contracts or if other important developments are expected to significantly increase the borrower's cash flow and debt-service capacity and strength, then the borrower's commitment to repay may be sufficient. A preponderance of such evidence may be sufficient to warrant

1. A discussion of the criteria is found within the corresponding subsections that follow.

returning a restructured loan to accrual status. The restructured terms must reasonably ensure performance and full repayment.

It is imperative that the reasons for restoring restructured debt to accrual status be documented. A restoration should be supported by a current, well-documented evaluation of the borrower's financial condition and prospects for repayment. This documentation will be reviewed by examiners.

The formal restructuring of a loan or other debt instrument should be undertaken in ways that will improve the likelihood that the credit will be repaid in full in accordance with reasonably restructured repayment terms.[2] Regulatory reporting requirements and GAAP do *not* require a banking organization that restructures a loan to grant excessive concessions, forgive principal, or take other steps not commensurate with the borrower's ability to repay in order to use the reporting treatment specified in FAS 15. Furthermore, the restructured terms may include prudent contingent payment provisions that permit an institution to obtain appropriate recovery of concessions granted in the restructuring, if the borrower's condition substantially improves.

2065.1.3 RESTRUCTURINGS RESULTING IN A MARKET INTEREST RATE

A FAS 114 restructuring that specifies an effective interest rate that is equal to or greater than the rate the lending banking organization is willing to accept at the time of the restructuring, for a new loan with comparable risk (assuming the loan is not impaired by the restructuring agreement), does not have to be reported as a troubled-debt restructuring after the year of restructuring.

2065.l.4 NONACCRUAL TREATMENT OF MULTIPLE LOANS TO ONE BORROWER

As a general principle, whether to place an asset in nonaccrual status should be determined by an assessment of the individual asset's collectibility. One loan to a borrower being placed in nonaccrual status does not automatically have to result in all other extensions of credit to that borrower being placed in nonaccrual status. When a single borrower has multiple extensions of credit outstanding and one meets the criteria for nonaccrual status, the lender should evaluate the others to determine whether one or more of them should also be placed in nonaccrual status.

2065.1.4.1 Troubled-Debt Restructuring—Returning a Multiple-Note Structure to Accrual Status

On June 10, 1993, interagency guidance was issued to clarify a March 10, 1993, interagency policy statement on credit availability. The guidance addresses a troubled-debt restructuring (TDR) that involves multiple notes (sometimes referred to as A/B note structures). An example of a multiple-note structure is when the first, or A, note would represent the portion of the original-loan principal amount that would be expected to be fully collected along with contractual interest. The second part of the restructured loan, or B note, represents the portion of the original loan that has been charged off.

Such TDRs generally may take any of three forms: (1) In certain TDRs, the B note may be a contingent receivable that is payable only if certain conditions are met (for example, if there is sufficient cash flow from the property). (2) For other TDRs, the B note may be contingency-forgiven (note B is forgiven if note A is paid in full). (3) In other instances, an institution would have granted a concession (for example, a rate reduction) to the troubled borrower but the B note would remain a contractual obligation of the borrower. Because the B note is not reflected as an asset on the institution's books and is unlikely to be collected, the B note is viewed as a contingent receivable for reporting purposes.

Financial institutions may return the A note to accrual status provided the following conditions are met:

1. *The restructuring qualifies as a TDR as defined by FAS 15, and there is economic substance to the restructuring.* (Under FAS 15, a restructuring of debt is considered a TDR if "the creditor for economic or legal reasons related to the debtor's financial difficulties grants a concession to the debtor that it would not otherwise consider.")

2. A restructured loan may not be restored to accrual status unless there is reasonable assurance of repayment and performance under its modified terms in accordance with a reasonable repayment schedule.

2. *The portion of the original loan represented by the B note has been charged off.* The charge-off must be supported by a current, well-documented evaluation of the borrower's financial condition and prospects for repayment under the revised terms. The charge-off must be recorded before or at the time of the restructuring.
3. *The institution is reasonably assured of repayment of the A note and of performance in accordance with the modified terms.*
4. *In general, the borrower must have demonstrated sustained repayment performance (either immediately before or after the restructuring) in accordance with the modified terms for a reasonable period before the date on which the A note is returned to accrual status.* Sustained payment performance generally would be for a minimum of six months and involve payments in the form of cash or cash equivalents.

The A note would be initially disclosed as a TDR. However, if the A note yields a market rate of interest and performs in accordance with the restructured terms, the note would not have to be disclosed as a TDR in the year after the restructuring. To be considered a market rate of interest, the interest rate on the A note at the time of the restructuring must be equal to or greater than the rate that the institution is willing to accept for a new receivable with comparable risk. (See SR-93-30.)

2065.1.4.2 Nonaccrual Loans That Have Demonstrated Sustained Contractual Performance

Certain borrowers have resumed paying the full amount of scheduled contractual interest and principal payments on loans that are past due and in nonaccrual status. Although prior arrearages may not have been eliminated by payments from the borrowers, some borrowers have demonstrated sustained performance over a time in accordance with contractual terms. The interagency guidance of June 10, 1993, announced that such loans may henceforth be returned to accrual status, even though the loans have not been brought fully current. They may be returned to accrual status if (1) there is reasonable assurance of repayment of all principal and interest amounts contractually due (including arrearages) within a reasonable period and (2) the borrower has made payments of cash or cash equivalents over a sustained period (generally a minimum of six months) *in accordance with the contractual terms.* When the federal financial institution regulatory reporting criteria for restoration to accrual status are met, previous charge-offs taken would not have to be fully recovered before such loans are returned to accrual status. Loans that meet this criteria should continue to be disclosed as past due as appropriate (for example, 90 days past due and still accruing) until they have been brought fully current. (See SR-93-30.)

2065.1.5 ACQUISITION OF NONACCRUAL ASSETS

Banking organizations (or the receiver of a failed institution) may sell loans or debt securities maintained in nonaccrual status. Such loans or debt securities that have been acquired from an unaffiliated third party should be reported by the purchaser in accordance with AICPA Practice Bulletin No. 6. When the criteria specified in this bulletin are met, these assets may be placed in nonaccrual status.[3]

2065.1.6 TREATMENT OF NONACCRUAL LOANS WITH PARTIAL CHARGE-OFFS

Whether partial charge-offs associated with a nonaccrual loan that has not been formally restructured must first be fully recovered before the loan can be restored to accrual status is an issue that has not been explicitly addressed by GAAP and bank regulatory reporting requirements. In accordance with the instructions for the bank call report and the bank holding company reports (FR-Y series), restoration to accrual status is permitted when (1) the loan has been brought fully current with respect to principal and interest and (2) it is expected that the full contractual balance of the loan (including any amounts charged off) plus interest will be fully collectible under the terms of the loan.[4]

3. AICPA Practice Bulletin No. 6, "Amortization of Discounts on Certain Acquired Loans," American Institute of Certified Public Accountants, August 1989.

4. The instructions for the call reports and FR-Y reports discuss the criteria for restoration to accrual status in the glossary entries for "nonaccrual status." This guidance also permits restoration to accrual status for nonaccrual assets that are both well secured *and* in the process of collection. In addition, this guidance permits restoration to accrual status, when certain criteria are met, of formally restructured debt and acquired nonaccrual assets.

Thus, in determining whether a partially charged-off loan that has been brought fully current can be returned to accrual status, it is important to determine whether the banking organization expects to receive the full amount of principal and interest called for by the terms of the loan.

When a loan has been brought fully current with respect to contractual principal and interest, and when the borrower's financial condition and economic conditions that could affect the borrower's ability to repay have improved to the point that repayment of the full amount of contractual principal (including any amounts charged off) and interest is expected, the loan may be restored to accrual status even if the charge-off has not been recovered. However, this treatment would not be appropriate if the charge-off reflects continuing doubt about the collectibility of principal or interest. Because loans or other assets are required to be placed in nonaccrual status when full repayment of principal or interest is not expected, such loans could not be restored to accrual status.

It is imperative that the reasons for the restoration of a partially charged-off loan to accrual status be supported by a current, well-documented evaluation of the borrower's financial condition and prospects for full repayment of contractual principal (including any amounts charged off) and interest. This documentation will be subject to review by examiners.

A nonaccrual loan or debt instrument may have been formally restructured in accordance with FAS 15 so that it meets the criteria for restoration to accrual status presented in section 2065.1.2 addressing restructured loans. Under GAAP, when a charge-off was taken before the date of the restructuring, it does not have to be recovered before the restructured loan can be restored to accrual status. When a charge-off occurs after the date of the restructuring, the considerations and treatments discussed earlier in this section are applicable.

2065.1.7 IN-SUBSTANCE FORECLOSURES

FAS 114 addresses the accounting for impaired loans and clarifies existing accounting guidance for in-substance foreclosures. Under the impairment standard and related amendments to FAS 15, a collateral-dependent real estate loan[5] would be reported as ''other real estate owned'' (OREO) only if the lender had taken possession of the collateral. For other collateral-dependent real estate loans, loss recognition would be based on the fair value of the collateral if foreclosure is probable.[6] Such loans would remain in the loan category and would not be reported as OREO. For depository institution examinations, any portion of the loan balance on a collateral-dependent loan that exceeds the fair value of the collateral and that can be identified as uncollectible would generally be classified as a loss and be promptly charged off against the ALLL.

A collateralized loan that becomes impaired is not considered ''collateral dependent'' if repayment is available from reliable sources other than the collateral. Any impairment on such a loan may, at the depository institution's option, be determined based on the present value of the expected future cash flows discounted at the loan's effective interest rate or, as a practical expedient, based on the loan's observable market price. (See SR-95-38.)

Losses must be recognized on real estate loans that meet the in-substance foreclosure criteria with the collateral being valued according to its fair value. Such loans do not have to be reported as OREO unless possession of the underlying collateral has been obtained. (See SR-93-30.)

2065.1.8 LIQUIDATION VALUES OF REAL ESTATE LOANS

In accordance with the March 10, 1993, interagency policy statement Credit Availability, loans secured by real estate should be based on the borrower's ability to pay over time, rather than on a presumption of immediate liquidation. Interagency guidance issued on June 10, 1993, emphasizes that it is *not* regulatory policy to value collateral that underlies real estate loans on a liquidation basis. (See SR-93-30.)

5. A collateral-dependent real estate loan is a loan for which repayment is expected to be provided solely by the underlying collateral and there are no other available and reliable sources of repayment.

6. The fair value of the assets transferred is the amount that the debtor could reasonably expect to receive for them in a current sale between a willing buyer and a willing seller, other than in a forced or liquidation sale.

The adequacy of a banking organization's allowance for loan and lease losses (ALLL) (including amounts based on an analysis of the commercial real estate portfolio) must be based on a careful, well-documented, and consistently applied analysis of the loan and lease portfolio.[1] The determination of the adequacy of the ALLL should be based on management's consideration of all current significant conditions that might affect the ability of borrowers (or guarantors, if any) to fulfill their obligations to the institution. While historical loss experience provides a reasonable starting point, historical losses or even recent trends in losses are not sufficient, without further analysis, to produce a reliable estimate of anticipated loss.

In determining the adequacy of the ALLL, management should consider factors such as changes in the nature and volume of the portfolio; the experience, ability, and depth of lending management and staff; changes in credit standards; collection policies and historical collection experience; concentrations of credit risk; trends in the volume and severity of past-due and classified loans; and trends in the volume of nonaccrual loans, specific problem loans, and commitments. In addition, this analysis should consider the quality of the organization's systems and management in identifying, monitoring, and addressing asset-quality problems. Furthermore, management should consider external factors such as local and national economic conditions and developments, competition, and legal and regulatory requirements, as well as reasonably foreseeable events that are likely to affect the collectibility of the loan portfolio.

Management should adequately document the factors that were considered, the methodology and process that were used in determining the adequacy of the ALLL, and the range of possible credit losses estimated by this process. The complexity and scope of this analysis must be appropriate to the size and nature of the organization and provide for sufficient flexibility to accommodate changing circumstances.

Examiners will evaluate the methodology and process that management has followed in arriving at an overall estimate of the ALLL to ensure that all of the relevant factors affecting the collectibility of the portfolio have been appropriately considered. In addition, the overall estimate of the ALLL and the range of possible credit losses estimated by management will be reviewed for reasonableness in view of these factors. The examiner's analysis will also consider the quality of the organization's systems and management in identifying, monitoring, and addressing asset-quality problems. (See sections 2065.3, 2065.4, and 2128.08.)

The value of the collateral will be considered by examiners in reviewing and classifying a commercial real estate loan. However, for a performing commercial real estate loan, the supervisory policies of the agencies do not require automatic increases to the ALLL solely because the value of the collateral has declined to an amount that is less than the loan balance.

In assessing the ALLL, it is important to recognize that management's process, methodology, and underlying assumptions require a substantial degree of judgment. Even when an organization maintains sound loan-administration and -collection procedures and effective internal systems and controls, the estimation of losses may not be precise due to the wide range of factors that must be considered. Further, the ability to estimate losses on specific loans and categories of loans improves over time as substantive information accumulates regarding the factors affecting repayment prospects. When management has (1) maintained effective systems and controls for identifying, monitoring, and addressing asset-quality problems and (2) analyzed all significant factors affecting the collectibility of the portfolio, examiners should give considerable weight to management's estimates in assessing the adequacy of the overall ALLL.

Examiners and bank holding company management should consider the impact of the Financial Accounting Standards Board's (FASB) Statement No. 114, "Accounting by Creditors for Impairment of a Loan" (FAS 114) (as amended by FASB Statement No. 118, "Accounting by Creditors for Impairment of a Loan—Income Recognition and Disclosures"), on the ALLL-estimating process. FAS 114 sets forth guidance for estimating the impairment of

1. The estimation process described in this section permits a more accurate estimate of anticipated losses than could be achieved by assessing the loan portfolio solely on an aggregate basis. However, it is only an estimation process and does not imply that any part of the ALLL is segregated for, or allocated to, any particular asset or group of assets. The ALLL is available to absorb overall credit losses originating from the loan and lease portfolio. The balance of the ALLL is management's estimation of potential credit losses, synonymous with its determination as to the adequacy of the *overall* ALLL.

a loan for general financial reporting purposes. Under FAS 114, a loan is *impaired* when, based on current information and events, it is probable that a creditor will be unable to collect all amounts due (principal and interest) according to the contractual terms of the loan agreement.

When a creditor has determined that a loan is impaired, FAS 114 requires that an allowance be established based on the present value of the expected future cash flows of the loan discounted at the loan's effective interest rate (that is, the contract rate, as adjusted for any net deferred loan fees or costs, premiums, or discounts) or, as a practical expedient, at the loan's observable market price or at the fair value of the collateral if the loan is collateral dependent. Since the allowances under FAS 114 apply only to a subset of loans,[2] FAS 114 does not address the adequacy of a creditor's *overall* ALLL or how the creditor should assess the adequacy of its ALLL. Examiners should not focus unduly on the adequacy of this or any other portion of the ALLL established for a subset of loans. Bank holding companies are required to follow FAS 114 (as amended by FAS 118) when reporting in the FR Y-9C report for the holding company on a consolidated basis.

2065.2.1 INSPECTION OBJECTIVES

1. To evaluate the methodology and process that management employs in compiling an *overall* estimate of the ALLL.
2. To understand and evaluate the nature of the external (economic and social climate, the extent of competition) and internal (credit strategies, levels of acceptable credit risk, and lending policies and procedures) lending environment and how they might influence management's estimate of the ALLL.
3. To determine the accuracy and reasonableness of management's estimate of the *overall* ALLL.
4. To evaluate the quality of the BHC's systems and management performance in identifying, monitoring, and resolving asset-quality problems.

2065.2.2 INSPECTION PROCEDURES

1. Determine whether the banking organization has carefully documented and applied an accurate and consistent method of analysis for estimating the *overall* ALLL. When making such a determination, ascertain whether—
   a. management has considered all significant factors and conditions that might affect the collectibility of the loan, including the borrower's repayment practices, the value of accessible underlying collateral, and other factors (that is, those factors listed in this section);
   b. management has documented all factors that were considered and the methodology and process that were used to evaluate the adequacy of the allowance; and
   c. the complexity and scope of the analysis are appropriate for the size and nature of the organization.
2. Evaluate the methodology and process that management has followed in arriving at an overall estimate of the ALLL.
3. Determine the reasonableness of management's consolidated estimate of the ALLL, including the range of possible credit losses. Determine whether management has properly evaluated the overall composition of the loan portfolio at all organizational levels by—
   a. identifying potential problem loans, including loans classified by all bank regulatory agencies;
   b. determining trends with respect to loan volume (growth (in particular, rapid growth), levels of delinquencies, nonaccruals, and nonperforming loans);
   c. considering the previous loss and recovery experience including the timeliness of charge-offs;
   d. evaluating the performance of concentrations of credit (related interests, geographic regions, industries, lesser-developed countries (LDCs), highly leveraged loans, and the size of credit exposures (few large loans versus numerous small loans));
   e. determining the amount of loans and problem loans (delinquent, nonaccrual, and nonperforming) by lending officer or committee; and
   f. evaluating the levels and performance of loans involving related parties.
4. For each level of the organization, determine the percentage of past-due loans to the loan portfolio and compare it with prior periods.

2. The guidance on impairment in FAS 114 does not apply to "large groups of smaller balance homogeneous loans that are collectively evaluated for impairment," loans that are measured at fair value or at the lower of cost or fair value, or leases and debt securities as defined in FAS 115, "Accounting for Certain Investments in Debt and Equity Securities." FAS 114 does apply to loans that are restructured in a troubled-debt restructuring involving a modification of terms.

The examiner may find it beneficial to compute the ratio for groups of loans by type, size, or risk levels.

5. Compare the loans classified during regulatory examinations or BHC inspections with the previous examinations or inspections and also with those classified by management before the regulatory examinations or inspections. Investigate the current status of previously classified loans.
6. Compute the percentage of the ALLL to average outstanding loans and compare those results with those of the previous inspection. Investigate the reasons for variations between those periods.
7. Assess the quality of the organization's systems and internal controls in identifying, monitoring, and addressing asset-quality problems.

The Federal Reserve Board and the other federal regulators of banks and savings associations issued a joint policy statement that provides comprehensive guidance on the maintenance of an adequate allowance for loan and lease losses (ALLL) and on an effective loan-review system. The statement, effective December 23, 1993, is designed to further promote consistency in supervisory policies among banks and thrifts.

This policy statement applies to all depository institutions insured by the Federal Deposit Insurance Corporation (FDIC) except for FDIC-insured branches and agencies of foreign banks. The statement also does not apply to nonfederally insured branches and agencies of foreign banks. FDIC-insured and nonfederally insured branches and agencies of foreign banks continue to be subject to separate guidance issued by their primary supervisory agency. *The policy statement does not apply directly to bank holding companies. However, the boards of directors and management of bank holding companies should consider the statement as they supervise and administer policies and procedures pertaining to the financial institution subsidiaries of the bank holding company. Bank holding company examiners should consider the guidance of the policy statement when evaluating a bank holding company's supervisory policies as they pertain to its financial institution subsidiaries.*

The policy statement discusses the nature and purpose of the ALLL; defines an adequate ALLL; and covers the responsibilities of the board of directors, the institution's management, and the examiner. The policy statement emphasizes that it is the responsibility of the board of directors and management of each institution to maintain the ALLL at an adequate level. The policy statement also discusses the analysis of the loan and lease portfolio, factors to consider in estimating credit losses, and the characteristics of an effective loan-review system.

In addition, the statement includes a section on examiner responsibilities. The section consists of quantitative guidance the examiner should use to identify those institutions whose ALLL levels and related ALLL-evaluation processes should be subject to closer review by examiners. Although this examination guidance does not pertain directly to the inspection of bank holding companies, it keeps the holding company management and Federal Reserve System bank holding company examiners apprised of the methods used by federal financial institution examiners to assess and evaluate the adequacy of the ALLL for bank holding company bank and thrift subsidiaries. (See SR-93-70.)

The policy statement reiterates existing policy that Federal Reserve state member bank examiners will generally accept bank management's estimates in their assessment of the adequacy of the ALLL when management has (1) maintained effective systems and controls for identifying, monitoring, and addressing asset-quality problems in a timely manner; (2) analyzed all significant factors that affect the collectibility of the portfolio in a reasonable manner; and (3) established an acceptable ALLL-evaluation process that meets the objectives for an adequate ALLL.[1]

The Financial Accounting Standards Board (FASB) Statement No. 114 (FAS 114), "Accounting by Creditors for Impairment of a Loan," as amended by FASB Statement No. 118 (FAS 118), "Accounting by Creditors for Impairment of a Loan—Income Recognition and Disclosures," sets forth standards for estimating the impairment of a loan for general financial-reporting purposes. According to FAS 114, a loan is *impaired* when, based on current information and events, it is probable that a creditor will be unable to collect all amounts due (principal and interest) according to the contractual terms of the loan agreement. FAS 118 eliminated the former income-recognition provisions of FAS 114.

FAS 114 and FAS 118 became effective for fiscal years beginning after December 15, 1994, with earlier application permitted. FAS 114 requires that an allowance be established based on the present value of expected future cash flows of the loan discounted at the loan's effective interest rate (that is, the contract rate, as adjusted for any net deferred loan fees or costs, premiums, or discounts) or, as a practical expedient, at the loan's observable market price or at the fair value of the collateral if the loan is collateral dependent. Since allowances under

1. SR-99-13 reemphasizes the need for balanced, yet conservative, reserving practices. Banking organizations may reserve conservatively at the higher end of the range of estimated losses when those levels are management's best estimate. They may also reflect a margin for imprecision. Unallocated reserves are acceptable when they are determined in accordance with GAAP.

FAS 114 apply only to a subset of loans (those that are subject to the standard and that are deemed to be impaired), FAS 114 does not address the adequacy of a creditor's overall ALLL or how the creditor should assess the adequacy of its ALLL. In addition to the allowance for credit losses calculated under FAS 114, a creditor should continue to recognize an ALLL necessary to comply with FASB Statement No. 5 (FAS 5), ''Accounting for Contingencies.'' Furthermore, the guidance in FAS 114 applies only to a subset of the loan and lease portfolio as the term is used in this policy statement.[2]

FAS 114, as amended by FAS 118, has been adopted by the Federal Financial Institutions Examination Council (FFIEC) for purposes of reporting by banks in call reports, subject to the additional regulatory reporting guidelines discussed below. Furthermore, the FFIEC concluded that FAS 114 sets forth methods for establishing only a portion of an institution's ALLL. Accordingly, while banks must use the methods set forth in FAS 114 to determine the portion of the ALLL attributable to impaired loans as defined by the statement for purposes of reporting in call reports, no separate reporting of the portion established under FAS 114 has been required in these reports. The overall ALLL should continue to be reported on existing call report line items. The text of the interagency policy statement follows.[3] (Footnotes have been renumbered.) (See also sections 2065.1, 2065.2, and 2065.4.)

2065.3.1 1993 INTERAGENCY POLICY STATEMENT ON THE ALLOWANCE FOR LOAN AND LEASE LOSSES

The text in brackets was not part of the 1993 policy statement.

2065.3.1.1 Nature and Purpose of the ALLL

Federally insured depository institutions (''institutions'') must maintain an ALLL at a level that is adequate to absorb estimated credit losses associated with the loan and lease portfolio, including all binding commitments to lend.[4] To the extent not provided for in a separate liability account, the ALLL should also be sufficient to absorb estimated credit losses associated with off-balance-sheet credit instruments such as standby letters of credit.[5]

For purposes of this policy statement, the term ''estimated credit losses'' means an estimate of the current amount of the loan and lease portfolio (net of unearned income) that is not likely to be collected; that is, net charge-offs that are likely to be realized for a loan or pool of loans given facts and circumstances as of the evaluation date. These estimated credit losses should meet the criteria for accrual of a loss contingency (i.e., a provision to the ALLL) set forth in generally accepted accounting principles (GAAP). When available information confirms specific loans and leases, or portions thereof, to be uncollectible, these amounts should be promptly charged off against the ALLL.

Estimates of credit losses should reflect consideration of all significant factors that affect the collectibility of the portfolio as of the evaluation date. For individually analyzed loans, these estimates should reflect consideration of the facts and circumstances that affect the repayment of such loans as of the evaluation date. For pools of loans, estimated credit losses should reflect consideration of the institution's historical net charge-off rate on pools of similar loans,

2. In 1999, FASB considered the interaction between the two primary accounting standards on the ALLL, FAS 5 and FAS 114. An allowance calculated under FAS 5 may be required for loans that are not individually identified as being impaired under FAS 114. Reserve calculations for specific impaired loans under FAS 114 should incorporate an evaluation of environmental factors (such as industry, geographic, economic, and political factors). Reserves calculated under FAS 5 should not be required for loans that are determined to be impaired under FAS 114. (See SR-99-13.)

SR-99-22 reaffirms the principles in SR-99-13. It indicates that the Securities and Exchange Commission (SEC) does not have a policy of seeking reductions in financial institutions' loan-loss allowance levels and that it will consult with the banking agencies as it considers whether to take a significant action regarding an institution's ALLL-accounting practices.

3. For savings associations, the ALLL is included in ''general valuation allowances'' (GVAs). GVAs may also be required on assets other than loans and leases.

4. In the case of binding commitments to lend and off-balance-sheet credit instruments, such losses represent the amount of loans and leases that will likely not be collected (given facts and circumstances as of the evaluation date) and, thus, will be charged off. For purposes of this policy statement, the loan and lease portfolio, binding commitments to lend, and off-balance-sheet credit commitments are referred to as ''loans,'' ''loans and leases,'' the ''loan and lease portfolio,'' or the ''portfolio.''

5. Recourse liability accounts (that arise from recourse obligations for any transfers of loans that are reported as sales for regulatory reporting purposes) should be reported as liabilities that are separate and distinct from the ALLL.

adjusted for changes in trends, conditions, and other relevant factors that affect repayment of the loans in these pools as of the evaluation date. Methodologies for the determination of the historical net charge-off rate on a pool of loans can range from a simple average of an institution's net charge-off experience over a relevant period of years—coupled with appropriate adjustments as noted above for factors that affect repayment—to more complex techniques, such as migration analysis.

As discussed more fully below, for analytical purposes, an institution may attribute portions of the ALLL to individual loans or groups of loans. However, the ALLL is available to absorb all credit losses that arise from the loan and lease portfolio and is not segregated for, or allocated to, any particular loan or group of loans.

2065.3.1.2 Responsibility of the Board of Directors and Management

2065.3.1.2.1 Adequate ALLL Level

It is the responsibility of the board of directors and management of each institution to maintain the ALLL at an adequate level.[6] For purposes of the Reports of Condition and Income (call report) and the Thrift Financial Report (TFR), an adequate ALLL should be no less than the sum of the following items *given facts and circumstances as of the evaluation date* (after deduction of all portions of the portfolio classified loss):

1. for loans and leases *classified substandard or doubtful*, whether analyzed and provided for individually or as part of pools, all estimated credit losses over the remaining effective lives of these loans;
2. for components of the loan and lease portfolio that are *not classified*, all estimated credit losses over the upcoming 12 months;[7] and
3. amounts for estimated losses from transfer risk on international loans.

Furthermore, when determining the appropriate level for the ALLL, management's analysis should be conservative so that the overall ALLL appropriately reflects a margin for the imprecision inherent in most estimates of expected credit losses. This additional margin for imprecision might be incorporated into the ALLL through the amounts attributed for analytical purposes to individual loans or groups of loans or in a portion of the ALLL that is not attributed to specific components of the loan portfolio.[8]

The adequacy of the ALLL should be evaluated as of the end of each quarter, or more frequently if warranted, and appropriate provisions made to maintain the ALLL at an adequate level as of each call report or Thrift Financial Report date. This evaluation will be subject to review by examiners.

2065.3.1.2.2 Related Responsibilities

In carrying out their responsibility for maintaining an adequate ALLL, the board of directors and management are expected to—

1. ensure that the institution has an effective loan-review system and controls (which

6. Financial Accounting Standards Board (FASB) Statement No. 114, "Accounting by Creditors for Impairment of a Loan," provides that an "allowance for credit losses" must be calculated on a present-value basis when a loan is impaired. FASB Statement No. 114 states that it "does *not* address how a creditor should assess the *overall adequacy* of the allowance for credit losses" (emphasis added), and that, in addition to the allowance for credit losses calculated under FASB Statement No. 114, a creditor should continue to recognize an ALLL necessary to comply with FASB Statement No. 5, "Accounting for Contingencies." Furthermore, the guidance in FASB Statement No. 114 only applies to a subset of the loan and lease portfolio as the term is used in this policy statement (e.g., the FASB standard does *not* apply to leases, binding commitments to lend, and large groups of smaller-balance homogeneous loans that are collectively evaluated for impairment). In contrast, this policy statement provides guidance on assessing the *overall adequacy* of the ALLL.

7. In certain circumstances, subject to examiner review, a net charge-off horizon of less than one year from the balance-sheet date may be employed for components of the portfolio that have not been classified. For institutions with conservative charge-off policies, a charge-off horizon of less than one year might be appropriate for pools of loans that are neither classified nor subject to greater-than-normal credit risk and that have well-documented and highly predictable cash flows and loss rates, such as pools of certain smaller consumer installment or credit card loans. On the other hand, a net charge-off horizon of more than one year for loans that have not been classified might be appropriate until an institution's loan-review function and credit-grading system results in accurate and timely assessments of the portfolio. In such situations, an institution should expeditiously correct deficiencies in its loan-review function and credit-grading system.

8. As discussed later in this policy statement, institutions are encouraged to segment their loan and lease portfolios into as many components as practical when analyzing the adequacy of the ALLL. Therefore, institutions are encouraged to reflect the margin for imprecision in amounts attributable for analytical purposes to these components of the portfolio, to the extent possible.

include an effective credit-grading system) that identify, monitor, and address asset-quality problems in an accurate and timely manner (to be effective, the institution's loan-review system and controls must be responsive to changes in internal and external factors affecting the level of credit risk in the portfolio);
2. ensure the prompt charge-off of loans, or portions of loans, that available information confirms to be uncollectible; and
3. ensure that the institution's process for determining an adequate level for the ALLL is based on a comprehensive, adequately documented, and consistently applied analysis of the institution's loan and lease portfolio that considers all significant factors that affect the collectibility of the portfolio and supports the range of credit losses estimated by this process.

As discussed more fully in appendix 1, it is essential that institutions maintain effective loan-review systems, although smaller institutions would not be expected to maintain separate loan-review departments. An effective loan-review system should work to ensure the accuracy of internal credit-grading systems and, thus, the quality of the information used to assess the adequacy of the ALLL. The complexity and scope of the institution's ALLL-evaluation process, loan-review system, and other relevant controls should be appropriate in view of the size of the institution and the nature of its lending activities, and provide for sufficient flexibility to accommodate changes in the factors that affect the collectibility of the portfolio.

2065.3.1.2.3 Analysis of the Loan and Lease Portfolio

In determining the appropriate level of the ALLL, the institution should rely primarily on an analysis of the various components of its portfolio, including all significant credits on an individual basis. When analyzing the adequacy of the ALLL, institutions should segment their loan and lease portfolios into as many components as practical. Each component would normally have similar characteristics, such as risk classification, past-due status, type of loan, industry, or collateral. A depository institution may, for example, analyze the following components of its portfolio and provide for them in the ALLL:

1. all significant credits on an individual basis that are classified doubtful (or the institution's equivalent)
2. all other significant credits reviewed individually (If no allocation can be determined for such credits on an individual basis, they should be provided for as part of an appropriate pool below.)
3. all other loans and leases that are not included by examiners or by the institution's credit-grading system in the population of loans reviewed individually, but are delinquent or are classified or designated special mention (e.g., pools of smaller delinquent, special-mention, and classified commercial and industrial loans; real estate loans; consumer loans; and lease-financing receivables)
4. homogeneous loans that have not been reviewed individually or are not delinquent, classified, or designated as special mention (e.g., pools of direct consumer loans, indirect consumer loans, credit card loans, home equity lines of credit, and residential real estate mortgages)
5. all other loans that have not been considered or provided for elsewhere (e.g., pools of commercial and industrial loans that have not been reviewed, classified, or designated special mention; standby letters of credit; and other off-balance-sheet commitments to lend)

In addition to estimated credit losses, the losses that arise from the transfer risk associated with an institution's cross-border lending activities require special consideration. Over and above any minimum amount that is required by the Interagency Country Exposure Review Committee to be provided in the allocated transfer-risk reserve[8a] (or charged against the ALLL), the institution must determine that the ALLL is adequate to absorb all estimated losses from transfer risk associated with its cross-border lending exposure. (See appendix 2 for factors to consider.)

[8a. The ATRR is a special reserve established and maintained for specified international assets pursuant to the International Lending Supervision Act of 1983. (See 12 U.S.C. 3904(a).) At least annually, the Federal Reserve and the other federal banking agencies determine jointly (1) which international assets that are subject to transfer risk warrant establishment of an ATRR, (2) the amount of the ATRR for the specified assets, and (3) whether an ATRR previously established for specified assets may be reduced.]

[When determining whether an ATRR is required for particular international assets, the federal banking agencies consider if the quality of a banking institution's assets has been impaired by a protracted inability of public or private obligors in a foreign country to make payments on their external indebtedness as indicated by factors as to whether—

1. such obligors have failed to make full interest payments on external indebtedness, or
2. such obligors have failed to comply with the terms of any restructured indebtedness, or
3. a foreign country has failed to comply with any International Monetary Fund or other suitable adjustment program, or
4. no definite prospects exist for the orderly restoration of debt service.

Also, when determining the amount of the ATRR, the federal banking agencies consider—

1. the length of time the quality of the asset has been impaired,
2. what recent actions have been taken to restore debt-service capability,
3. the prospects for restored asset quality, and
4. any other factors relevant to the quality of the asset.

The initial year's provision for the ATRR shall be 10 percent of the principal amount of each specified international asset, or such greater or lesser percentage determined by the federal banking agencies. Additional provisions, if any, in subsequent years will be 15 percent of the principal amount of each specified international asset, or such greater or lesser percentage determined by the federal banking agencies.

The ATRR is established only by a charge to current income. The amounts charged cannot be included in the banking institution's capital or surplus. For these and other requirements, as well as certain other accounting procedures for the ATTR, the reporting and disclosure of international assets, and the accounting for fees on international loans, see sections 211.43, 211.44, and 211.45 of Regulation K. A banking institution does not have to establish an ATRR if it writes down in the period in which the ATRR is required, or has written down in prior periods, the value of the specified international assets in the requisite amount for each such asset.]

2065.3.1.2.4 Factors to Consider in the Estimation of Credit Losses

As previously mentioned, estimates of credit losses should reflect consideration of all significant factors that affect the collectibility of the portfolio as of the evaluation date. While historical loss experience provides a reasonable starting point for the institution's analysis, historical losses, or even recent trends in losses are not, by

themselves, a sufficient basis to determine the appropriate level for the ALLL. Management should also consider any factors that are likely to cause estimated credit losses associated with the institution's current portfolio to differ from historical loss experience, including but not limited to—

1. changes in lending policies and procedures, including underwriting standards and collection, charge-off, and recovery practices;
2. changes in national and local economic and business conditions and developments, including the condition of various market segments;[9]
3. changes in the nature and volume of the portfolio;
4. changes in the experience, ability, and depth of lending management and staff;
5. changes in the trend of the volume and severity of past-due and classified loans, and trends in the volume of nonaccrual loans, troubled-debt restructurings, and other loan modifications;
6. changes in the quality of the institution's loan-review system and the degree of oversight by the institution's board of directors;
7. the existence and effect of any concentrations of credit and changes in the level of such concentrations; and
8. the effect of external factors such as competition and legal and regulatory requirements on the level of estimated credit losses in the institution's current portfolio.

Institutions are also encouraged to use ratio analysis as a supplemental check or tool for evaluating the overall reasonableness of the ALLL. Ratio analysis can be useful in identifying divergent trends (compared with the institution's peer group and its own historical practices) in the relationship of the ALLL to classified and nonclassified loans and leases, to past-due and nonaccrual loans and leases, to total loans and binding commitments, and to historical gross and net charge-offs. However, while such comparisons can be helpful as a supplemental check of the reasonableness of management's assumptions and analyses, they are not, by themselves, a sufficient basis for determining the adequacy of the ALLL. In particular, such comparisons do not obviate the need for a comprehensive analysis of the loan and lease portfolio and the factors affecting its collectibility.

9. Credit-loss and -recovery experience may vary significantly depending upon the business cycle. For example, an overreliance on recent credit-loss experience during a period of economic growth will not result in realistic estimates of credit losses during a period of economic downturn.

2065.3.1.3 Examiner Responsibilities

Examiners will assess the asset quality of an institution's loan and lease portfolio and the adequacy of the ALLL. In the review and classification of the loan and lease portfolio, examiners should consider all significant factors that affect the collectibility of the portfolio, including the value of any collateral. In reviewing the adequacy of the ALLL, examiners will—

1. consider the quality of the institution's loan-review system and management in identifying, monitoring, and addressing asset-quality problems (this will include a review of the institution's credit-grading system and loan-review function);[10]
2. evaluate the ALLL-evaluation process that management has followed to arrive at an overall estimate of the ALLL and the related assumptions made by management in order to ensure that the institution's historical loss experience and all significant factors that affect the collectibility of the portfolio (including changes in the quality of the institution's loan-review function and other factors previously discussed) have been appropriately considered;
3. review the overall level of the ALLL and the range of credit losses estimated by management for reasonableness in view of the factors discussed in the prior sections of this policy statement;
4. perform a quantitative analysis (e.g., using the types of ratio analysis previously discussed) as a check of the reasonableness of the ALLL; and
5. review the adequacy of the documentation that has been maintained by management to support the adequacy of the ALLL.

10. The review of an institution's loan-review system (including credit grading) by an examiner will usually include tests involving a sample of the institution's loans. If differences noted between examiner credit grades and those of the institution's loan-review system indicate problems with the loan-review system, especially where the credit grades assigned by the institution are more liberal than those assigned by the examiner, the institution would be expected to make appropriate adjustments to the assignment of its credit grades to the loan and lease portfolio and to its estimate of the ALLL. Furthermore, the institution would be expected to improve its loan-review system. (Appendix 1 discusses effective loan-review systems.)

After analyzing an institution's policies, practices, and historical credit-loss experience, the examiner should further check the reasonableness of management's ALLL methodology by comparing the reported ALLL (after the deduction of all loans, or portions thereof, classified as loss) against the sum of the following amounts:

1. 50 percent of the portfolio that is classified doubtful
2. 15 percent of the portfolio that is classified substandard
3. for the portions of the portfolio that have not been classified (including those loans designated special mention), estimated credit losses over the upcoming 12 months *given facts and circumstances as of the evaluation date* (based on the institution's average annual rate of net charge-offs experienced over the previous two or three years on similar loans, adjusted for current conditions and trends)[11]

This amount is neither a ''floor'' nor a ''safe-harbor'' level for an institution's ALLL. However, examiners will view a shortfall relative to this amount as indicating a need to more closely review management's analysis to determine whether it is reasonable and supported by the weight of reliable evidence and that all relevant factors have been appropriately considered.[12]

In assessing the adequacy of the ALLL, it is important to recognize that the related process, methodology, and underlying assumptions require a substantial degree of judgment. Even when an institution maintains sound loan-administration and -collection procedures and effective internal systems and controls, the estimation of credit losses will not be precise due to the wide range of factors that must be considered. Further, the ability to estimate credit losses on specific loans and categories of loans improves over time as substantive information accumulates regarding the factors affecting repayment prospects. Therefore, examiners will generally accept management's estimates in their assessment of the adequacy of the ALLL when management has (1) maintained effective systems and controls for identifying, monitoring, and addressing asset-quality problems in a timely manner, (2) analyzed all significant factors that affect the collectibility of the portfolio in a reasonable manner, and (3) established an acceptable ALLL-evaluation process that meets the objectives for an adequate ALLL.

After the completion of all aspects of the ALLL review described in this section, if the examiner does not concur that the reported ALLL level is adequate or if the ALLL-evaluation process is deficient or based on the results of an unreliable loan-review system, recommendations for correcting these problems, including any examiner concerns regarding an appropriate level for the ALLL, should be noted in the report of examination.

2065.3.1.4 ALLL Level Reflected in Regulatory Reports

The agencies believe that an ALLL established in accordance with this policy statement will fall within the range of acceptable estimates developed in accordance with GAAP. When an institution's reported ALLL does not meet the objectives for an adequate ALLL, the institution will be required to increase its provision for loan and lease losses expense sufficiently to restore the level of the ALLL reported on its call report or TFR to an adequate level as of the evaluation date.

2065.3.1.5 Appendix 1—Loan-Review Systems

The nature of loan-review systems may vary based on an institution's size, complexity, and management practices. For example, a loan-review system may include components of a traditional loan-review function that is indepen-

11. In cases where the institution has an insufficient basis for determining this amount, the examiner may use the industry-average net charge-off rate for nonclassified loans and leases.

12. The weights of 50 percent and 15 percent for doubtful and substandard loans, respectively, are estimates of the industry's average loss experience over time on similarly classified credits. Because they represent the average industry experience, these weights do not take into account idiosyncratic factors that may be important for estimating expected credit losses for a particular institution, such as the composition of its portfolio; the quality of underwriting, collection, and loan-review systems; and current economic conditions and trends. *Nor do these weights incorporate any additional margin to reflect the imprecision inherent in estimates of expected credit losses.* Due to such institution-specific factors, including an institution's historical loss experience adjusted for current conditions and trends, in many cases an ALLL exceeding the sum of 1, 2, and 3 above might still be inadequate, while in other cases, the weight of evidence might indicate that an ALLL less than this amount is adequate. In all circumstances, for purposes of the call report or Thrift Financial Report, the reported ALLL should meet the standard for an adequate ALLL set forth in the section entitled ''Responsibility of the Board of Directors and Management.''

dent of the lending function, or it may place some reliance on loan officers. In addition, the use of the term ''loan-review system'' can refer to various responsibilities assigned to credit administration, loan administration, problem-loan workout, or other areas of an institution. These responsibilities may range from administering the internal problem-loan reporting process to maintaining the integrity of the credit-grading process (e.g., ensuring that changes are made in credit grades as needed) and coordinating the information necessary to assess the adequacy of the allowance for loan and lease losses (ALLL). Regardless of the structure of the loan-review system in an institution, at a minimum, an effective loan-review system should have the following objectives:

1. To promptly identify loans having potential credit weaknesses and appropriately classify loans with well-defined credit weaknesses that jeopardize repayment so that timely action can be taken and credit losses can be minimized.
2. To project relevant trends that affect the collectibility of the portfolio and isolate potential problem areas.
3. To provide essential information to determine the adequacy of the ALLL.
4. To assess the adequacy of and adherence to internal credit policies and loan-administration procedures and to monitor compliance with relevant laws and regulations.
5. To evaluate the activities of lending personnel
6. To provide senior management and the board of directors with an objective and timely assessment of the overall quality of the loan portfolio.
7. To provide management with accurate and timely information related to credit quality that can be used for financial and regulatory reporting purposes.

2065.3.1.5.1 Credit-Grading Systems

The foundation for any loan-review system is accurate and timely credit grading, which involves an assessment of credit quality and leads to the identification of problem loans. An effective credit-grading system provides important information on the collectibility of the portfolio for use in the determination of an adequate level for the ALLL.

Regardless of the particular type of loan-review system employed, an effective credit-grading framework generally places primary reliance on loan officers to identify emerging loan problems. However, given the importance and subjective nature of credit grading, a loan officer's judgment regarding the assignment of a particular credit grade to a loan may be subject to review by (1) peers, superiors, or loan committee(s); (2) an independent, qualified part-time or full-time person(s); (3) an internal department staffed with credit-review specialists; or (4) outside credit-review consultants. A credit-grading review that is independent of the lending function is the preferred approach because it typically provides a more conservative and realistic assessment of credit quality. Because accurate and timely credit grading is a critical component of an effective loan-review system, each institution should ensure that its loan-review system includes the following attributes:

1. a formal credit-grading system that can be reconciled with the framework used by the federal regulatory agencies[13]
2. an identification or grouping of loans that warrant the special attention of management
3. documentation supporting the reason(s) why a particular loan merits special attention
4. a mechanism for direct, periodic, and timely reporting to senior management and the board of directors on the status of loans identified as meriting special attention and the action(s) taken by management
5. appropriate documentation of the institution's credit-loss experience for various components of its loan and lease portfolio[14]

An institution should maintain a written description of its credit-grading system, including a discussion of the factors used to assign appropriate credit grades to loans. Loan credit grades should reflect the risk of credit losses.

13. An institution may have a credit-grading system that differs from the credit-grading framework used by the federal banking agencies. However, each institution that maintains a credit-grading system that differs from the agencies' framework should maintain documentation that translates its credit-grading system into the pass/special-mention/substandard/doubtful/loss credit-grading framework used by the federal regulatory agencies. This documentation should be sufficient to enable examiners to reconcile the totals for the various credit grades under the institution's system to the agencies' categories listed above.

14. Institutions are encouraged to maintain records of net credit-loss experience for credits in each of the following categories: items not classified or designated as special-mention, special-mention, substandard, doubtful, and loss.

In addition, the loan-review program should be in writing and reviewed and approved at least annually by the board of directors to evidence their support of and commitment to the system.

2065.3.1.5.2 Loan-Review-System Elements

The following discussion refers to the primary activities comprising a loan-review system that were previously addressed, ranging from the credit-administration function to the independent internal loan-review function. An institution's written policy and documentation for its loan-review system should address the following elements:

1. qualifications of loan-review personnel
2. independence of loan-review personnel
3. frequency of reviews
4. scope of reviews
5. depth of reviews
6. review of findings and follow-up
7. workpaper and report distribution, including distribution of reports to senior management and the board of directors

Qualifications of loan-review personnel. Persons involved in the loan-review function should be qualified based on level of education, experience, and extent of formal credit training, and should be knowledgeable in both sound lending practices and the institution's lending guidelines for the types of loans offered by the institution. In addition, these persons should be knowledgeable of relevant laws and regulations affecting lending activities.

Independence of loan-review personnel. An effective loan-review system utilizes both the initial identification of emerging problem loans by loan officers and the credit review of loans by individuals independent of the credit-approval decisions. An important element of an effective system is to place responsibility on loan officers for continuous portfolio analysis and prompt identification and reporting of problem loans. Because of their frequent contact with borrowers, loan officers can usually identify potential problems before they become apparent to others. However, institutions should be careful to avoid overreliance upon loan officers for identification of problem loans. Institutions should ensure that loans are also reviewed by individuals that do not have control over the loans they review and are not part of, or influenced by anyone associated with, the loan-approval process.

While larger institutions typically establish a separate department staffed with credit-review specialists, cost and volume considerations may not justify such a system in smaller institutions. In many smaller institutions, an independent committee of outside directors may fill this role. Whether or not the institution has an independent loan-review department, the loan-review function should report *directly* to the board of directors or a committee thereof (though senior management may be responsible for appropriate administrative functions so long as they do not compromise the independence of the loan-review function).

Frequency of reviews. Optimally, the loan-review function can be used to provide useful continual feedback on the effectiveness of the lending process in order to identify any emerging problems. For example, the frequency of review of significant credits could be at least annually, upon renewal, or more frequently when internal or external factors indicate a potential for deteriorating credit quality in a particular type of loan or pool of loans. A system of ongoing or periodic portfolio reviews is particularly important to the ALLL-determination process, which is dependent on the accurate and timely identification of problem loans.

Scope of reviews. The review should cover all loans that are significant. Also, the review typically includes, in addition to all loans over a predetermined size, a sample of smaller loans; past-due, nonaccrual, renewed, and restructured loans; loans previously classified or designated as special-mention by the institution or by its examiners; insider loans; and concentrations and other loans affected by common repayment factors. The percentage of the portfolio selected for review should provide reasonable assurance that the results of the review have identified the major problems in the portfolio and reflect its quality as a whole. Management should document that the scope of its reviews continues to identify major problems in the portfolio and reflects the portfolio's quality as a whole. The scope of loan reviews should be approved by the institution's board of directors on an annual basis or when any significant changes to the scope of reviews are made.

Depth of reviews. These reviews should analyze a number of important aspects of selected loans, including—

1. credit quality,
2. sufficiency of credit and collateral documentation,
3. proper lien perfection,
4. proper approval by the loan officer and loan committee(s),
5. adherence to any loan-agreement covenants, and
6. compliance with internal policies and procedures and laws and regulations.

Furthermore, these reviews should consider the appropriateness and timeliness of the identification of problem loans by loan officers.

Review of findings and follow-up. Findings should be reviewed with appropriate loan officers, department managers, and members of senior management, and any existing or planned corrective action should be elicited for all noted deficiencies and identified weaknesses, including the time frames for correction. All noted deficiencies and identified weaknesses that remain unresolved beyond the assigned time frames for correction should be promptly reported to senior management and the board of directors.

Workpaper and report distribution. A list of loans reviewed, the date of the review, and documentation (including summary analyses) to substantiate assigned classifications or designations of loans as special-mention should be prepared on all loans reviewed. A report that summarizes the results of the loan review should be submitted to the board of directors on at least a quarterly basis.[15] In addition to reporting current credit-quality findings, comparative trends can be presented to the board of directors that identify significant changes in the overall quality of the portfolio. Findings should also address the adequacy of and adherence to internal policies, practices, and procedures, and compliance with laws and regulations so that any noted deficiencies can be remedied in a timely manner.

15. The board of directors should be informed more frequently than quarterly when material adverse trends are noted.

2065.3.1.6 Appendix 2—International Transfer Risk Considerations

With respect to international transfer risk,[16] an institution should support its determination of the adequacy of its allowance for loan and lease losses by performing an analysis of the transfer risk, commensurate with the size and composition of the institution's exposure to each country. Such analyses should take into consideration the following factors, as appropriate:

1. the institution's loan-portfolio mix for each country (e.g., types of borrowers, loan maturities, collateral, guarantees, special credit facilities, and other distinguishing factors)
2. the institution's business strategy and its debt-management plans for each country
3. each country's balance-of-payments position
4. each country's level of international reserves
5. each country's established payment-performance record and its future debt-servicing prospects
6. each country's sociopolitical situation and its effect on the adoption or implementation of economic reforms, in particular those affecting debt-servicing capacity
7. each country's current standing with multilateral and official creditors
8. the status of each country's relationships with bank creditors
9. the most recent evaluations distributed by the Interagency Country Exposure Review Committee (ICERC) of the federal banking agencies

[16. For additional information on international transfer risk, a subset of country risk, see section 4090.0 of this manual, SR-02-5, and section 7040.3 of the *Commercial Bank Examination Manual.*]

A supplemental interagency Policy Statement on Allowance for Loan and Lease Losses Methodologies and Documentation for Banks and Savings Institutions[1] was issued by the Federal Financial Institutions Examination Council (FFIEC) on July 2, 2001.[2] The policy statement clarifies the agencies' expectations for documentation that supports the ALLL methodology. Additionally, the statement emphasizes the need for appropriate ALLL policies and procedures, which should include an effective loan-review system. The guidance also provides examples of appropriate supporting documentation, as well as illustrations on how to implement this guidance. (See SR-01-17.) While this policy statement, by its terms, applies only to depository institutions insured by the Federal Deposit Insurance Corporation (which includes state member banks), the Federal Reserve believes this guidance is broadly applicable to bank holding companies. Accordingly, examiners should apply the policy, as appropriate, in their inspections of bank holding companies and their nonbank subsidiaries. This policy, however, does not apply to federally insured branches and agencies of foreign banks. Federally insured branches and agencies of foreign banks continue to be subject to separate guidance issued by their primary supervisory agency.

The guidance requires that a financial institution's ALLL methodology be in accordance with generally accepted accounting principles (GAAP) and all outstanding supervisory guidance. An ALLL methodology should be systematic, consistently applied, and auditable. The methodology should be validated periodically and modified to incorporate new events or findings, as needed. The guidance specifies that management, under the direction of the board of directors, should implement appropriate procedures and controls to ensure compliance with the institution's ALLL policies and procedures. Institution management should (1) segment the portfolio to evaluate credit risks; (2) select loss rates that best reflect the probable loss; and (3) be responsive to changes in the organization, the economy, or the lending environment by changing the methodology, when appropriate. Furthermore, supporting information should be included on summary schedules, whenever feasible. Under this policy, institutions with less-complex loan products or portfolios, such as community banks, may use a more streamlined approach to implement this guidance.

The policy statement is consistent with the Federal Reserve's long-standing policy to promote strong internal controls over an institution's ALLL process. It supplements and does not affect or modify the guidance in the interagency policy statement on the ALLL issued in December 1993. (See SR-93-70.) In this regard, the new policy statement recognizes that determining an appropriate allowance involves a high degree of management judgment and is inevitably imprecise. Accordingly, an institution may determine that the amount of loss falls within a range. In accordance with GAAP, an institution should record its best estimate within the range of credit losses. (See also sections 2065.2 and 2065.3.) (See also the March 1, 2004, interagency Update on Accounting for Loan and Lease Losses (SR-04-5).)

The policy statement is provided below. Some wording has been slightly modified for this manual, as indicated by asterisks or text enclosed in brackets. Some footnotes have also been renumbered.

2065.4.1 2001 POLICY STATEMENT ON ALLL METHODOLOGIES AND DOCUMENTATION

Boards of directors of banks * * * are responsible for ensuring that their institutions have controls in place to consistently determine the allowance for loan and lease losses (ALLL) in accordance with the institutions' stated policies and procedures, generally accepted accounting principles (GAAP), and ALLL supervisory guidance.[3] To fulfill this responsibility, boards of directors instruct management to develop and maintain an appropriate, systematic, and consistently applied process to determine the amounts of the ALLL and provisions for loan losses. Management should create and implement suitable policies and procedures to communicate

1. See 66 *Fed. Reg.* 35629–35639 (July 6, 2001).

2. The guidance was developed in consultation with Securities and Exchange Commission staff, who are issuing parallel guidance in the form of Staff Accounting Bulletin No. 102.

3. [The actual policy statement includes a bibliography] that lists applicable ALLL GAAP guidance, interagency statements, and other reference materials that may assist in understanding and implementing an ALLL in accordance with GAAP. See [the appendix] for additional information on applying GAAP to determine the ALLL.

the ALLL process internally to all applicable personnel. Regardless of who develops and implements these policies, procedures, and underlying controls, the board of directors should assure themselves that the policies specifically address the institution's unique goals, systems, risk profile, personnel, and other resources before approving them. Additionally, by creating an environment that encourages personnel to follow these policies and procedures, management improves procedural discipline and compliance.

The determination of the amounts of the ALLL and provisions for loan and lease losses should be based on management's current judgments about the credit quality of the loan portfolio, and should consider all known relevant internal and external factors that affect loan collectibility as of the reporting date. The amounts reported each period for the provision for loan and lease losses and the ALLL should be reviewed and approved by the board of directors. To ensure the methodology remains appropriate for the institution, the board of directors should have the methodology periodically validated and, if appropriate, revised. Further, the audit committee[4] should oversee and monitor the internal controls over the ALLL-determination process.[5]

The [Federal Reserve and other] banking agencies[6] have long-standing examination policies that call for examiners to review an institution's lending and loan-review functions and recommend improvements, if needed. Additionally, in 1995 and 1996, the banking agencies adopted interagency guidelines establishing standards for safety and soundness, pursuant to section 39 of the Federal Deposit Insurance Act (FDI Act).[7] The interagency asset-quality guidelines and [this guidance will assist] an institution in estimating and establishing a sufficient ALLL supported by adequate documentation, as required under the FDI Act. Additionally, the guidelines require operational and managerial standards that are appropriate for an institution's size and the nature and scope of its activities.

For financial-reporting purposes, including regulatory reporting, the provision for loan and lease losses and the ALLL must be determined in accordance with GAAP. GAAP requires that allowances be well documented, with clear explanations of the supporting analyses and rationale.[8] This [2001] policy statement describes but does not increase the documentation requirements already existing within GAAP. Failure to maintain, analyze, or support an adequate ALLL in accordance with GAAP and supervisory guidance is generally an unsafe and unsound banking practice.[9]

This guidance [the 2001 policy statement] applies equally to all institutions, regardless of the size. However, institutions with less-complex lending activities and products may find it more efficient to combine a number of procedures (e.g., information gathering, documentation, and internal-approval processes) while continuing to ensure the institution has a consistent and appropriate methodology. Thus, much of the supporting documentation required for an institution with more-complex products or portfolios may be combined into fewer supporting documents in an institution with less-complex products or portfolios. For example, simplified documentation can include spreadsheets, checklists, and other summary documents that many institutions currently use. Illustrations A and C provide specific examples of how less-complex institutions may determine and document portions of their loan-loss allowance.

4. All institutions are encouraged to establish audit committees; however, at small institutions without audit committees, the board of directors retains this responsibility.

5. Institutions and their auditors should refer to Statement on Auditing Standards No. 61, "Communication with Audit Committees" (as amended by Statement on Auditing Standards No. 90, "Audit Committee Communications"), which requires certain discussions between the auditor and the audit committee. These discussions should include items, such as accounting policies and estimates, judgments, and uncertainties that have a significant impact on the accounting information included in the financial statements.

6. The [other] banking agencies are the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision.

7. Institutions should refer to the guidelines *** for state member banks, appendix D to part 208***.

8. The documentation guidance within this [2001] policy statement is predominantly based upon the GAAP guidance from Financial Accounting Standards Board (FASB) Statement No. 5 and No. 114 (FAS 5 and FAS 114, respectively); Emerging Issues Task Force Topic No. D-80 (EITF Topic D-80 and attachments), "Application of FASB Statements No. 5 and No. 114 to a Loan Portfolio" (which includes the *Viewpoints* article—an article issued in 1999 by FASB staff providing guidance on certain issues regarding the ALLL, particularly on the application of FAS 5 and FAS 114 and how these statements interrelate); Chapter 7, "Credit Losses," the American Institute of Certified Public Accountants' (AICPA) Audit and Accounting Guide, *Banks and Savings Institutions*, 2000 edition (AICPA Audit Guide); and the Securities and Exchange Commission's (SEC) Financial Reporting Release No. 28 (FRR 28).

9. Failure to maintain adequate supporting documentation does not relieve an institution of its obligation to record an appropriate ALLL.

2065.4.1.1 Documentation Standards

Appropriate written supporting documentation for the loan-loss provision and allowance facili-

tates review of the ALLL process and reported amounts, builds discipline and consistency into the ALLL-determination process, and improves the process for estimating loan and lease losses by helping to ensure that all relevant factors are appropriately considered in the ALLL analysis. An institution should document the relationship between the findings of its detailed review of the loan portfolio and the amount of the ALLL and the provision for loan and lease losses reported in each period.[10]

At a minimum, institutions should maintain written supporting documentation for the following decisions, strategies, and processes:

- policies and procedures—
  - — over the systems and controls that maintain an appropriate ALLL and
  - — over the ALLL methodology
- loan-grading system or process
- summary or consolidation of the ALLL balance
- validation of the ALLL methodology
- periodic adjustments to the ALLL process

2065.4.1.2 Policies and Procedures

Financial institutions utilize a wide range of policies, procedures, and control systems in their ALLL process. Sound policies should be appropriately tailored to the size and complexity of the institution and its loan portfolio.

In order for an institution's ALLL methodology to be effective, the institution's written policies and procedures for the systems and controls that maintain an appropriate ALLL should address but not be limited to—

- the roles and responsibilities of the institution's departments and personnel (including the lending function, credit review, financial reporting, internal audit, senior management, audit committee, board of directors, and others, as applicable) who determine, or review, as applicable, the ALLL to be reported in the financial statements;
- the institution's accounting policies for loans, [leases, and their loan losses], including the policies for charge-offs and recoveries and for estimating the fair value of collateral, where applicable;
- the description of the institution's systematic methodology, which should be consistent with the institution's accounting policies for determining its ALLL;[11] and
- the system of internal controls used to ensure that the ALLL process is maintained in accordance with GAAP and supervisory guidance.

An internal-control system for the ALLL-estimation process should—

- include measures to provide assurance regarding the reliability and integrity of information and compliance with laws, regulations, and internal policies and procedures;
- reasonably assure that the institution's financial statements (including regulatory reports) are prepared in accordance with GAAP and ALLL supervisory guidance;[12] and
- include a well-defined loan-review process containing—
  - — an effective loan-grading system that is consistently applied, identifies differing risk characteristics and loan-quality problems accurately and in a timely manner, and prompts appropriate administrative actions;
  - — sufficient internal controls to ensure that all relevant loan-review information is appropriately considered in estimating losses. This includes maintaining appropriate reports, details of reviews performed, and identification of personnel involved; and
  - — clear formal communication and coordination between an institution's credit-administration function, financial-reporting group, management, board of directors, and others who are involved in

10. This position is fully described in the SEC's FRR 28, in which the SEC indicates that the books and records of public companies engaged in lending activities should include documentation of the rationale supporting each period's determination that the ALLL and provision amounts reported were adequate.

11. Further explanation is presented in the ''Methodology'' section that appears below.

12. In addition to the supporting documentation requirements for financial institutions, as described in interagency asset-quality guidelines, public companies are required to comply with the books and records provisions of the Securities Exchange Act of 1934 (Exchange Act). Under sections 13(b)(2)–(7) of the Exchange Act, registrants must make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of assets of the registrant. Registrants also must maintain internal accounting controls that are sufficient to provide reasonable assurances that, among other things, transactions are recorded as necessary to permit the preparation of financial statements in conformity with GAAP. See also SEC Staff Accounting Bulletin No. 99, *Materiality.*

the ALLL-determination or -review process, as applicable (e.g., written policies and procedures, management reports, audit programs, and committee minutes).

2065.4.1.3 Methodology

An ALLL methodology is a system that an institution designs and implements to reasonably estimate loan and lease losses as of the financial statement date. It is critical that ALLL methodologies incorporate management's current judgments about the credit quality of the loan portfolio through a disciplined and consistently applied process.

An institution's ALLL methodology is influenced by institution-specific factors, such as an institution's size, organizational structure, business environment and strategy, management style, loan-portfolio characteristics, loan-administration procedures, and management information systems. However, there are certain common elements an institution should incorporate in its ALLL methodology. A summary of common elements is provided in [the appendix].[13]

2065.4.1.3.1 Documentation of ALLL Methodology in Written Policies and Procedures

An institution's written policies and procedures should describe the primary elements of the institution's ALLL methodology, including portfolio segmentation and impairment measurement. In order for an institution's ALLL methodology to be effective, the institution's written policies and procedures should describe the methodology—

- for segmenting the portfolio:
  - — how the segmentation process is performed (i.e., by loan type, industry, risk rates, etc.),
  - — when a loan-grading system is used to segment the portfolio:
    - the definitions of each loan grade,
    - a reconciliation of the internal loan grades to supervisory loan grades, and
    - the delineation of responsibilities for the loan-grading system.
- for determining and measuring impairment under FAS 114:
  - — the methods used to identify loans to be analyzed individually;
  - — for individually reviewed loans that are impaired, how the amount of any impairment is determined and measured, including—
    - procedures describing the impairment-measurement techniques available and
    - steps performed to determine which technique is most appropriate in a given situation.
  - — the methods used to determine whether and how loans individually evaluated under FAS 114, but not considered to be individually impaired, should be grouped with other loans that share common characteristics for impairment evaluation under FAS 5.
- for determining and measuring impairment under FAS 5—
  - — how loans with similar characteristics are grouped to be evaluated for loan collectibility (such as loan type, past-due status, and risk);
  - — how loss rates are determined (e.g., historical loss rates adjusted for environmental factors or migration analysis) and what factors are considered when establishing appropriate time frames over which to evaluate loss experience; and
  - — descriptions of qualitative factors (e.g., industry, geographical, economic, and political factors) that may affect loss rates or other loss measurements.

The supporting documents for the ALLL may be integrated in an institution's credit files, loan-review reports or worksheets, board of directors' and committee meeting minutes, computer reports, or other appropriate documents and files.

2065.4.1.4 ALLL Under FAS 114

An institution's ALLL methodology related to FAS 114 loans begins with the use of its normal loan-review procedures to identify whether a loan is impaired as defined by the accounting standard. Institutions should document—

- the method and process for identifying loans to be evaluated under FAS 114 and
- the analysis that resulted in an impairment decision for each loan and the determination of the impairment-measurement method to be

13. Also, refer to paragraph 7.05 of the AICPA Audit Guide.

used (i.e., present value of expected future cash flows, fair value of collateral less costs to sell, or the loan's observable market price).

Once an institution has determined which of the three available measurement methods to use for an impaired loan under FAS 114, it should maintain supporting documentation as follows:

- When using the present-value-of-expected-future-cash-flows method—
  - — the amount and timing of cash flows,
  - — the effective interest rate used to discount the cash flows, and
  - — the basis for the determination of cash flows, including consideration of current environmental factors and other information reflecting past events and current conditions.
- When using the fair-value-of-collateral method—
  - — how fair value was determined, including the use of appraisals, valuation assumptions, and calculations,
  - — the supporting rationale for adjustments to appraised values, if any,
  - — the determination of costs to sell, if applicable, and
  - — appraisal quality, and the expertise and independence of the appraiser.
- When using the observable-market-price-of-a-loan method—
  - — the amount, source, and date of the observable market price.

Illustration A describes a practice used by a small financial institution to document its FAS 114 measurement of impairment using a comprehensive worksheet.[14] [Examples 1 and 2 provide examples of applying and documenting impairment-measurement methods under FAS 114. Some loans that are evauluated individually for impairment under FAS 114 may be fully collateralized and therefore require no ALLL. Example 3 presents an institution whose loan portfolio includes fully collateralized loans. It describes the documentation maintained by that institution to support its conclusion that no ALLL was needed for those loans.]

14. The [referenced] illustrations are presented to assist institutions in evaluating how to implement the guidance provided in this document. The methods described in the illustrations may not be suitable for all institutions and are not considered required processes or actions. For additional descriptions of key aspects of ALLL guidance, a series of [numbered examples is provided. These examples were included in appendix A of the policy statement as questions and answers. The wording of the examples has been slightly modified for this format.]

Illustration A

Documenting an ALLL Under FAS 114

Comprehensive worksheet for the impairment-measurement process

A small institution utilizes a comprehensive worksheet for each loan being reviewed individually under FAS 114. Each worksheet includes a description of why the loan was selected for individual review, the impairment-measurement technique used, the measurement calculation, a comparison to the current loan balance, and the amount of the ALLL for that loan. The rationale for the impairment-measurement technique used (e.g., present value of expected future cash flows, observable market price of the loan, fair value of the collateral) is also described on the worksheet.

Example 1: ALLL Under FAS 114—Measuring and Documenting Impairment

Facts. Approximately one-third of Institution A's commercial loan portfolio consists of large-balance, nonhomogeneous loans. Due to their large individual balances, these loans meet the criteria under Institution A's policies and procedures for individual review for impairment under FAS 114. Upon review of the large-balance loans, Institution A determines that certain of the loans are impaired as defined by FAS 114.

Analysis. For the commercial loans reviewed under FAS 114 that are individually impaired, Institution A should measure and document the impairment on those loans. For those loans that are reviewed individually under FAS 114 and considered individually impaired, Institution A must use one of the methods for measuring impairment that is specified by FAS 114 (that is, the present value of expected future cash flows,

the loan's observable market price, or the fair value of collateral).

An impairment-measurement method other than the methods allowed by FAS 114 cannot be used. For the loans considered individually impaired under FAS 114, under the circumstances described above, it would not be appropriate for Institution A to choose a measurement method not prescribed by FAS 114. For example, it would not be appropriate to measure loan impairment by applying a loss rate to each loan based on the average historical loss percentage for all of its commercial loans for the past five years.

Institution A should maintain, as sufficient, objective evidence, written documentation to support its measurement of loan impairment under FAS 114. If it uses the present value of expected future cash flows to measure impairment of a loan, it should document (1) the amount and timing of cash flows, (2) the effective interest rate used to discount the cash flows, and (3) the basis for the determination of cash flows, including consideration of current environmental factors[15] and other information reflecting past events and current conditions. If Institution A uses the fair value of collateral to measure impairment, it should document (1) how it determined the fair value, including the use of appraisals, valuation assumptions and calculations; (2) the supporting rationale for adjustments to appraised values, if any, and the determination of costs to sell, if applicable; (3) appraisal quality; and (4) the expertise and independence of the appraiser. Similarly, Institution A should document the amount, source, and date of the observable market price of a loan, if that method of measuring loan impairment is used.

Example 2: ALLL Under FAS 114—Measuring Impairment for a Collateral-Dependent Loan

Facts. Institution B has a $10 million loan outstanding to Company X that is secured by real estate, which Institution B individually evaluates under FAS 114 due to the loan's size. Company X is delinquent in its loan payments under the terms of the loan agreement. Accordingly, Institution B determines that its loan to Company X is impaired, as defined by FAS 114. Because the loan is collateral dependent, Institution B measures impairment of the loan based on the fair value of the collateral. Institution B determines that the most recent valuation of the collateral was performed by an appraiser 18 months ago and, at that time, the estimated value of the collateral (fair value less costs to sell) was $12 million.

Institution B believes that certain of the assumptions that were used to value the collateral 18 months ago do not reflect current market conditions and, therefore, the appraiser's valuation does not approximate current fair value of the collateral. Several buildings, which are comparable to the real estate collateral, were recently completed in the area, increasing vacancy rates, decreasing lease rates, and attracting several tenants away from the borrower. Accordingly, credit-review personnel at Institution B adjust certain of the valuation assumptions to better reflect the current market conditions as they relate to the loan's collateral.[16] After adjusting the collateral-valuation assumptions, the credit-review department determines that the current estimated fair value of the collateral, less costs to sell, is $8 million. Given that the recorded investment in the loan is $10 million, Institution B concludes that the loan is impaired by $2 million and records an allowance for loan losses of $2 million.

Analysis. Institution B should maintain documentation to support its determination of the allowance for loan losses of $2 million for the loan to Company X. It should document that it measured impairment of the loan to Company X by using the fair value of the loan's collateral, less costs to sell, which it estimated to be $8 million. This documentation should include (1) the institution's rationale and basis for the $8 million valuation, including the revised valuation assumptions it used; (2) the valuation calculation; and (3) the determination of costs to sell, if applicable. Because Institution B arrived at the valuation of $8 million by modifying an earlier appraisal, it should document its rationale and basis for the changes it made to the valuation assumptions that resulted in the collateral value declining from $12 million 18 months ago to $8 million in the current period.[17]

15. Question 16 in Exhibit D-80A of EITF Topic D-80 and [its] attachments indicates that environmental factors include existing industry, geographical, economic, and political factors.

16. When reviewing collateral-dependent loans, Institution B may often find it more appropriate to obtain an updated appraisal to estimate the effect of current market conditions on the appraised value instead of internally estimating an adjustment.

17. In accordance with the FFIEC's *Federal Register*

Example 3: ALLL Under FAS 114—Fully Collateralized Loans

Facts. Institution C has $10 million in loans that are fully collateralized by highly rated debt securities with readily determinable market values. The loan agreement for each of these loans requires the borrower to provide qualifying collateral sufficient to maintain a loan-to-value ratio with sufficient margin to absorb volatility in the securities' market prices. Institution C's collateral department has physical control of the debt securities through safekeeping arrangements. In addition, Institution C perfected its security interest in the collateral when the funds were originally distributed. On a quarterly basis, Institution C's credit-administration function determines the market value of the collateral for each loan using two independent market quotes and compares the collateral value to the loan carrying value. If there are any collateral deficiencies, Institution C notifies the borrower and requests that the borrower immediately remedy the deficiency. Due in part to its efficient operation, Institution C has historically not incurred any material losses on these loans. Institution C believes these loans are fully collateralized and therefore does not maintain any ALLL balance for these loans.

Analysis. To adequately support its determination that no allowance is needed for this group of loans, Institution C must maintain the following documentation:

- The management summary of the ALLL must include documentation indicating that, in accordance with the institution's ALLL policy, (1) Institution C has verified the collateral protection on these loans, (2) no probable loss has been incurred, and (3) no ALLL is necessary.
- The documentation in Institution C's loan files must include (1) the two independent market quotes obtained each quarter for each loan's collateral amount, (2) the documents evidencing the perfection of the security interest in the collateral and other relevant supporting documents, and (3) Institution C's ALLL policy, including guidance for determining when a loan is considered "fully collateralized," which would not require an ALLL. Institution C's policy should require the following factors to be considered and fully documented:
  - — volatility of the market value of the collateral
  - — recency and reliability of the appraisal or other valuation
  - — recency of the institution's or third party's inspection of the collateral
  - — historical losses on similar loans
  - — confidence in the institution's lien or security position including appropriate—
    - type of security perfection (e.g., physical possession of collateral or secured filing);
    - filing of security perfection (i.e., correct documents and with the appropriate officials);
    - relationship to other liens; and
    - other factors as appropriate for the loan type.

notice, Implementation Issues Arising from FASB No. 114, "Accounting by Creditors for Impairment of a Loan," published February 10, 1995 (60 *Fed. Reg.* 7966), impaired, collateral-dependent loans must be reported at the fair value of collateral, less costs to sell, in regulatory reports. This treatment is to be applied to all collateral-dependent loans, regardless of type of collateral.

2065.4.1.5 ALLL Under FAS 5

2065.4.1.5.1 Segmenting the Portfolio

For loans evaluated on a group basis under FAS 5, management should segment the loan portfolio by identifying risk characteristics that are common to groups of loans. Institutions typically decide how to segment their loan portfolios based on many factors, which vary with their business strategies as well as their information system capabilities. Smaller institutions that are involved in less complex activities often segment the portfolio into broad loan categories. This method of segmenting the portfolio is likely to be appropriate in only small institutions offering a narrow range of loan products. Larger institutions typically offer a more diverse and complex mix of loan products. Such institutions may start by segmenting the portfolio into major loan types but typically have more detailed information available that allows them to further segregate the portfolio into product-line segments based on the risk characteristics of each portfolio segment. Regardless of the segmentation method used, an institution should maintain documentation to support its conclusion that the loans in each segment have similar attributes or characteristics.

As economic and other business conditions change, institutions often modify their business strategies, which may result in adjustments to the way in which they segment their loan portfolio for purposes of estimating loan losses. Illustration B presents an example in which an institution refined its segmentation method to more effectively consider risk factors and maintains documentation to support this change.

Illustration B

Documenting Segmenting Practices

Documenting a refinement in a segmentation method

An institution with a significant portfolio of consumer loans performed a review of its ALLL methodology. The institution had determined its ALLL based upon historical loss rates in the overall consumer portfolio. The ALLL methodology was validated by comparing actual loss rates (charge-offs) for the past two years to the estimated loss rates. During this process, the institution decided to evaluate loss rates on an individual-product basis (e.g., auto loans, unsecured loans, or home equity loans). This analysis disclosed significant differences in the loss rates on different products. With this additional information, the methodology was amended in the current period to segment the portfolio by product, resulting in a better estimation of the loan losses associated with the portfolio. To support this change in segmentation practice, the credit-review committee records contain the analysis that was used as a basis for the change and the written report describing the need for the change.

Institutions use a variety of documents to support the segmentation of their portfolios. Some of these documents include—

- loan trial balances by categories and types of loans,
- management reports about the mix of loans in the portfolio,
- delinquency and nonaccrual reports, and
- a summary presentation of the results of an internal or external loan-grading review.

Reports generated to assess the profitability of a loan-product line may be useful in identifying areas in which to further segment the portfolio.

2065.4.1.5.2 Estimating Loss on Groups of Loans

Based on the segmentation of the loan portfolio, an institution should estimate the FAS 5 portion of its ALLL. For those segments that require an ALLL,[18] the institution should estimate the loan and lease losses, on at least a quarterly basis, based upon its ongoing loan-review process and analysis of loan performance. The institution should follow a systematic and consistently applied approach to select the most appropriate loss-measurement methods and support its conclusions and rationale with written documentation. Regardless of the methods used to measure losses, an institution should demonstrate and document that the loss-measurement methods used to estimate the ALLL for each segment are determined in accordance with GAAP as of the financial statement date.[19]

One method of estimating loan losses for groups of loans is through the application of loss rates to the groups' aggregate loan balances. Such loss rates typically reflect the institution's historical loan-loss experience for each group of loans, adjusted for relevant environmental factors (e.g., industry, geographical, economic, and political factors) over a defined period of time. If an institution does not have loss experience of its own, it may be appropriate to reference the loss experience of other institutions, provided that the institution demonstrates that the attributes of the loans in its portfolio segment are similar to those of the loans included in the portfolio of the institution providing the loss experience.[20] Institutions should maintain supporting documentation for the technique used to develop their loss rates, including the period of time over which the losses were incurred. If a range of loss is determined, institutions should maintain documentation to support the identified range and the rationale used for determining which estimate is the best estimate within the range of loan losses. An example of

18. An example of a loan segment that does not generally require an ALLL is loans that are fully secured by deposits maintained at the lending institution.

19. Refer to paragraph 8(b) of FAS 5***.

20. Refer to paragraph 23 of FAS 5.

how a small institution performs a comprehensive historical loss analysis is provided as the first item in illustration C.

Before employing a loss-estimation model, an institution should evaluate and modify, as needed, the model's assumptions to ensure that the resulting loss estimate is consistent with GAAP. In order to demonstrate consistency with GAAP, institutions that use loss-estimation models typically document the evaluation, the conclusions regarding the appropriateness of estimating loan losses with a model or other loss-estimation tool, and the support for adjustments to the model or its results.

In developing loss measurements, institutions should consider the impact of current environmental factors and then document which factors were used in the analysis and how those factors affected the loss measurements. Factors that should be considered in developing loss measurements include the following:[21]

- levels of and trends in delinquencies and impaired loans
- levels of and trends in charge-offs and recoveries
- trends in volume and terms of loans
- effects of any changes in risk-selection and underwriting standards, and other changes in lending policies, procedures, and practices
- experience, ability, and depth of lending management and other relevant staff
- national and local economic trends and conditions
- industry conditions
- effects of changes in credit concentrations

For any adjustment of loss measurements for environmental factors, the institution should maintain sufficient, objective evidence to support the amount of the adjustment and to explain why the adjustment is necessary to reflect current information, events, circumstances, and conditions in the loss measurements.

The second item in illustration C provides an example of how an institution adjusts its commercial real estate historical loss rates for changes in local economic conditions. Example 4 provides an example of maintaining supporting documentation for adjustments to portfolio-segment loss rates for an environmental factor related to an economic downturn in the borrower's primary industry. Example 5 describes one institution's process for determining and documenting an ALLL for loans that are not individually impaired but have characteristics indicating there are loan losses on a group basis.

21. Refer to paragraph 7.13 in the AICPA Audit Guide.

Illustration C

Documenting the Setting of Loss Rates

Comprehensive loss analysis in a small institution

A small institution determines its loss rates based on loss rates over a three-year historical period. The analysis is conducted by type of loan and is further segmented by originating branch office. The analysis considers charge-offs and recoveries in determining the loss rate. The institution also considers the loss rates for each loan grade and compares them to historical losses on similarly rated loans in arriving at the historical loss factor. The institution maintains supporting documentation for its loss-factor analysis, including historical losses by type of loan, originating branch office, and loan grade for the three-year period.

Adjustment of loss rates for changes in local economic conditions

An institution develops a factor to adjust loss rates for its assessment of the impact of changes in the local economy. For example, when analyzing the loss rate on commercial real estate loans, the assessment identifies changes in recent commercial building occupancy rates. The institution generally finds the occupancy statistics to be a good indicator of probable losses on these types of loans. The institution maintains documentation that summarizes the relationship between current occupancy rates and its loss experience.

Example 4: ALLL Under FAS 5—Adjusting Loss Rates

Facts. Institution D's lending area includes a metropolitan area that is financially dependent

upon the profitability of a number of manufacturing businesses. These businesses use highly specialized equipment and significant quantities of rare metals in the manufacturing process. Due to increased low-cost foreign competition, several of the parts suppliers servicing these manufacturing firms declared bankruptcy. The foreign suppliers have subsequently increased prices, and the manufacturing firms have suffered from increased equipment maintenance costs and smaller profit margins. Additionally, the cost of the rare metals used in the manufacturing process increased and has now stabilized at double last year's price. Due to these events, the manufacturing businesses are experiencing financial difficulties and have recently announced downsizing plans.

Although Institution D has yet to confirm an increase in its loss experience as a result of these events, management knows that it lends to a significant number of businesses and individuals whose repayment ability depends upon the long-term viability of the manufacturing businesses. Institution D's management has identified particular segments of its commercial and consumer customer bases that include borrowers highly dependent upon sales or salary from the manufacturing businesses. Institution D's management performs an analysis of the affected portfolio segments to adjust its historical loss rates used to determine the ALLL. In this particular case, Institution D has experienced similar business and lending conditions in the past that it can compare to current conditions.

Analysis. Institution D should document its support for the loss-rate adjustments that result from considering these manufacturing firms' financial downturns. It should document its identification of the particular segments of its commercial and consumer loan portfolio for which it is probable that the manufacturing business' financial downturn has resulted in loan losses. In addition, it should document its analysis that resulted in the adjustments to the loss rates for the affected portfolio segments. As part of its documentation, Institution D should maintain copies of the documents supporting the analysis, including relevant newspaper articles, economic reports, economic data, and notes from discussions with individual borrowers.

Since Institution D has had similar situations in the past, its supporting documentation should also include an analysis of how the current conditions compare to its previous loss experiences in similar circumstances. As part of its effective ALLL methodology, a summary should be created of the amount and rationale for the adjustment factor, which management presents to the audit committee and board for their review and approval prior to the issuance of the financial statements.

Example 5: ALLL Under FAS 5—Estimating Losses on Loans Individually Reviewed for Impairment but Not Considered Individually Impaired

Facts. Institution E has outstanding loans of $2 million to Company Y and $1 million to Company Z, both of which are paying as agreed upon in the loan documents. The institution's ALLL policy specifies that all loans greater than $750,000 must be individually reviewed for impairment under FAS 114. Company Y's financial statements reflect a strong net worth, good profits, and ongoing ability to meet debt-service requirements. In contrast, recent information indicates Company Z's profitability is declining and its cash flow is tight. Accordingly, this loan is rated substandard under the institution's loan-grading system. Despite its concern, management believes Company Z will resolve its problems and determines that neither loan is individually impaired as defined by FAS 114.

Institution E segments its loan portfolio to estimate loan losses under FAS 5. Two of its loan portfolio segments are Segment 1 and Segment 2. The loan to Company Y has risk characteristics similar to the loans included in Segment 1, and the loan to Company Z has risk characteristics similar to the loans included in Segment 2.[22]

In its determination of the ALLL under FAS 5, Institution E includes its loans to Company Y and Company Z in the groups of loans with similar characteristics (i.e., Segment 1 for Company Y's loan and Segment 2 for Company Z's loan). Management's analyses of Segment 1 and Segment 2 indicate that it is probable that each segment includes some losses, even though the losses cannot be identified to one or more specific loans. Management estimates that the use of its historical loss rates for these two segments, with adjustments for changes in environmental factors, provides a reasonable estimate of the institution's probable loan losses in these segments.

22. These groups of loans do not include any loans that have been individually reviewed for impairment under FAS 114 and determined to be impaired as defined by FAS 114.

Analysis. Institution E should adequately document an ALLL under FAS 5 for these loans that were individually reviewed for impairment but are not considered individually impaired. As part of its effective ALLL methodology, Institution E documents the decision to include its loans to Company Y and Company Z in its determination of its ALLL under FAS 5. It should also document the specific characteristics of the loans that were the basis for grouping these loans with other loans in Segment 1 and Segment 2, respectively. Institution E maintains documentation to support its method of estimating loan losses for Segment 1 and Segment 2, including the average loss rate used, the analysis of historical losses by loan type and by internal risk rating, and support for any adjustments to its historical loss rates. The institution also maintains copies of the economic and other reports that provided source data.

2065.4.1.6 Consolidating the Loss Estimates

To verify that ALLL balances are presented fairly in accordance with GAAP and are auditable, management should prepare a document that summarizes the amount to be reported in the financial statements for the ALLL. The board of directors should review and approve this summary.

Common elements in such summaries include—

- the estimate of the probable loss or range of loss incurred for each category evaluated (e.g., individually evaluated impaired loans, homogeneous pools, and other groups of loans that are collectively evaluated for impairment);
- the aggregate probable loss estimated using the institution's methodology;
- a summary of the current ALLL balance;
- the amount, if any, by which the ALLL is to be adjusted;[23] and
- depending on the level of detail that supports the ALLL analysis, detailed subschedules of loss estimates that reconcile to the summary schedule.

Illustration D describes how an institution documents its estimated ALLL by adding comprehensive explanations to its summary schedule.

Generally, an institution's review and approval process for the ALLL relies upon the data provided in these consolidated summaries. There may be instances in which individuals or committees that review the ALLL methodology and resulting allowance balance identify adjustments that need to be made to the loss estimates to provide a better estimate of loan losses. These changes may be due to information not known at the time of the initial loss estimate (e.g., information that surfaces after determining and adjusting, as necessary, historical loss rates, or a recent decline in the marketability of property after conducting a FAS 114 valuation based upon the fair value of collateral). It is important that these adjustments are consistent with GAAP and are reviewed and approved by appropriate personnel. Additionally, the summary should provide each subsequent reviewer with an understanding of the support behind these adjustments. Therefore, management should document the nature of any adjustments and the underlying rationale for making the changes. This documentation should be provided to those making the final determination of the ALLL amount. Example 6 addresses the documentation of the final amount of the ALLL.

23. Subsequent to adjustments, there should be no material differences between the consolidated loss estimate, as determined by the methodology, and the final ALLL balance reported in the financial statements.

Illustration D

Summarizing Loss Estimates

Descriptive comments added to the consolidated ALLL summary schedule

To simplify the supporting documentation process and to eliminate redundancy, an institution adds detailed supporting information to its summary schedule. For example, this institution's board of directors receives, within the body of the ALLL summary schedule, a brief description of the institution's policy for selecting loans for evaluation under FAS 114. Additionally, the institution identifies which FAS 114 impairment-measurement method was used for each individually reviewed impaired loan. Other items on the schedule include a brief description of the loss factors for each segment of the loan portfolio, the basis for adjustments to loss rates, and explanations of changes in ALLL amounts from period to period, including cross-references to more detailed supporting documents.

Example 6: Consolidating the Loss Estimates—Documenting the Reported ALLL

Facts. Institution F determines its ALLL using an established systematic process. At the end of each period, the accounting department prepares a summary schedule that includes the amount of each of the components of the ALLL, as well as the total ALLL amount, for review by senior management, the credit committee, and, ultimately, the board of directors. Members of senior management and the credit committee meet to discuss the ALLL. During these discussions, they identify changes that are required by GAAP to be made to certain of the ALLL estimates. As a result of the adjustments made by senior management, the total amount of the ALLL changes. However, senior management (or its designee) does not update the ALLL summary schedule to reflect the adjustments or reasons for the adjustments. When performing their audit of the financial statements, the independent accountants are provided with the original ALLL summary schedule that was reviewed by senior management and the credit committee, as well as a verbal explanation of the changes made by senior management and the credit committee when they met to discuss the loan-loss allowance.

Analysis. Institution F's documentation practices supporting the balance of its loan-loss allowance, as reported in its financial statements, are not in compliance with existing documentation guidance. An institution must maintain supporting documentation for the loan-loss allowance amount reported in its financial statements. As illustrated above, there may be instances in which ALLL reviewers identify adjustments that need to be made to the loan-loss estimates. The nature of the adjustments, how they were measured or determined, and the underlying rationale for making the changes to the ALLL balance should be documented. Appropriate documentation of the adjustments should be provided to the board of directors (or its designee) for review of the final ALLL amount to be reported in the financial statements. For institutions subject to external audit, this documentation should also be made available to the independent accountants. If changes frequently occur during management or credit committee reviews of the ALLL, management may find it appropriate to analyze the reasons for the frequent changes and to reassess the methodology the institution uses.

2065.4.1.7 Validating the ALLL Methodology

An institution's ALLL methodology is considered valid when it accurately estimates the amount of loss contained in the portfolio. Thus, the institution's methodology should include procedures that adjust loss-estimation methods to reduce differences between estimated losses and actual subsequent charge-offs, as necessary.

To verify that the ALLL methodology is valid and conforms to GAAP and supervisory guidance, an institution's directors should establish internal-control policies, appropriate for the size of the institution and the type and complexity of its loan products. These policies should include procedures for a review, by a party who is independent of the ALLL-estimation process, of the ALLL methodology and its application in order to confirm its effectiveness.

In practice, financial institutions employ numerous procedures when validating the reasonableness of their ALLL methodology and

determining whether there may be deficiencies in their overall methodology or loan-grading process. Examples are—

- a review of trends in loan volume, delinquencies, restructurings, and concentrations;
- a review of previous charge-off and recovery history, including an evaluation of the timeliness of the entries to record both the charge-offs and the recoveries;
- a review by a party that is independent of the ALLL-estimation process (this often involves the independent party reviewing, on a test basis, source documents and underlying assumptions to determine that the established methodology develops reasonable loss estimates); and
- an evaluation of the appraisal process of the underlying collateral. (This may be accomplished by periodically comparing the appraised value to the actual sales price on selected properties sold.)

2065.4.1.7.1 Supporting Documentation for the Validation Process

Management usually supports the validation process with the workpapers from the ALLL-review function. Additional documentation often includes the summary findings of the independent reviewer. The institution's board of directors, or its designee, reviews the findings and acknowledges its review in its meeting minutes. If the methodology is changed based upon the findings of the validation process, documentation that describes and supports the changes should be maintained.

2065.4.1.8 Appendix—Application of GAAP

[This appendix was designated appendix B in the policy statement.] An ALLL recorded pursuant to GAAP is an institution's best estimate of the probable amount of loans and lease-financing receivables that it will be unable to collect based on current information and events.[24] A creditor should record an ALLL when the criteria for accrual of a loss contingency as set forth in GAAP have been met. Estimating the amount of an ALLL involves a high degree of management judgment and is inevitably imprecise. Accordingly, an institution may determine that the amount of loss falls within a range. An institution should record its best estimate within the range of loan losses.[25]

Under GAAP, Statement of Financial Accounting Standards No. 5, ''Accounting for Contingencies'' (FAS 5), provides the basic guidance for recognition of a loss contingency, such as the collectibility of loans (receivables), when it is probable that a loss has been incurred and the amount can be reasonably estimated. Statement of Financial Accounting Standards No. 114, ''Accounting by Creditors for Impairment of a Loan'' (FAS 114) provides more specific guidance about the measurement and disclosure of impairment for certain types of loans.[26] Specifically, FAS 114 applies to loans that are identified for evaluation on an individual basis. Loans are considered impaired when, based on current information and events, it is probable that the creditor will be unable to collect all interest and principal payments due according to the contractual terms of the loan agreement.

For individually impaired loans, FAS 114 provides guidance on the acceptable methods to measure impairment. Specifically, FAS 114 states that when a loan is impaired, a creditor should measure impairment based on the present value of expected future principal and interest cash flows discounted at the loan's effective interest rate, except that as a practical expedient, a creditor may measure impairment based on a loan's observable market price or the fair value of collateral, if the loan is collateral dependent. When developing the estimate of expected future cash flows for a loan, an institution should consider all available information reflecting past events and current conditions, including the

24. This appendix provides guidance on the ALLL and does not address allowances for credit losses for off-balance-sheet instruments (e.g., loan commitments, guarantees, and standby letters of credit). Institutions should record liabilities for these exposures in accordance with GAAP. Further guidance on this topic is presented in the American Institute of Certified Public Accountants' Audit and Accounting Guide, *Banks and Savings Institutions*, 2000 edition (AICPA Audit Guide). Additionally, this appendix does not address allowances or accounting for assets or portions of assets sold with recourse, which is described in Statement of Financial Accounting Standards No. 140, ''Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities—a Replacement of FASB Statement No. 125'' (FAS 140).

25. Refer to FASB Interpretation No. 14, ''Reasonable Estimation of the Amount of a Loss,'' and Emerging Issues Task Force Topic No. D-80, ''Application of FASB Statements No. 5 and No. 114 to a Loan Portfolio'' (EITF Topic D-80).

26. EITF Topic D-80 includes additional guidance on the requirements of FAS 5 and FAS 114 and how they relate to each other.***

effect of existing environmental factors. The following illustration provides an example of an institution estimating a loan's impairment when the loan has been partially charged off.

Illustration

Interaction of FAS 114 with an Adversely Classified Loan, Partial Charge-Off, and the Overall ALLL

An institution determined that a collateral-dependent loan, which it identified for evaluation, was impaired. In accordance with FAS 114, the institution established an ALLL for the amount that the recorded investment in the loan exceeded the fair value of the underlying collateral, less costs to sell.

Consistent with relevant regulatory guidance, the institution classified as "Loss," the portion of the recorded investment deemed to be the confirmed loss and classified the remaining recorded investment as "Substandard." For this loan, the amount classified "Loss" was less than the impairment amount (as determined under FAS 114). The institution charged off the "Loss" portion of the loan. After the charge-off, the portion of the ALLL related to this "Substandard" loan (1) reflects an appropriate measure of impairment under FAS 114, and (2) is included in the aggregate FAS 114 ALLL for all loans that were identified for evaluation and individually considered impaired. The aggregate FAS 114 ALLL is included in the institution's overall ALLL.

Large groups of smaller-balance homogeneous loans that are collectively evaluated for impairment are not included in the scope of FAS 114.[27] Such groups of loans may include, but are not limited to, credit card, residential mortgage, and consumer installment loans. FAS 5 addresses the accounting for impairment of these loans. Also, FAS 5 provides the accounting guidance for impairment of loans that are not identified for evaluation on an individual basis and loans that are individually evaluated but are not individually considered impaired. Institutions should ensure that they do not layer their loan-loss allowances. Layering is the inappropriate practice of recording in the ALLL more than one amount for the same probable loan loss. Layering can happen when an institution includes a loan in one segment, determines its best estimate of loss for that loan either individually or on a group basis (after taking into account all appropriate environmental factors, conditions, and events), and then includes the loan in another group, which receives an additional ALLL amount.[28]

While different institutions may use different methods, there are certain common elements that should be included in any loan-loss allowance methodology. Generally, an institution's methodology should—

- include a detailed analysis of the loan portfolio, performed on a regular basis;
- consider all loans (whether on an individual or group basis);
- identify loans to be evaluated for impairment on an individual basis under FAS 114 and segment the remainder of the portfolio into groups of loans with similar risk characteristics for evaluation and analysis under FAS 5;
- consider all known relevant internal and external factors that may affect loan collectibility;
- be applied consistently but, when appropriate, be modified for new factors affecting collectibility;
- consider the particular risks inherent in different kinds of lending;
- consider current collateral values (less costs to sell), where applicable;
- require that analyses, estimates, reviews, and other ALLL methodology functions be performed by competent and well-trained personnel;
- be based on current and reliable data;
- be well documented, in writing, with clear explanations of the supporting analyses and rationale; and
- include a systematic and logical method to consolidate the loss estimates and ensure the

27. In addition, FAS 114 does not apply to loans measured at fair value or at the lower of cost or fair value, leases, or debt securities.

28. According to the Federal Financial Institutions Examination Council's *Federal Register* notice, Implementation Issues Arising from FASB Statement No. 114, "Accounting by Creditors for Impairment of a Loan," published February 10, 1995, institution-specific issues should be reviewed when estimating loan losses under FAS 114. This analysis should be conducted as part of the evaluation of each individual loan reviewed under FAS 114 to avoid potential ALLL layering.

ALLL balance is recorded in accordance with GAAP.[29]

A systematic methodology that is properly designed and implemented should result in an institution's best estimate of the ALLL. Accordingly, institutions should adjust their ALLL balance, either upward or downward, in each period for differences between the results of the systematic determination process and the unadjusted ALLL balance in the general ledger.[30]

2065.4.2 INSPECTION OBJECTIVES

1. To evaluate internal controls over the loan-loss estimation process by evaluating the ALLL written policy and the process used to create and maintain the policy, loan-grading systems, and other associated internal controls over credit risk.
2. To determine the existence of an ALLL balance and review the summary schedule supporting it.
3. To analyze and review the evaluation for Statement of Financial Accounting Standards No. 114 (FAS 114) (for individually listed loans).
4. To analyze and review the evaluation for Statement of Financial Accounting Standards No. 5 (FAS 5) (for groups of loans).
5. To determine if the BHC has adequately developed a range of loss and a margin for imprecision.
6. To determine that the ALLL reflects estimated credit losses for specifically identified loans (or groups of loans) and any estimated *probable* credit losses inherent in the remainder of the loan portfolio at the balance-sheet date.
7. To analyze and review the ALLL-documentation support.
8. To determine the adequacy of the BHC's process to evaluate the ALLL methodology and to adjust the methodology, as needed.

2065.4.3 INSPECTION PROCEDURES

1. Determine if the board of directors has developed and maintained an appropriate, systematic, and consistently applied process to determine the amounts of the ALLL and provision for loan losses, or if it has instructed management to do so. Determine if the ALLL policies specifically address the BHC's goals, risk profile, personnel, and other resources.
2. Determine if the board of directors has approved the written ALLL policy.
3. Determine if the BHC's loan-loss estimate, in accordance with its methodology, is consistent with generally accepted accounting principles and supervisory guidance. Additionally, ensure that the BHC's loan-loss estimate is materially consistent with the reported balance of the BHC's ALLL account.
4. Determine if the ALLL methodology is periodically validated by an independent party and, if appropriate, revised.
5. Ascertain whether the audit committee is overseeing and monitoring the internal controls over the ALLL-documentation process.
6. Ascertain that the BHC maintains adequate written documentation of its ALLL, including clear explanations of the supporting analyses and rationale. The documentation should consist of—
   - policies and procedures over the systems and controls that maintain an appropriate ALLL and over the ALLL methodology,
   - the loan-grading system or process,
   - a summary or consolidation (including losses) of the ALLL balance,
   - a validation of the ALLL methodology, and
   - periodic adjustments to the ALLL process.
7. Determine if the amount reported for the ALLL for each period and the provisions for loan and leases losses are reviewed and approved by the board of directors.

29. Refer to paragraph 7.05 of the AICPA Audit Guide.
30. Institutions should refer to the guidance on materiality in SEC Staff Accounting Bulletin No. 99, *Materiality*.

A holding company and its depository institution subsidiaries may generally file a consolidated group income tax return. For bank regulatory purposes, however, each depository institution is viewed as, and reports as, a separate legal and accounting entity. Each holding company subsidiary that participates in filing a consolidated tax return should record its tax expenses or tax benefits as though it had filed a tax return as a separate entity. The amount and timing of any intercompany payments or refunds to the subsidiary that result from its being a part of the consolidated return group should be no more favorable than if the subsidiary was a separate taxpayer. A consolidated return permits the parent's and other subsidiaries' taxable losses to be offset against other subsidiaries' taxable income, with the parent most often providing the principal loss. This can be illustrated with the following example:

	Parent Only	*Bank*	*Non-bank A*	*Non-bank B*	*Consolidated*
Contribution to consolidated net taxable income (loss):	$(100)	$2,000	$500	$(50)	$2,350
Assumed tax rate	40%	40%	40%	40%	40%
Tax payment/ (benefit)	$(40)	$ 800	$200	$(20)	$ 940

In this example, the parent, as the representative of the consolidated group to the Internal Revenue Service, would collect $800 from the bank subsidiary and $200 from Nonbank Subsidiary A, and pay $20 to Nonbank Subsidiary B. In return, the parent would remit to the tax authorities $940, resulting in a net cash retention of $40 by the parent.

Bank holding companies employ numerous methods to determine the amount of estimated payments to be received from their subsidiaries. Although the tax-accounting methods to be used by bank holding companies are not prescribed by the Federal Reserve System, the method employed must afford subsidiaries equitable treatment compared with filing separate returns. In general terms, tax transactions between any subsidiary and its parent should be conducted as though the subsidiary was dealing directly with state or federal taxing authorities.

In 1978 the Board of Governors addressed the issue of intercorporate income tax settlements by issuing a formal Policy Statement Regarding Intercorporate Income Tax Accounting Transactions of Bank Holding Companies and State-Chartered Banks That Are Members of the Federal Reserve System. The statement was revised and replaced by the December 1998 Policy Statement on Income Tax Allocation in a Holding Company Structure, which does not materially change any of the guidance previously issued.

The tax structure of bank holding companies becomes more complicated when deferred taxes are considered in the intercorporate tax settlements.[1] Deferred taxes occur when taxable income, for financial reporting purposes, differs from taxable income as reported to the taxing authorities. This difference is due to timing differences between financial-statement income and tax income for loan-loss provisions and other items, such as foreign tax credits. In addition, differences result from the use of the cash basis of accounting for tax purposes, as opposed to the accrual basis of accounting used in financial reporting. The different bases are chosen by management.

An example of deferred income taxes follows, using an estimated tax rate of 40 percent.

	Financial Reporting	*Tax Return*
Pre-tax income	$200	$150
Currently payable	60	60
Deferred portion	20	—
TOTAL	80	60
Net income	$120	$90

The deferred portion represents the tax effect of delaying the recognition of income or taking more of a deduction for tax-return purposes (40% x $50). This is a temporary difference since over the ''life'' of the bank holding company, income and deductions should theoretically equalize for both book and tax purposes.

Financial Accounting Standards Board State-

1. The issue becomes more complex because of GAAP-based tax expenses versus actual taxes paid under relevant tax laws (the difference between the two expenses is either a deferred tax liability or asset on the balance sheet). If the sharing agreement is based on the tax expense on the statement of income, more funds may be transferred to the paying agent than are required to settle the actual taxes owed.

ment No. 109 (FASB 109), ''Accounting for Income Taxes,'' provides guidance on many aspects of accounting for income taxes, including the accounting for deferred tax liabilities and assets. FASB 109 describes how a bank holding company should record (1) taxes payable or refundable for the current year and (2) deferred tax liabilities and assets for the future tax consequences of events that have been recognized in the banking organization's financial statements or tax returns.

Generally, all bank holding companies must file annual income tax returns. The bank holding company can pay the entire amount of tax (that is, the amount still due after estimated tax payments) on or before the due date for filing, or it can elect to pay by the extension deadline if one is granted. Bank holding companies may receive extensions from taxing authorities to file their returns later. For the federal tax return, a six-month extension may be granted.

Bank holding companies generally pay estimated taxes throughout the year. The most common payment dates will be as follows (assuming calendar period):

April 15 — first estimate (25%)
June 15 — second estimate (25%)
September 15 — third estimate (25%)
December 15 — fourth estimate (25%)
March 15 — Due date for income tax return for U.S. corporations or foreign corporations with offices in the United States. Last day for filing for the automatic six-month extension.
September 15 — Due date of return if six-month extensions were granted.

The bank holding company will calculate the amount of the estimated payments to the Internal Revenue Service by using one of two methods: (1) prior year's tax liability (most commonly used) or (2) 90 percent of the estimated tax based on the current year's estimated taxable income.

Bank holding companies have engaged in intercorporate income tax settlements that have the effect of transferring assets and income from a bank subsidiary to the parent company in excess of those settlements that would be consistent with the Board's 1978 policy statement. The Board will apply appropriate supervisory remedies to situations that are considered inequitable or improper. These remedies may include, under certain circumstances, the Board's cease-and-desist powers.

On occasion, bank holding companies have used deferred tax assets as a vehicle to transfer cash or other earning assets of subsidiaries, principally from the bank, into the parent company. The Board's opinion is that each deferred tax asset or liability must remain on the books of the subsidiary. If deferred tax assets have been transferred to the parent, regardless of when the transfer may have occurred, immediate arrangements must be made to return the asset to the appropriate subsidiary. Instances of transferring deferred tax assets to the parent are worthy of inclusion in the Examiner's Comments and Matters Requiring Special Board Attention, page one of the inspection report.

2070.0.1 INTERAGENCY POLICY STATEMENT ON INCOME TAX ALLOCATION IN A HOLDING COMPANY STRUCTURE

The federal bank and savings association's regulatory agencies (the agencies) issued the following policy statement to provide guidance to banking organizations and savings associations regarding the allocation and payment of taxes among a holding company and its subsidiaries. A holding company and its subsidiaries will often file a consolidated group income tax return. However, for bank regulatory purposes, each depository institution of the consolidated group is viewed as, and reports as, a separate legal and accounting entity. Accordingly, each depository institution's applicable income taxes, reflecting either an expense or benefit, should be recorded as if the institution had filed as a separate tax-paying entity.[2] The amount and timing of payments or refunds should be no less favorable to a subsidiary than if it was a separate taxpayer. Any practice that is not consistent with this policy statement may be viewed as an unsafe and unsound practice prompting either informal or formal corrective action. See SR-98-38.

2070.0.1.1 Tax-Sharing Agreements

A holding company and its subsidiary institutions are encouraged to enter into a written,

2. Throughout the policy statement, the terms ''separate entity'' and ''separate taxpayer'' are used synonymously. When a depository institution has subsidiaries of its own, the institution's applicable income taxes on a separate-entity basis include the taxes of the subsidiaries *of the institution* that are included with the institution in the consolidated group return.

comprehensive tax-allocation agreement tailored to their specific circumstances. The agreement should be approved by the respective boards of directors. Although each agreement will be different, tax-allocation agreements usually address certain issues common to consolidated groups.

Therefore, such an agreement should—

1. require a subsidiary depository institution to compute its income taxes (both current and deferred) on a separate-entity basis;
2. discuss the amount and timing of the institution's payments for current tax expense, including estimated tax payments;
3. discuss reimbursements to an institution when it has a loss for tax purposes; and
4. prohibit the payment or other transfer of deferred taxes by the institution to another member of the consolidated group.

2070.0.1.2 Measurement of Current and Deferred Income Taxes

Generally accepted accounting principles, instructions for the preparation of both the Thrift Financial Report and the federally supervised bank Reports of Condition and Income, and other guidance issued by the agencies require depository institutions to account for their current and deferred tax liability or benefit.

When the depository-institution members of a consolidated group prepare separate bank regulatory reports, each subsidiary institution should record current and deferred taxes as if it files its tax returns on a separate-entity basis, regardless of the consolidated group's tax-paying or -refund status. Certain adjustments for statutory tax considerations that arise in a consolidated return, e.g., application of graduated tax rates, may be made to the separate-entity calculation as long as they are made on a consistent and equitable basis among the holding company affiliates.

In addition, when an organization's consolidated income tax obligation arising from the alternative minimum tax (AMT) exceeds its regular tax on a consolidated basis, the excess should be consistently and equitably allocated among the members of the consolidated group. The allocation method should be based upon the portion of tax preferences, adjustments, and other items generated by each group member which causes the AMT to be applicable at the consolidated level.

2070.0.1.3 Tax Payments to the Parent Company

Tax payments from a subsidiary institution to the parent company should not exceed the amount the institution has properly recorded as its current tax expense on a separate-entity basis. Furthermore, such payments, including estimated tax payments, generally should not be made before the institution would have been obligated to pay the taxing authority had it filed as a separate entity. Payments made in advance may be considered extensions of credit from the subsidiary to the parent and may be subject to affiliate transaction rules, i.e., sections 23A and 23B of the Federal Reserve Act.

A subsidiary institution should not pay its deferred tax liabilities or the deferred portion of its applicable income taxes to the parent. The deferred tax account is not a tax liability required to be paid in the current reporting period. As a result, the payment of deferred income taxes by an institution to its holding company is considered a dividend subject to dividend restrictions,[3] not the extinguishment of a liability. Furthermore, such payments may constitute an unsafe and unsound banking practice.

2070.0.1.4 Tax Refunds from the Parent Company

An institution incurring a loss for tax purposes should record a current income tax benefit and receive a refund from its parent in an amount no less than the amount the institution would have been entitled to receive as a separate entity. The refund should be made to the institution within a reasonable period following the date the institution would have filed its own return, regardless of whether the consolidated group is receiving a refund. If a refund is not made to the institution within this period, the institution's primary federal regulator may consider the receivable as either an extension of credit or a dividend from the subsidiary to the parent. A parent company may reimburse an institution more than the

3. These restrictions include the prompt-corrective-action provisions of section 38(d)(1) of the Federal Deposit Insurance Act (12 U.S.C. 1831o(d)(1)) and its implementing regulations: for insured state nonmember banks, 12 CFR 325, subpart B; for national banks, 12 CFR section 6.6; for savings associations, 12 CFR 565; and for state member banks, 12 CFR 208.45.

refund amount it is due on a separate-entity basis. Provided the institution will not later be required to repay this excess amount to the parent, the additional funds received should be reported as a capital contribution.

If the institution, as a separate entity, would not be entitled to a current refund because it has no carry-back benefits available on a separate-entity basis, its holding company may still be able to utilize the institution's tax loss to reduce the consolidated group's current tax liability. In this situation, the holding company may reimburse the institution for the use of the tax loss. If the reimbursement will be made on a timely basis, the institution should reflect the tax benefit of the loss in the current portion of its applicable income taxes in the period the loss is incurred. Otherwise, the institution should not recognize the tax benefit in the current portion of its applicable income taxes in the loss year. Rather, the tax loss represents a loss carryforward, the benefit of which is recognized as a deferred tax asset, net of any valuation allowance.

Regardless of the treatment of an institution's tax loss for regulatory reporting and supervisory purposes, a parent company that receives a tax refund from a taxing authority obtains these funds as agent for the consolidated group on behalf of the group members.[4] Accordingly, an organization's tax-allocation agreement or other corporate policies should not purport to characterize refunds attributable to a subsidiary depository institution that the parent receives from a taxing authority as the property of the parent.

2070.0.1.5 Income-Tax-Forgiveness Transactions

A parent company may require a subsidiary institution to pay it less than the full amount of the current income tax liability that the institution calculated on a separate-entity basis. Provided the parent will not later require the institution to pay the remainder of the current tax liability, the amount of this unremitted liability should be accounted for as having been paid with a simultaneous capital contribution by the parent to the subsidiary.

In contrast, a parent cannot make a capital contribution to a subsidiary institution by ''forgiving'' some or all of the subsidiary's deferred tax liability. Transactions in which a parent ''forgives'' any portion of a subsidiary institution's deferred tax liability should not be reflected in the institution's regulatory reports. These transactions lack economic substance because each member of the consolidated group is jointly and severally liable for the group's potential future obligation to the taxing authorities. Although the subsidiaries have no direct obligation to remit tax payments to the taxing authorities, these authorities can collect some or all of a group liability from any of the group members if tax payments are not made when due.

2070.0.2 QUALIFYING SUBCHAPTER S CORPORATIONS

The Small Business Job Protection Act of 1996 made changes to the Internal Revenue Code (the code). On October 29, 1996, the FFIEC issued a bulletin notifying all federally insured banks and thrifts of the impact of these changes. Thrift organizations may qualify for Subchapter S corporation status under the code's revisions and could generally receive pass-through tax treatment for federal income tax purposes if certain criteria are met.

The bulletin states that no formal application is required to be filed with the federal bank and thrift regulatory agencies merely as a result of an election by a bank, thrift, or parent holding company to become a Subchapter S corporation. However, if an institution takes certain steps to meet the criteria to qualify for this tax status, particularly the code's limitations on the number and types of shareholders, applications or notices to the agencies may be required.

The FFIEC bulletin also states that any distributions made by the Subchapter S banking organization to its shareholders, including distributions intended to cover shareholders' personal tax liabilities for their shares of the income of the institution, will continue to be regarded as dividends and subject to any limitations under relevant banking law. See SR-96-26.

2070.0.3 INSPECTION OBJECTIVES

1. To determine whether the supervisory and accounting guidance set forth in FASB 109, other tax-accounting standards, and the 1998 interagency policy statement on income tax allocation has been appropriately, equitably, and consistently applied.

4. See 26 CFR 1.1502-77(a).

2. To verify that the parent's intercorporate tax policy contains a provision requiring the subsidiaries to receive an appropriate refund from the parent when they incur a loss, and that such a refund would have been receivable from the tax authorities if the subsidiary was filing a separate return.
3. To ascertain that tax payments and tax refunds between financial institution subsidiaries and the parent company have been limited to no more than what the institution might have paid to or received from the tax authorities, if it had filed its tax returns on a timely, separate-entity basis.[5]
4. To determine that no deferred tax liability, corresponding asset, or the deferred portion of its applicable income taxes has been transferred from a bank subsidiary to the parent company.
5. To verify that there has been proper accountability for tax-forgiveness transactions between the parent company and its financial institution subsidiaries.
6. To substantiate that corporate practices are consistent with corporate policies.

2070.0.4 INSPECTION PROCEDURES

1. Obtain and discuss with the bank holding company's management its intercorporate income tax policies and tax-sharing agreements. Obtain and retain a copy of the intercorporate tax policies and agreements in the workpaper files. Review the written intercorporate tax-settlement policy and ascertain that it includes the following:
   a. a description of the method(s) used in determining the amount of estimated taxes paid by each subsidiary to the parent
   b. an indication of when payments are to be made
   c. a statement that deferred taxes are maintained on the affiliate's general ledger
   d. procedures for handling tax claims and refunds

Bank holding companies should also have written tax-sharing agreements with their subsidiaries that specify intercorporate tax-settlement policies. The Board encourages bank holding companies to develop such agreements. For tax-sharing agreements, the following inspection procedures should be followed:

   a. Determine whether each subsidiary is required to compute its income taxes (current and deferred) on a separate-entity basis.
   b. Ascertain if the amount and timing of payments for current tax expense, including estimated tax payments, are discussed.
   c. Determine if reimbursements are discussed when an institution has a loss for tax purposes.
   d. Determine if there is a prohibition on the payment or other transfer of deferred taxes by an institution to another member of the consolidated group.
2. Review briefly the parent's intercompany transaction report; general ledger income tax accounts; cash receipts and disbursements; and, if necessary, tax-return workpapers and other pertinent corporate documents.
   a. Ascertain that the taxes collected by the parent company from each depository institution subsidiary do not exceed the amount that would have been paid if a separate return had been filed.
   b. When depository institution subsidiaries are making their tax payments directly to the taxing authorities, determine whether other subsidiaries are paying their proportionate share.
3. Review the separate regulatory reports for depository institution members of the holding company that are included in the filing of a consolidated tax return.
   a. Verify that each subsidiary institution is recording current and deferred taxes as if it was filing its own tax returns on a separate-entity basis.
   b. Ascertain that any adjustments for statutory tax considerations, arising from filing a consolidated return, are also made to the separate-entity calculations consistently and equitably among the holding company affiliates.
4. Determine if any excess amounts (tax benefits), resulting from the filing of a consolidated return, are consistently and equitably allocated among the members of the consolidated group.
5. Review the tax payments that are made from the bank and the nonbank subsidiaries to the parent company.

5. The term ''separate-entity basis'' recognizes that certain adjustments, in particular tax elections in a consolidated return, may, in certain periods, result in higher payments by the bank than would have been made if the bank was unaffiliated.

a. Determine that payments, including estimated payments, that are being requested do not significantly precede the time that a consolidated or estimated current tax liability would be due and payable by the parent to the tax authorities.
b. Verify with management that the tax payments to the parent company were not in excess of the amounts recorded by its depository institution subsidiaries as current tax expense on a separate-entity basis.
c. Determine that subsidiary institutions are not paying their deferred tax liabilities on the deferred portions of their applicable income taxes to the parent company.
d. Ascertain that the parent company is not deriving tax monies from depository institution subsidiaries that are used for other operating needs.

6. When a subsidiary incurs a loss, review the tax system to determine that bank and nonbank subsidiaries are receiving an appropriate refund from the parent company, that is, an amount that is no less than what would have been received if the tax return had been filed on a separate-entity basis.
   a. Verify that the refund(s) are received no later than the date the institutions would have filed their own returns and that the refund is not characterized as the parent company's property.
   b. If the parent company does not require a subsidiary to pay its full amount of current tax liability, ascertain that the amount of the tax liability is recorded as having been paid and that the corresponding credit is recorded as a capital contribution from the parent company to the subsidiary.
7. Determine that the deferred tax accounts of each bank subsidiary are maintained on its books and that they are not transferred to the parent organization.
8. Determine if the Internal Revenue Service or other tax authorities have assessed any additional tax payments on the consolidated group, and whether the holding company has provided an additional reserve to cover the assessment.
9. Complete the Other Supervisory Issues page of the Report of Bank Holding Company Inspection (FR 1225 and FR 1241).
10. Verify the accuracy of the FR Y-8, Report of Intercompany Transactions, pertaining to the information on tax settlements.

2070.0.5 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
FFIEC Policy Statement on Income Tax Allocation in a Holding Company Structure			4-870	1999 FRB 111

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. *Federal Reserve Regulatory Service* reference.

The purpose of this Section is to discuss the types of funding ordinarily found in holding companies and to analyze their respective characteristics. It is not intended that this section include an analysis of the inter-relationships of these factors because that will be addressed in the various subsections of Section 4000 of the Manual.

The three major types of funding are short-term debt, long-term debt and equity. The ideal ''hypothetical'' holding company balance sheet would reflect sufficient equity to fund total bank and nonbank capital needs.

The complexity of the debt and/or equity financing will depend greatly upon the size and financial status of the holding company as well as the access to certain capital markets. The small holding company will be limited in the type and/or sophistication of financing instruments available for its use, and probably would look to local sources for its debt and equity needs. This would include sale of equity and debt instruments to owners of the holding company. The medium-sized holding company has access to public markets through investment bankers and occasionally may issue its own corporate notes in the commercial paper market. The large holding company has a wide range of choices depending upon its financial condition and the economic climate at the time of any offering. It also has the ability to place debt privately as an alternate to dealing with public markets. In summary, the type of financing needed by a holding company will vary with the size and nature of its banking and nonbanking operations. The following subsections address those issues.

A key principle underlying the Federal Reserve's supervision of bank holding companies is that such companies should be operated in a way that promotes the soundness of their subsidiary banks. Holding companies are expected to avoid funding strategies or practices that could undermine public confidence in the liquidity or stability of their banks. Consequently, bank holding companies should develop and maintain funding programs that are consistent with their lending and investment activities and that provide adequate liquidity to the parent company and its nonbank subsidiaries.

2080.05.1 FUNDING AND LIQUIDITY

A principal objective of a parent bank holding company's funding strategy should be to support capital investments in subsidiaries and long-term assets with capital and long-term sources of funds. Long-term or permanent financing not only reduces funding and liquidity risks, but also provides an organization with investors and lenders that have a long-run commitment to its viability. Long-term financing may take the form of term loans, long-term debt securities, convertible debentures, subordinated debt, and equity.

In general, liquidity can be measured by the ability of an organization to meet its maturing obligations, convert assets into cash with minimal loss, obtain cash from other sources, or roll over or issue new debt obligations. A major determinant of a bank holding company's liquidity position is the level of liquid assets available to support maturing liabilities. The use of short-term debt, including commercial paper, to fund long-term assets can result in unsafe and unsound banking conditions, especially if a bank holding company does not have alternative sources of liquidity or other reliable means to refinance or redeem its obligations. In addition, commercial paper proceeds should not be used to fund corporate dividends or pay current expenses. Funding mismatches can exacerbate an otherwise manageable period of financial stress or, in the extreme, undermine public confidence in an organization's viability. For this reason, bank holding companies, in managing their funding positions, should control liquidity risk by maintaining an adequate cushion of liquid assets to cover short-term liabilities. Holding companies should at all times have sufficient liquidity and funding flexibility to handle any runoff, whether anticipated or unforeseen, of commercial paper or other short-term obligations—without having an adverse impact on their subsidiary banks.

This objective can best be achieved by limiting the use of short-term debt to funding assets that can be readily converted to cash without undue loss. It should be emphasized, however, that the simple matching of the maturity of short-term debt with the stated or nominal maturity of assets does not, by itself, adequately ensure an organization's ability to retire its short-term obligations if the condition of the underlying assets precludes their timely sale or liquidation. In this regard, it is particularly important that parent company advances to subsidiaries be considered a reliable source of liquidity only to the extent that they fund assets of high quality that can readily be converted to cash. Consequently, effective procedures to monitor and ensure on an ongoing basis the quality and liquidity of the assets being funded by short-term debt are critical elements of a holding company's overall funding program.

Bank holding companies should establish and maintain reliable funding and contingency plans to meet ongoing liquidity needs and to address any unexpected funding mismatches that could develop over time. Such plans could include reduced reliance on short-term purchased funds, greater use of longer-term financing, appropriate internal limitations on parent company funding of long-term assets, and reliable alternate sources of liquidity. It is particularly important that bank holding companies have reliable plans or backup facilities to refinance or redeem their short-term debt obligations in the event assets being funded by these obligations cannot be liquidated in a timely manner when the debt must be repaid. In this connection, holding companies relying on backup lines of credit for contingency plan purposes should seek to arrange standby facilities that will be reliable during times of financial stress, rather than facilities that contain clauses which may relieve the lender of the obligation to fund the borrower in the event of a deterioration in the borrower's financial condition.

In developing and carrying out funding programs, bank holding companies should avoid overreliance or excessive dependence on any single short-term or potentially volatile source of funds, such as commercial paper, or any single maturity range. Prudent internal liquidity

policies and practices should include specifying limits for, and monitoring the degree of reliance on, particular maturity ranges and types of short-term funding. Special attention should be given to the use of overnight money since a loss of confidence in the issuing organization could lead to an immediate funding problem. Bank holding companies issuing overnight liabilities should maintain on an ongoing basis a cushion of superior quality assets that can be immediately liquidated or converted to cash with minimal loss. The absence of such a cushion or a clear ability to redeem overnight liabilities when they become due should generally be viewed as an unsafe and unsound banking practice.

2080.05.2 ADDITIONAL SUPERVISORY CONSIDERATIONS

Bank holding companies and their nonbank affiliates should maintain sufficient liquidity and capital strength to provide assurance that outstanding debt obligations issued to finance the activities of these entities can be serviced and repaid without adversely affecting the condition of the affiliated bank(s). In this regard, bank holding companies should maintain strong capital positions to enable them to withstand potential losses that might be incurred in the sale of assets to retire holding company debt obligations. It is particularly important that a bank holding company not allow its liquidity and funding policies or practices to undermine its ability to act as a source of strength to its affiliated bank(s).

The principles and guidelines outlined above constitute prudent financial practices for bank holding companies and most businesses in general. Holding company boards of directors should periodically assure themselves that funding plans, policies and practices are prudent in light of their organizations' overall financial condition. Such plans and policies should be consistent with the principles outlined above, including the need for appropriate internal limits on the level and type of short-term debt outstanding and the need for realistic and reliable contingency plans to meet any unanticipated runoff of short-term liabilities without adversely affecting affiliated banks.

2080.05.3 EXAMINER'S APPLICATION OF PRINCIPLES IN EVALUATING LIQUIDITY AND IN FORMULATING CORRECTIVE ACTION PROGRAMS

Reserve Bank examiners should be guided by these principles in evaluating liquidity and in formulating corrective action programs for bank holding companies that are experiencing earnings weaknesses or asset-quality problems, or that are otherwise subject to unusual liquidity pressures. In particular, bank holding companies with less than satisfactory parent or consolidated supervisory ratings (that is, 3 or worse), or any other holding companies subject to potentially serious liquidity or funding pressures, should be asked to prepare a realistic and specific action plan for reducing or redeeming entirely their outstanding short-term obligations without directly or indirectly undermining the condition of their affiliated bank(s).[1] Such contingency plans should be reviewed and evaluated by Reserve Bank supervisory personnel during or subsequent to on-site inspections. Any deficiencies in the plan, if not addressed by management, should be brought to the attention of the organization's board of directors. If the liquidity or funding position of such a company appears likely to worsen significantly, or if the company's financial condition worsens to a sufficient degree, the company should be expected to implement on a timely basis its plan to curtail or eliminate its reliance on commercial paper or other volatile, short-term sources of funds. Any decisions or steps taken by Reserve Banks in this regard should be discussed and coordinated with Board staff.

Reference should also be made to other manual sections that address funding, cash flow, or liquidity (for example, 2010.1, 2080.0, 2080.1, 2080.2, 2080.4, 2080.5, 2080.6, 4010.0, 4010.1, 4010.2, 5010.27, and 5010.28).

1. It is important to note that there are securities registration requirements under the Securities Act of 1933 related to the issuance of commercial paper. A bank holding company should have procedures in place to ensure compliance with all applicable securities and SEC requirements. Refer to manual section 2080.1.

Commercial paper is a generic term that is generally used to describe short-term unsecured promissory notes issued by well-recognized and generally financially sound corporations. The largest commercial paper issuers are finance companies and bank holding companies which use the proceeds as a source of funds in lieu of fixed rate borrowing.

Generally accepted limitations on issuances and uses of commercial paper derive from Section 3(a)(3) of the Securities Act of 1933 (1933 Act). Section 3(a)(3) exempts from the registration requirements of the 1933 Act ''any note . . . which arises out of a current transaction or the proceeds of which have been or are to be used for current transactions and which has a maturity at the time of issuance not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited. . . .'' The Securities and Exchange Commission (SEC) has rulemaking authority over the issuance of commercial paper.

The five criteria, as set forth in an SEC interpretation (SA Release #33–4412, September 20, 1961), that are deemed necessary to qualify securities for the commercial paper exemption are that the commercial paper must:

- Be of prime quality and negotiable;
- Be of a type not ordinarily purchased by the general public;
- Be issued to facilitate current operational business requirements;
- Be eligible for discounting by a Federal Reserve Bank;
- Have a maturity not exceeding nine months.

2080.1.1 MEETING THE SEC CRITERIA

The above criteria are discussed below.

2080.1.1.1 Nine-Month Maturity Standard

Although roll-over of commercial paper proceeds on maturity is common, the SEC has stated that obligations that are payable on demand or have provisions for automatic roll-over do not satisfy the nine-month maturity standard. However, the SEC staff has issued ''no action'' letters for commercial paper master note agreements which allow eligible investors to make daily purchases and withdrawals (subject to a minimum amount of $25,000) as long as the note and each investor's interest therein, does not exceed nine months. Such master note agreements may permit prepayment by the issuer, or upon demand of the investor, at any time.

2080.1.1.2 Prime Quality

Most commercial paper is rated by at least one of five nationally recognized statistical rating organizations. The SEC has not clearly articulated the line at which it will regard a specific rating of commercial paper as being ''not prime'' and, indeed, there is no requirement that a rating be obtained at all in order to qualify. SEC staff has issued a series of ''no-action'' letters to individual bank holding companies based on specific facts and circumstances even where it does not appear that a rating was obtained. However, where commercial paper is downgraded to below what is generally regarded as ''investment quality'' (ratings of less than medium grade—refer to the *Commercial Bank Examination Manual*, section 203.1), or a rating is withdrawn, BHCs may not be able to issue commercial paper based on the Section 3(a)(3) exemption, in the absence of a marked significant improvement in the issuer's financial condition.

2080.1.1.3 Current Transactions

There have been considerable interpretative problems arising out of the current transactions concept. The SEC staff has issued a partial laundry list of activities which would not be deemed suitable for investment of commercial paper proceeds, namely:

1. The discharge of existing indebtedness, unless such indebtedness is itself exempt under section 3(a)(3) of the 1933 Act;
2. The purchase or construction of a plant or the purchase of durable machinery or equipment;
3. The funding of commercial real estate development or financing;
4. The purchase of real estate mortgages or other securities;
5. The financing of mobile homes or home improvements; or

6. The purchase or establishment of a business enterprise.

The SEC has opined that commercial paper, which is used as bridge financing by a bank holding company to fund a permanent acquisition within the 270-day maturity period of the paper, will meet the current transactions criterion. The amount of a bank holding company's commercial paper cannot exceed the aggregate amount of ''current transactions'' of the bank holding company and its subsidiaries *on a consolidated basis*. For this purpose, ''current transactions'' include dividends, interest, taxes and short-term loan repayments. In summary, in most cases, the ''current transactions'' requirement will not be a significant limitation on issuances of commercial paper by bank holding companies.

In addition to meeting SEC requirements, a bank holding company must meet funding and liquidity criteria prescribed by the Board. For a detailed discussion on acceptable use of commercial paper in connection with a bank holding company overall funding strategies, see Sections 2080.05 and 2080.6.

2080.1.1.4 Sales to Institutional Investors

Commercial paper is generally marketed only to institutional investors (corporations, pension funds, insurance companies, etc.) although sales to individuals are not prohibited. It is clear, however, from the legislative history of the Section 3(a)(3) exemption that commercial paper was not to be marketed for sale to the general public. Currently, SEC staff will not issue a no-action letter if the minimum denomination of the commercial paper to be issued is less than $25,000. One of the underlying premises of the Section 3(a)(3) exemption is that purchasers of commercial paper have sufficient financial sophistication to make informed investment decisions without the benefit of the information provided by a registration statement. It is, therefore, generally recognized today that any individual purchaser of commercial paper should meet the ''accredited investor'' criteria of commercial paper set forth in SEC Regulation D (17 C.F.R 230.501(a)). To qualify as an ''accredited investor'', an individual can meet one of two tests—a net worth test or an income test. To qualify under the net worth test, an individual or an individual and his or her spouse must have a net worth at the time of purchase in excess of $1 million. The alternative test requires $200,000 in income for each of the last two years ($300,000 if the spouse's income is included) and a reasonable expectation of reaching the same income level in the current year.

For additional information on marketing of commercial paper, see the next subsection.

2080.1.2 MARKETING OF COMMERCIAL PAPER

The sale of bank holding company (or nonbank subsidiary) commercial paper by an affiliated bank to depositors or other investors raises a number of supervisory issues. Of particular concern is the possibility that individuals may purchase holding company paper with the misunderstanding that it is an insured deposit or obligation of the subsidiary bank. The probability of this occurring is increased when a bank subsidiary is actively engaged in the marketing of the paper of its holding company or nonbank affiliate, or when the holding company or nonbank affiliate has a name similar to the name of the commercial bank subsidiary.

It is a long-standing policy of the Federal Reserve (refer to letters SR 90–19 and SR–620) that debt obligations of a bank holding company or a nonbank affiliate should not be issued, marketed or sold in a way that conveys the misimpression or misunderstanding that such instruments are either: 1) federally-insured deposits, or 2) obligations of, or guaranteed by, an insured depository institution. The purchase of such holding company obligations by retail depositors of an affiliated depository institution can, in the event of default, result in losses to individuals who believed that they had acquired federally-insured or guaranteed instruments. In addition to the problems created for these individuals, such a situation could impair public confidence in the affiliated depository institution and lead to unexpected withdrawals or liquidity pressures.

Events surrounding the sale of uninsured debt obligations of holding companies to retail customers of affiliated depository institutions have focused attention on the potential for problems in this area. In view of these concerns, the Federal Reserve emphasizes that this policy applies to the sale of both long- and short-term debt obligations of a bank holding company and any nonbank affiliate, as well as to the sale of uninsured debt securities issued by a state member bank or its subsidiaries. Debt obligations covered by this supervisory policy include commercial paper and all other short-term and long-

term debt securities, such as thrift notes and subordinated debentures.

Bank holding companies and nondepository affiliates that have issued or plan to issue uninsured obligations or debt securities should not market or sell these instruments in any public area of an insured depository institution where retail deposits are accepted, including any lobby area of the depository institution. Bank holding companies and any affiliates that are engaged in issuing debt obligations should establish appropriate policies and controls over the marketing and sale of the instruments. In particular, internal controls should be established to ensure that the promotion, sale, and subsequent customer relationship resulting from the sale of uninsured debt obligations is separated from the retail deposit-taking functions of affiliated depository institutions.

State member banks, including their subsidiaries, may also be engaged in issuing nondeposit debt securities (such as subordinated debt), and it is equally important to ensure that such securities are not marketed or sold in a manner that could give the purchaser the impression that the obligations are federally-insured deposits. Consequently, state member banks and their subsidiaries that have issued or plan to issue nondeposit debt securities should not market or sell these instruments in any public area of the bank where retail deposits are accepted, including any lobby area of the bank. Consistent with long-standing Federal Reserve policy, debt obligations of bank holding companies or their nonbank affiliates, including commercial paper and other short- or long-term debt securities, should prominently indicate that: 1) they are not obligations of an insured depository institution; and 2) they are not insured by the Federal Deposit Insurance Corporation. In cases where purchasers do not take physical possession of the obligation, the purchasers should be provided with a printed advice that conveys this information. Employees engaged in the sale of bank holding company debt obligations should be instructed to relate this information verbally to potential purchasers. In addition, with respect to the sale of holding company debt obligations, the instruments or related documentation should not display the name of the affiliated bank in such a way that could create confusion among potential purchasers about the identity of the obligor. State member banks involved in the sale of uninsured nondeposit debt securities of the bank should establish procedures to ensure that potential purchasers understand that the debt security is not federally-insured or guaranteed.

Federal Reserve examiners are responsible for monitoring compliance with this supervisory policy; and, as part of the examination of state member banks and bank holding companies, are expected to continue to review the polices and internal controls relating to the marketing and sale of debt obligations and securities. Examiners should determine whether the marketing and sale of uninsured nondeposit debt obligations are sufficiently separated and distinguished from retail banking operations, particularly the deposit-taking function of the insured depository affiliate.

In determining whether the activities are sufficiently separated, examiners should take into account: 1) whether the sale of uninsured debt obligations of a holding company affiliate or uninsured nondeposit debt securities of a state member bank is physically separated from the bank's retail-deposit taking function, including the general lobby area[1]; 2) whether advertisements that promote uninsured debt obligations of the holding company also promote insured deposits of the affiliated depository institution in a way that could lead to confusion; 3) whether similar names or logos between the insured depository institution and the issuing nonbank affiliate are used in a misleading way to promote securities of a nonbank affiliate without clearly identifying the obligor; 4) whether retail deposit-taking employees of the insured depository institution are engaged in the promotion or sale of uninsured debt securities of a nonbank affiliate; 5) whether information on the sale of uninsured debt obligations of a nonbank holding company affiliate is available in the retail banking area; and 6) whether retail deposit statements for bank customers also promote information on the sale of uninsured debt obligations of the bank holding company or a nonbank affiliate.

The Board's policy is that the manner in which commercial paper is sold should not lead bank customers or investors to construe commercial paper as an insured obligation or an instrument which may be higher in yield but equal in risk to insured bank deposits. All purchasers of commercial paper should clearly understand that such paper is an obligation of the parent company or nonbank subsidiary and not an obligation of the bank and that the quality

1. This policy is not intended to preclude the sale of holding company affiliate obligations from a bank's money market desk, provided that the money market function is separate from any public area where retail deposits are accepted, including any lobby area.

of the investment depends on the risks and operating characteristics associated with the overall holding company and its nonbanking activities.

2080.1.3 THRIFT NOTES AND SIMILAR DEBT INSTRUMENTS

In the event a bank holding company or nonbanking affiliate issues thrift notes or other debt obligations which do not fall within the generally accepted definition of commercial paper, examiners should be guided by the Board's 1978 position on the issuance of small denomination debt obligations by bank holding companies and their nonbanking affiliates. At that time, the Board was considering thrift notes issued by a nonbanking subsidiary of a bank holding company and concluded that such obligations should prominently indicate in bold type on their face that the obligations are not obligations of a bank and are not FDIC insured. The Board also stated that the obligations should not be sold on the premises of affiliated banks. Where there is substantial reliance on the sale of thrift notes to fund the operations of a bank holding company or nonbanking subsidiary, other than an industrial bank, a violation of the Glass–Steagall Act may be involved. Such cases should be discussed with Reserve Bank counsel.

2080.1.4 OTHER SHORT-TERM INDEBTEDNESS

A company's access to bank credit is almost universal, and most small to medium-sized companies will reflect this type of debt on their balance sheets. An important point to remember about bank debt is that maturities of the bank notes are usually short-term while the proceeds of the borrowings are often applied to long-term assets, that is, investment in the bank's capital and/or long-term debt accounts. The note may be subject to renewal on an annual basis, and the creditor may have the opportunity to call the note at renewal if the financial condition of the company has deteriorated. Rates of interest on short- term bank notes are usually pegged to the creditor's prime rate plus some fraction thereof. The principal is often repaid over a period of years as the notes are rolled over despite their short-term maturity.

2080.1.5 CURRENT PORTION OF LONG-TERM DEBT

This type of debt has many of the short-term characteristics of bank debt, with possibly one additional important feature. Such debt is usually tied to a written agreement between creditor and debtor, and encompasses certain minimum standards of performance to be adhered to by the company. The examiner must review the agreement to determine that the company is operating within the parameters of the covenants laid out in the agreement. Failure to abide by the covenants can trigger default provisions of the agreement and escalate the repayment of the total loan balance outstanding.

2080.1.6 INSPECTION OBJECTIVES

1. To determine the company's policy and actual practices with respect to the sale of uninsured debt obligations and securities issued by bank holding companies, nonbank affiliates or State member banks. More often than not, an informal policy evolves from practice. It then becomes important to interview senior officers in charge of this function to determine if they are adequately aware of the statutory and regulatory constraints with respect to appropriate usage of commercial paper.
2. To review the company's funding and liquidity strategy with a view to determining whether it has sufficient liquid assets to support maturing liabilities and whether there are any funding mismatches. (See Manual sections 2080.05, 4010.2.3, 4010.2.7, and 5010.24.1)
3. To determine compliance with the Federal Reserve System's supervisory policy with regard to the marketing of commercial paper, thrift notes or similar type debt instruments (refer to Board letter S 2427 dated June 27, 1980, and supervisory letters SR 90–19 and SR 620).
4. To identify potential weaknesses in corporate policy and practices.

2080.1.7 INSPECTION PROCEDURES

1. Review the bank holding company's procedures for authorizing the issuance of commercial paper and other uninsured debt obligations and securities of the holding company and/or its nonbank affiliates.
2. Review the board of directors' resolution authorizing the issuance of commercial paper and other uninsured debt obligations and securities.

3. Determine whether the company has sought a ''no action'' letter from the SEC. A ''no action'' letter indicates the SEC has reviewed the company's issuance of commercial paper and plans ''no action'' to require the registration of the commercial paper as ''securities.'' Some companies rely on the opinion of their own counsel that their paper is not subject to SEC registration requirements. If the company does not have a ''no action'' letter there should be a legal opinion on file from the holding company's attorney regarding exemption from registration under section 5 of the 1933 Act.

4. Obtain a copy of the holding company's written policy on paper usage to compare with resolution and practice.

5. Review to determine the extent to which the commercial paper and other uninsured debt obligations are supported by back-up lines of credit provided by unaffiliated banks. These lines are established to cover any unexpected run-off of paper at maturity. Commitments for lines of credit should be in writing and have expiration dates. Commitment fees substantiate the enforceability of the commitment whereas compensating balances tend to indicate that the lending commitment is less formal. The examiner should determine whether material adverse change clauses exist in back-up line of credit agreements which may affect their reliability. Comment if it appears that those provisions might be utilized.

Compensating balance arrangements should be disclosed. A company may commit to a compensating balance, but if it relies on its bank subsidiary to provide the funds the bank should be compensated for utilization of its funds.

Reciprocal back-up lines may be established. This may eliminate the need for fees or compensating balances and may provide a certain comfort level for company management.

6. Obtain a listing of commercial paper and other uninsured debt obligation holders from management to the extent known. In the case of larger BHCs, there is a choice between issuing paper on a local level or placing it nationally through the auspices of an investment banking firm. In the latter case, there is likely to be no record of who purchases the paper because the paper is usually sold on a bearer basis. Holding companies looking for a wider market, national recognition, and higher ratings place their paper through an investment banking firm. However, it should be recognized that the market for commercial paper placed in this manner is more sophisticated and knowledgeable and therefore more sensitive to adverse developments than a local market. The smaller company can be content to sell its paper on a local level through its corporate headquarters, knowing its customer profile and limiting the amount to any one paperholder, thereby limiting its exposure to refinancing problems caused by large scale redemptions.

7. Review for potential weaknesses in corporate policy and practices. Any amounts in excess of 10 percent in the hands of one paperholder should be discussed with management and noted in the report. A large paperholder could refuse to purchase new paper at maturity (rollover) and place the company in a liquidity squeeze, requiring sell-off of assets or draw down of back-up lines.

Rollovers are prohibited under the 1933 Act. The instrument must have a definite date of maturity with no automatic provision for reinvestment of proceeds. Companies must abide by the 270-day provision and if the paperholder elects to reinvest the funds, a new instrument should be executed.

8. Request a copy of the commercial paper, thrift note or similar type instrument, and any printed advice to the purchasing customer for review. These documents should be checked for compliance with the standards set forth under the captions ''Marketing of Commercial Paper'' and ''Thrift Notes and Similar Debt Instruments'' in this section of the Manual.

9. If a bank sells the commercial paper and/or other uninsured debt obligations of its holding company or nonbanking affiliate, review the procedures to separate their sale from the retail operations of the bank.

This segregation should be reviewed as part of all holding company inspections. Examiner judgment must be relied upon, to a large extent, to determine whether the marketing activities of commercial bank subsidiaries for the bank holding company's commercial paper and other uninsured debt obligations are sufficiently separated and distinguished from retail banking operations, particularly the deposit- taking function. In making this determination, the examiner should consider whether:

a. The sale of uninsured debt obligations of a holding company affiliate or uninsured nondeposit debt securities of a state member bank is physically separated from the bank's retail-deposit taking function, including the general lobby area;

b. Advertisements that promote uninsured debt obligations of the holding company also

promote insured deposits of the affiliated depository institution in a way that could lead to confusion;

c. Similar names or logos between the insured depository institution and the issuing nonbank affiliate are used in a misleading way to promote securities of a nonbank affiliate without clearly identifying the obligor;

d. Retail deposit-taking employees of the insured depository institution are engaged in the promotion or sale of uninsured debt securities of a nonbank affiliate;

e. Information on the sale of uninsured debt obligations of a nonbank holding company affiliate is available in the retail banking area; and

f. Retail deposit statements for bank customers also promote information on the sale of uninsured debt obligations of the bank holding company or a nonbank affiliate.

In those cases where the bank holding company or nonbanking affiliates issue thrift notes or similar type debt instruments, ascertain that these obligations are not being sold on the premises of affiliated banks.

10. The procedures in Nos. 8 and 9 address the manner in which bank holding companies (or nonbanking subsidiaries) market their commercial paper, thrift notes or similar type debt instruments; consequently, implementation will necessitate review of marketing procedures of all holding companies (or nonbanking subsidiaries), regardless of the type of charter or the identity of the primary supervisor of the subsidiary (affiliate) bank. Exceptions to the policies on the marketing of such paper should be noted on the ''Commercial Paper and Lines of Credit'' pages and discussed on the ''Examiner's Comments'' page of the inspection report. The managements of all bank holding companies must be fully informed of the Federal Reserve's policy with respect to the marketing of holding company debt obligations, as in SR Letter 90–19, and exceptions should be addressed in the supervisory follow-up process.

Long-term debt represents an alternative financing method to short-term debt and equity funds. Before choosing this type of funding the bank holding company will need to determine how the advantages and disadvantages of long-term debt apply to its financial position and funding needs. Interest on long-term debt is an expense item and therefore is tax deductible. The company issuing debt effectively pays approximately ''half-price'' (interest expense net of tax deduction) on debt while the company issuing equity pays the full dividend rate without a tax benefit. Counterbalancing the tax advantage is the fact that long-term debt must be serviced and retired to prevent default and cannot be used as an offset for losses.

The issuance of long-term debt will be relatively advantageous to the holding company whose price/earnings ratio is low and whose stock is selling significantly below book value. In this instance, the cost to the company of equity funding rises proportionately to the drop in the price of the stock since less funds are obtained for an equal number of shares, yet the dividend per share remains the same.

A major factor influencing a bank holding company's decision to issue long-term debt instead of equity is the dilution impact of new equity. Straight debt will not dilute ownership and is typically retired from cash flow, whereas new equity dilutes earnings per share (more so than the impact of the debt's interest expense on earnings).

Preferred stock can be retired through a sinking fund and is sometimes convertible to common shares. Convertible stock adds to the dilution effect when the conversion is exercised and prior to conversion, ''fully diluted'' earnings per share must be reported that assume full conversion. The bank holding company will consider both stockholder and market reaction to any dilution effects of long-term financing. The BHC may view debt financing as the best alternative if it feels that a diluted earnings per share would drive down the market price of its stock and contribute to stockholder discontent.

Inherent in any financing are intangible costs. While it is evident that on the surface debt financing is cheaper than equity financing, it would be hard to quantify the effects of potential missed interest payment or default associated with debt instruments. The bank holding company also will be concerned with its additional ''debt capacity'' if the present issuance of debt pushes the debt/equity ratio beyond acceptable limits.

Theoretically, ''straight debt'' is a direct secured or unsecured obligation requiring repayment at maturity and generally taking a senior position in the claim on assets. Principal is sometimes payable in a lump sum, often through the use of a sinking fund, while interest is paid at stated periods throughout the life of the note.

2080.2.1 CONVERTIBLE SUBORDINATED DEBENTURE

A convertible subordinated debenture is an unsecured debt that is subordinate to other debt and convertible to common stock at a certain date or price. The essential provision of this debt is that it may eventually be retired by equity and inherently has the potential for dilution. With this type of financing, the creditor typically has the right to convert the bond into a stated number of shares of common stock at some future time. Usually the conversion price is 10 to 15 percent above the market price of the stock. This encourages the bondholder to keep the bond until the market price meets or surpasses the conversion price. In many convertible debt agreements, the bank holding company issuing debt will have the option to call the issue when the conversion price equals the market price.

The bank holding company will issue a convertible subordinated debenture when its stock price is depressed. The convertibility provision is added as a ''sweetner'' to the issue and counteracts the negative aspect of its subordinated position. The subordinated nature of this issue will help a bank holding company with prior debt which includes covenants that dictate against additional senior debt.

2080.2.2 CONVERTIBLE PREFERRED DEBENTURE

This debt instrument is similar to straight convertible debt except it is convertible into preferred stock. This alternative is open to the bank holding company which needs to add a ''sweetner'' to this issue in order to market it, but does not want dilution of ''common'' ownership.

2080.2.3 NEGATIVE COVENANTS

The lender will be concerned with the borrower's debt structure when offering financing. If the borrower's debt/equity ratio is approaching an unacceptable level, the lender will try to assure that the bank holding company does not overextend itself. While the lender may demand the right to approve future equity issues, the lender is likely to be more willing to give such approval than to allow more debt because the equity issue adds to the capital base, and this base is a possible source of funds for the payment of debt.

Closely related to the restriction on further debt is the position of the lender in the liquidation of assets. The holder of a straight debt issue will usually demand to be senior to other debt holders. This characteristic is particularly suited to straight debt because straight debt is more vulnerable to default than convertible debt and doesn't have other sweetners such as a conversion right or a right to participate in distributions of earnings. The examiner will want to determine how the covenants affect future debt financing and if the effect is positive or negative.

The lender is likely to seek to insure that neither the structure nor policies of the bank holding company are altered without its approval during the life of the debt. The lender can insure this through other negative covenants attached to the debt. Some common covenants of this type include (1) limitations on capital expenditures and on the sale of assets, (2) restrictions on the BHC's redemption of its own stock, (3) restrictions on investments in general, (4) restrictions on dividend payment without prior approval, and (5) the imposition of loan to capital ratios, deposit to capital ratios and asset to capital ratios.

2080.2.4 INSPECTION OBJECTIVES

1. To determine the existence of and adherence to policies on long-term debt.
2. To review the use of long-term funds.
3. To determine the existence of debt covenants and compliance by the holding company.

2080.2.5 INSPECTION PROCEDURES

1. Review the parent-only balance sheet and income statement for debt and interest expense captions.
2. Review the consolidated balance sheet and income statement for debt and interest expense captions.
3. Review any written policies and procedures available as part of an overall capital plan. If no plan or policies exist, the examiner should encourage management to develop them, and in large BHCs, to put them in writing.
4. Determine that the bank holding company does not finance long-term assets with short-term debt, as this leaves the holding company vulnerable to rising interest rates and the possibility of a credit crunch. On the other hand, it may be beneficial for the holding company to finance short-term assets with long-term debt. This is particularly true during periods of rising interest rates because the bank holding company can get higher yields on loans financed by lower cost long-term debt, than it can with commercial paper that has to be turned over at generally increasing rates. In any event, the bank holding company will need to insure that it has ample capacity to finance additional long-term assets with long-term debt when the opportunity presents itself.
5. Review any sinking fund provisions usually found with straight debt and straight preferred issues if the issue is not going to be refinanced by further debt or by an equity issue. Since payments to the fund will directly drain cash reserves, it is imperative that the bank holding company have adequate annual cash flow to service both the interest and add to the sinking fund. The larger the debt, the more the lender will look for a sinking fund feature as a means of precluding a default when maturity occurs and refinancing is not available. When a sinking fund exists the examiner will need to analyze the parent's cash flow statement to see that payments do not produce an adverse cash drain.

The capacity of the holding company to serve as a source of financial strength to its bank subsidiaries is a major consideration of the Federal Reserve Board in supervising a bank holding company. The cornerstone of this financial strength is capital adequacy.

The financial structure of banking organizations allows for the use of substantial leverage. If capital is large in relation to debt, additional borrowing is relatively inexpensive. However, because of added risk to lenders, the cost of borrowing increases as new obligations are assumed. At some point, therefore, equity financing becomes less costly and may become the only alternative available for needed funds.

Basically, a holding company's financial structure can be viewed in two ways: the ''single entity'' approach, whereby the holding company is considered an integrated entity and financial strength is assessed on the basis of its consolidated totals, and the ''building block'' approach, wherein the holding company is seen as a collection of individual components. In the latter view, the company's financial strength is assessed primarily in terms of the financial structure of each component.

When applying the ''building block'' approach, the liability and capital structure of each subsidiary is compared to the norm of its particular industry. The use of the ''building block'' approach has some advantages:

1. Comparative statistics are usually available to measure the performance and strength of the individual subsidiaries.

2. It permits comparison of capitalization between holding companies engaged in differing activities.

3. It identifies the degree of leveraging within a single subsidiary of a bank holding company.

The parent should maintain a favorable balance of debt and equity so that it will be able to assist its subsidiaries when necessary through contributions of its own capital or through additional funds generated from debt or equity financing.

At times, however, sale of additional stock may not be a viable alternative for capital formation, even when a company can show a favorable debt/equity balance. Reluctance to enter into a new stock offering may stem from a desire to avoid further dilution of existing ownership interest or from an unfavorable market price of outstanding stock in relation to book value. In these instances, long-term quasi-capital funds may sometimes be obtained through other sources, such as convertible securities or subordinated debt.

2080.3.1 PREFERRED STOCK

Preferred stock is becoming a more acceptable alternative due to certain advantages. Through contracted covenants, it is senior to common stock because it usually has no voting voice in management as does common stock. Preferred stock usually carries a fixed dividend rate that is either cumulative or noncumulative. Cumulative preferred provides that unpaid dividends in prior years must be paid to preferred shareholders before common dividends can be paid. A noncumulative feature provides that dividends foregone during lean years are lost permanently. From the viewpoint of the bank holding company, a noncumulative preferred issue is more desirable, while investors would desire a cumulative feature.

Perpetual preferred stock does not have a stated maturity date and it may not be redeemed at the option of the holder. Advantages that preferred stock can offer the bank holding company are (1) avoidance of dilution of earnings per common share and (2) absence of voting rights. On the other hand, dividend payments, particularly cumulative dividends, are expensive since they are not a tax-deductible expense as is interest on debt. Cumulative dividends can be particularly draining on cash when they are declared after several years of suspended dividends and payment is then made in a lump sum.

Preferred stock is usually retired by refinancing with debt or through its own conversion feature. If the bank holding company feels that it can afford an equity issue in the future but not at present, it can issue a convertible preferred debenture to postpone the equity issue until a later date. On the other hand, if debt is the desired method of financing but the present debt/equity ratio is not acceptable, the bank holding company will issue preferred and refinance with debt at a more opportune time. However, the Board has expressed concern that in applications to form a BHC, preferred stock not be used as a debt substitute resulting in circumvention of its debt guidelines. On applications with preferred stock which has debt-like characteris-

tics, such stock may be treated as debt in the financial analysis.

2080.3.2 INSPECTION OBJECTIVES

1. To determine the existence of and adherence to parent company policies on capital adequacy within the subsidiaries and for the consolidated organization.
2. To review the use of proceeds of equity capital financings.
3. To review any debt covenants that pertain to a minimum acceptable capital position.

2080.3.3 INSPECTION PROCEDURES

1. Review any existing BHC policies regarding capital adequacy or capital planning.
2. Request any plans regarding proposed capital issues.

Earnings retention provides the most immediate source of capital formation and growth. Earnings retained after dividend payout can often be sufficient to keep pace with asset growth, thereby preserving the balance or relationship between equity capital and total assets. Often referred to as ''internal funding,'' earnings retention should be carefully reviewed to assure that the BHC's capital base is keeping pace with asset growth.

Bank earnings retention should be reviewed carefully due to the dividend requirements often imposed on banks by their parent companies. Although a bank's board of directors must approve the declaration and payment of any bank dividend, often the bank's board is actually ratifying a decision determined at the parent level. The need for bank retention of earnings is particularly pronounced either during periods of expansion or periods of declining earnings or losses.

Parent company management may be under pressure from shareholders or ''the market'' to increase dividends or to maintain dividends at historic levels despite reversals in consolidated earnings trends. Examiners should be careful to point out to management that dividend pressures often serve to the detriment of the bank subsidiary(ies) which is often asked to supply the proceeds via a dividend to the parent company. As a regulator of banks (and bank holding companies), the Federal Reserve System is concerned with the preservation and maintenance of a sound banking system and in particular, soundly capitalized banks. Earnings retention contributes to capital growth and should be encouraged. For additional information on earnings retention and dividends see sections 2020.5.1, 4010.1, and 4020.1.

2080.4.1 PAYMENT OF DIVIDENDS BY BANK SUBSIDIARIES

Bank dividends can be determined to be excessive if they exceed the limitations imposed by either section 5199(b) or 5204 (also referred to as sections 56 and 60(b)) of the Revised Statutes and accordingly, should be reviewed with regard to those limitations. The Federal Reserve Board amended Regulation H on December 20, 1990, regarding the payment of dividends by state member banks [12 C.F.R. 208.19(a) and 208.19(b)]. These new regulations make the elements that are taken into account in determining a state member bank's dividend paying capacity more consistent with generally accepted accounting principles. Two different calculations are performed to measure the amount of dividends that may be paid, a Net Profits Test and an Undivided Profits Test.

2080.4.1.1 Net Profits Test

The approval of the Federal Reserve is required for dividends declared by a member bank that in any calendar year exceeds the net profits of the current year, combined with retained net profits for the two proceeding years (the ''Net Profits Test''). Under the regulation, net profits of a year will equal net income. A member bank is required to use these rules in calculating net profits beginning in 1991 and thereafter.

2080.4.1.2 Undivided Profits Test

The parent company's bank subsidiaries must receive prior approval of the Federal Reserve before paying dividends in amounts greater than undivided profits then on hand, after deducting any bad debts in excess of the allowance for loan and lease losses. Under the regulations effective January 25, 1991, undivided profits then on hand include undivided profits plus the amount of ''surplus surplus'' that meets certain conditions. ''Surplus surplus'' is defined as the amount of capital surplus in excess of the amount required under applicable state law, and the regulations provide that a bank may include surplus surplus in undivided profits then on hand only if the bank can demonstrate that surplus surplus is from earnings of prior periods (''earned surplus surplus''). Transfers from surplus surplus to undivided profits must receive prior approval of the Federal Reserve. Bad debts in excess of the allowance for loan and lease losses must be subtracted from undivided profits then on hand in calculating the amount available for dividends. Bad debts are defined as debts due and unpaid for a period of six months unless well secured and in the process of collection.[1]

1. Because for most banks bad debts are less than the allowance for loan and lease losses, this subtraction will not apply to most banks.

Holding companies have turned to employee pension plans and, to a lesser degree, stock option plans as ways to provide added capital for holding company operations. While there may be a number of reasons for implementing such programs, one of the by-products is the flow of working capital into the holding company. The program usually involves a pre-tax contribution by the holding company to an employee benefit plan (e.g., profit sharing plan) and the resulting purchase by such plan of common or preferred shares of the holding company's stock. The holding company benefits through the use of the funds for working capital, and the plan provides for retirement benefits for employees as shareholders in the company. Since ESOPs are administered under the Employees Retirement Income Security Act of 1974 (ERISA), the guidelines delineated in SR 85–21 should be followed in determining whether possible ERISA violations exist. Reference should also be made to Manual section 4010.1.1.

2080.5.1 STOCK OPTION PROGRAMS

Employee stock option programs generate a nominal percentage of a holding company's financing needs to reward key employees for service rendered via the reduced price of the company's stock. While such programs constitute one method of available funding for a holding company, they generally may not be expected to add any capital amounts beyond nominal levels.

2080.5.2 EMPLOYEE STOCK OWNERSHIP PLANS (ESOPS)

Employee Stock Ownership Plans (ESOP) are an alternative holding company funding tool. An ESOP is a tax-qualified employee benefit plan which is designed to be invested primarily in employer stock. The concept of an ESOP is to encourage the establishment of employee benefit programs which expand the employees' share in company stock ownership. Participation in an ESOP may also significantly enhance employee motivation. The essential differences between an ESOP and other qualified stock bonus plans are that an ESOP is permitted, in certain circumstances, to incur liabilities in the acquisition of employer securities, and that an employer may receive additional tax credits for amounts contributed to ESOPs. Under limited circumstances, lenders to ESOP's may also receive benefits that result in reduced borrowing costs to the ESOP. As long as ESOP meets the IRS requirements for a qualified employee plan, it may invest up to 100% of its assets in ''qualifying'' employer securities. It is exempt from some of the self-dealing limitations applicable to most employee benefit plans, as it is viewed as a means of providing stock ownership interests for employees rather than as strictly a retirement plan. Furthermore, an ESOP may purchase the stock either from the employer company or from shareholders. Therefore, in addition to use as a tool of corporate finance, an ESOP may serve as a ready purchaser for outstanding stock, without a corresponding loss of voting control.

ESOPs are in some ways similar to deferred profit sharing plans. ESOPs are authorized under the same section, namely, section 401 of the Internal Revenue Code. Employer contributions (within limits based on a percentage of eligible payroll) are allowable deductions from the employer's pre-tax income. Contributions are held in trust, and benefits when paid out upon an employee's retirement, death, or termination of service, must be paid in company stock. The distinguishing feature of an ESOP lies in the fact that the direct purpose of the plan is to invest employer contributions in the stock of the company.

2080.5.2.1 Accounting Guidelines for Leveraged ESOP Transactions

Newly issued or existing shares of BHC stock are sometimes sold to the ESOP and paid for with money borrowed from a third party; these types of ESOPs are commonly referred to as ''leveraged ESOPs.'' The borrowings are generally serviced with contributions by the employer, which are a tax deductible expense. The borrowing arrangement by the ESOP often includes a guarantee or commitment by the employer (the BHC or the subsidiary bank) to make future contributions to the ESOP sufficient to meet debt service requirements.

When this occurs, questions arise involving the appropriate accounting for the leveraged ESOP transaction. The Accounting Standards Executive Committee of the American Institute

of CPAs has issued a Statement of Position (SOP) 72–3 which discusses ESOP borrowing situations. Since the Federal Reserve applies generally accepted accounting principles, banks and bank holding companies should follow SOP 76–3. The SOP statement covers cases where the employer either guarantees the ESOP loan or commits to make future ESOP contributions sufficient to service the debt. For such cases, the SOP indicates that the employer should credit a liability account for the amount of the ESOP debt and offset that entry by reducing shareholders' equity. The liability recorded by the employer should be reduced as the ESOP makes payments on the debt. This liability is recorded because the guarantee or commitment is in substance the employer's debt. When there is no guarantee, the ESOP is treated like any other shareholder.

In other words, where there is a leveraged ESOP which has purchased BHC stock, and there is a guarantee, commitment, or other arrangement which is in effect a guarantee relative to the debt service of the ESOP, for analytical purposes the amount of ESOP debt will be considered as parent debt and thus parent equity will be reduced accordingly. This will affect debt to equity ratios as well as consolidated capital ratios, where applicable.

2080.5.2.2 Fiduciary Standards under ERISA Pertaining to ESOPs

There are also general fiduciary standards under ERISA pertaining to ESOPs which have been delineated largely through court decisions rather than issuance of regulations. Although exempted from ERISA's asset diversification requirement, ESOP transactions are still required to meet fiduciary standards of prudence, and must be designed and administered for the "exclusive benefit" of plan employees. (ERISA §404(a) and 29 CFR 2550.407d–6). Yet, as stated above, ESOPs may have distinct advantages which inure primarily to the sponsoring company, its management and large shareholders. Due to these potential or actual conflicts of interest, it is important that the sponsoring employer and any other fiduciaries of a plan undertake every effort to assure full consideration of the best interests of plan employees.

The safeguarding of the statutory "exclusive" interests of plan employees pursuant to ERISA is within the jurisdiction of the IRS and the Department of Labor. The bank regulatory agencies also have some responsibility in their review and examination activities where employee benefit plans such as ESOPs are involved. In this connection, a Uniform Interagency Referral Agreement mandated by statute, has been in effect since 1980 whereby certain possible violations of the provisions of ERISA are referred to the DOL by the Division of Banking Supervision and Regulation, pursuant to delegated authority. SR 81–697 (SA) contains the procedures for making referrals to the Department of Labor. Attached to the SR letter is an exhibit, *ERISA Referral Format,* which lists the information necessary when making referrals. Holding company examiners can expedite the ERISA referral process by including that information in their reports.

2080.5.3 STATUS OF ESOP'S UNDER THE BHC ACT

On August 6, 1985, the Board determined (1985 FRB 804) that an ESOP that controls more than 25 percent of the voting shares of a bank or bank holding company is a bank holding company. The Board determined that the underlying trust which held the shares of the bank holding company is a "business trust" as defined in the BHC Act and was thus not excluded from the definition of a "company" under the terms of the Act.

2080.5.4 INSPECTION CONSIDERATIONS

Examiners should review unfunded pension liabilities of the BHC to determine their potential impact on the organization. In addition, examiners should review the soundness of any borrowings used to fund ESOP purchases of BHC stock. ESOP borrowings from an affiliated bank used to purchase BHC shares may result in an apparent increase in BHC capital which in fact turns out to have been funded with subsidiary bank funds, a practice considered suitable for in-depth review by examination staff. Section 401 (of the Internal Revenue Code) plan holdings of BHC stock need to be evaluated under the "content" provisions of the BHC Act, change in Bank Control Act, and Regulation Y.

When an ESOP is subject to the Change in Bank Control Act, this fact should be brought to the attention of a BHC's management. Section 225.41 of Regulation Y specifies transactions—acquisitions—that would require providing the

Board with 60 days prior written notice before acquiring control of a bank holding company (or a state member bank), unless the transaction is exempt under section 225.42 of the Regulation. In addition to the above, a determination should be made as to whether the ESOP is a bank holding company. The examiner may also refer to the Financial Accounting Standards Board's Statement No. 87, ''Employers' Accounting for Pensions.''

A key principle underlying the Federal Reserve's supervision of bank holding companies is that such companies should be operated in a way that promotes the soundness of their subsidiary banks. Holding companies are expected to avoid funding strategies or practices that could undermine public confidence in the liquidity or stability of their banks. Consequently, bank holding companies should develop and maintain funding programs that are consistent with their lending and investment activities and that provide adequate liquidity to the parent company and its nonbank subsidiaries.

2080.6.1 FUNDING BY SWEEPING DEPOSIT ACCOUNTS

A principal objective of a bank holding company's funding strategy should be to maintain an adequate degree of liquidity at the parent company and its subsidiaries. Funding mismatches can exacerbate an otherwise manageable period of financial stress and, in the extreme, undermine public confidence in an organization's viability. In developing and carrying out funding programs, bank holding companies should give special attention to the use of overnight or extremely short-term liabilities since a loss of confidence in the issuing organization could lead to an immediate funding problem. Accordingly, bank holding companies relying on overnight or extremely short-term funding sources should maintain a level of superior quality assets, namely, assets that can be immediately liquidated or converted to cash with minimal loss, that is at least equal to the amount of those funding sources.

A potential source of funding mismatch arises from the use of what has been commonly referred to as deposit sweeps. This practice is based upon an agreement with a subsidiary bank's deposit customers (typically corporate accounts) which permits these customers to reinvest amounts in their deposit accounts above a designated level in overnight obligations of the parent bank holding company. These obligations include such instruments as commercial paper, program notes, and master notes.

In view of the extremely short-term maturity of most sweep arrangements, banking organizations should exercise great care when investing the proceeds. Appropriate uses of the proceeds of deposit sweep arrangements are limited to short-term bank obligations, short-term U.S. Government securities, or other highly liquid, readily marketable, investment grade assets that can be disposed of with minimal loss of principal.[1] Use of such proceeds to finance mismatched asset positions, such as those involving leases, loans, or loan participations, can lead to liquidity problems at the parent company and are not considered appropriate. The absence of a clear ability to redeem overnight or extremely short-term liabilities when they become due should generally be viewed as an unsafe and unsound banking activity.

Reserve Bank supervisory and examination personnel are to ensure that bank holding companies and their state member banks are in compliance with this section and related supervisory letters addressing the marketing of uninsured debt instruments, including master notes and other sweep arrangements (refer to Manual sections 2080.05 and 2080.1). Banking organizations not in compliance should take the necessary steps to achieve full compliance within a reasonable period of time. Reserve Banks should provide copies of the supervisory letter SR 90–31 to any bank holding company engaged in sweep arrangements with their subsidiary banks, or to any other organization if necessary to facilitate compliance.

1. Some banking organizations have interpreted language in a 1987 letter signed by the Secretary of the Board as condoning funding practices that may not be consistent with the principles set forth in this supervisory letter and prior Board rulings. The 1987 letter involved a limited set of facts and circumstances that pertained to a particular banking organization; it did not establish or revise Federal Reserve policies on the proper use of the proceeds of short-term funding sources. In any event, banking organizations should no longer rely on the 1987 letter to justify the manner in which they use the proceeds of sweep arrangements. Banking organizations employing sweep arrangements are expected to ensure that these arrangements conform with the policies contained in this section and in the Manual section 2080.05 on bank holding company funding.

The control provisions of the Bank Holding Company Act (the act) are found in section 2(a)(1) and (2) (see 12 U.S.C. 1841(a)) under the definition of a bank holding company. A bank holding company is defined as ''any company which has control over any bank or over any company that is or becomes a bank holding company by virtue of the Act.''

The term ''company'' means any corporation, partnership, business trust, association, or similar organization, or any other trust.[1] Any corporation in which the majority of the shares are owned by the United States or by any state is not considered a company.

A ''company covered in 1970'' means a company that became a bank holding company as a result of the enactment of the Bank Holding Company Act Amendments of 1970 and which would have been a bank holding company on June 30, 1968, if those amendments had been enacted on that date.

2090.0.1 CONCLUSIVE PRESUMPTIONS OF CONTROL

The conclusive presumptions of control are established in section 2(a)(2)(A) and (B) of the act when—

1. a company directly or indirectly or acting through one or more other persons owns, controls, or has power to vote 25 percent or more of any class of voting securities of a bank or company or
2. a company controls in any manner the election of a majority of the directors or trustees of the bank or company.

''Acting through one or more other persons'' could include—

1. acting through the executive officer of a company, or a relative or business associate of that officer;
2. financing the purchase of shares of a bank or company when—
   a. the amount of credit approximates the purchase price,
   b. there is no definite maturity on the credit extended,
   c. the credit is obtained at a favorable rate of interest, and
   d. the bank whose shares are held as collateral maintains an excessive balance with the lending company;
3. by a resolution of a company's board of directors, guaranteeing an individual against any loss in relationship to his ownership in a bank or company when such ownership represents 25 percent or more of any voting class;
4. recognizing earnings from another company; or
5. participating in policy formation or daily operations of another company.

The ''power to vote'' includes the right to vote, to direct the voting of shares, or to immediately transfer shares to the name of the holder of such rights or the holder's nominee, pursuant to any proxy, contract, or agreement. However, when stock is held as collateral for a loan under an agreement which enables the lender to transfer the stock into the name of the lender or its nominee without the power to vote, the right to have the shares transferred does not in itself constitute control. To constitute control, the power to vote must be perfected along with the transfer of the stock into the name of the lender or its nominee.

2090.0.2 DIRECT CONTROL

Direct control exists when a company (as defined in section 2(b) of the act) owns 25 percent or more of any one class of voting securities of a bank (as defined in section 2(c) of the act) or company. ''Voting securities'' includes potential as well as actual voting authority.

2090.0.3 INDIRECT CONTROL

Indirect ownership or control is defined in section 2(g) of the act in subsections 1 and 2 as follows:

''(1) Shares owned or controlled by any subsidiary of a bank holding company shall be deemed to be indirectly owned or controlled by such bank holding company; and

''(2) Shares held or controlled directly or indirectly by trustees for the benefit of (A) a company, (B) the shareholders or members of a company, or (C) the employees

1. Unless the terms of the trust require it to terminate within 25 years or not later than 21 years and 10 months after the death of individuals living on the effective date of the trust.

(whether exclusively or not) of a company, shall be deemed to be controlled by such company.''

To assist in the interpretation of the above subsections the following explanations are provided.

1. All shares owned by a subsidiary of a bank holding company are deemed to be controlled by the parent's ownership interest in the directly owned subsidiary.
2. Shares held in a trust for the benefit of a company are deemed to be controlled by such company regardless of whether the trustee or company votes the shares. A company is deemed to be the beneficial owner of shares which it does not vote if all other shareholders' rights are retained by such company (that is, dividends, or other rights).
3. Shares owned by a trustee for the benefit of a company's subsidiary (or the subsidiary's shareholders, members, or employees) are deemed to be controlled by both the subsidiary and its parent.
4. Shares held in a trust for the benefit of an individual ''stockholder, member, or employee'' are not deemed to be controlled by a company because such shares are held for the individual regardless of his or her relationship with the company. For a company to have control over the shares held for the benefit of a company's ''stockholders, members, or employees,'' the shares must be held as a class.
5. If a trust meets the definition of a company, it is possible for such a trust to be a bank holding company. In addition, it is possible for a bank through the administration of a trust(s)(which does not meet the definition of a company) to become a bank holding company (that is, a bank which has control over various trusts whose shares aggregate to 25 percent or more of a bank or bank holding company could be deemed a bank holding company; a bank which administers a trust that owns 25 percent or more of a bank or bank holding company (and such trust does not meet the definition of a company) could be a bank holding company.

In addition to the above determinants involving conclusive presumptions of control, the Board has determined that whenever the transferability of 25 percent or more of any class of voting securities of a company is restricted, in any manner, upon the transfer of 25 percent or more of any class of voting securities of another company, the holders of the two securities affected by the restriction constitute a company for the purposes of the act. This determination applies unless one of the issuers of such securities is a subsidiary of the other and is so identified in a Board order or in a registration statement or report accepted by the Board under the act.

In any administrative or judicial proceedings regarding conclusive presumptions of control, a company would not be considered to control a bank or company at any given time unless that company, at the time in question, directly or indirectly owned, controlled, or had power to vote 5 percent or more of any class of voting securities of the bank or company.

2090.0.4 REBUTTABLE PRESUMPTIONS OF CONTROL

A rebuttable presumption of control exists when the Board determines, after notice and opportunity for hearings, that a company directly or indirectly exercises a controlling influence over the management or policies of a bank or company (section 2(a)(2)(C) of the act). With regard to the above, there is a presumption that any company which directly or indirectly owns, controls, or has power to vote less than 5 percent of any class of voting securities of a given bank or company does not have control over that bank or company (section 2(a)(3) of the act). This 5 percent presumption does not prohibit the Board from determining that a company exercises a ''controlling influence'' when such company owns, controls, or has power to vote less than 5 percent of any class of voting securities of another company or bank. However, in overcoming the presumption, the Board bears the burden of proving that such a controlling influence exists.

2090.0.4.1 Regulation Y Determinants of Control

The Board has established the following rebuttable presumptions of control in section 225.31 of Regulation Y for use in proceedings:

1. Control of voting securities.
   a. *Securities convertible into voting securities.* A company that owns, controls, or holds securities that are immediately convertible, at the option of the holder or owner, into voting securities of a bank

or other company controls the voting securities.

b. *Option or restriction on voting securities.* A company that enters into an agreement or understanding under which the rights of a holder of voting securities of a bank or other company are restricted in any manner controls the securities. This presumption does not apply where the agreement or understanding—
   (1) is a mutual agreement among shareholders granting to each other a right of first refusal with respect to their shares;
   (2) is incident to a bona fide loan transaction; or
   (3) relates to restrictions on transferability and continues only for the time necessary to obtain approval from the appropriate federal supervisory authority with respect to acquisition by the company of the securities.

2. Control over company.
   a. *Management agreement.* A company that enters into any agreement or understanding with a bank or other company (other than an investment advisory agreement), such as a management contract, under which the first company or any of its subsidiaries directs or exercises significant influence over the general management or overall operations of the bank or other company controls the bank or other company.
   b. *Shares controlled by company and associated individuals.* A company that, together with its management officials or principal shareholders (including members of the immediate families of either (as defined in 12 C.F.R. 206.2(k)) owns, controls, or holds with power to vote 25 percent or more of the outstanding shares of any class of voting securities of a bank or other company, if the first company owns, controls, or holds with power to vote more than 5 percent of the outstanding shares of any class of voting securities of the bank or other company.
   c. *Common management officials.* A company that has one or more management officials in common with a bank or other company controls the bank or other company, if the first company owns, controls, or holds with power to vote more than 5 percent of the outstanding shares of any class of voting securities of the bank or other company, and no other person controls as much as 5 percent of the outstanding shares of any class of voting securities of the bank or other company.
   d. *Shares held as fiduciary.* The presumptions of control in paragraphs 225.31(d)(2)(ii) and (iii) of Regulation Y do not apply if the securities are held by the company in a fiduciary capacity without sole discretionary authority to exercise the voting rights.

2090.0.4.2 Other Presumptions of Control

In addition to the rebuttable presumptions, there are a number of other circumstances that are indicative of control and may call for further investigation to uncover facts that support a determination of control. Such circumstances include the following:

1. A company owns at least 10 percent of each of two banks or at least 5 percent of each of three or more banks.
2. A company owns 5 percent or more of a bank or bank holding company and has been instrumental in the hiring or firing of one or more persons; establishing policies or places for branches; establishing hours of business; deciding on rates, terms, or acceptance of loans or deposits; following uniform advertising practices or using a common telephone system; or any other respects directing the activities of management or establishing the policies of the bank or company.
3. A company lends to a borrower on more favorable terms than it would have for a borrower of comparable credit standing to enable the borrower to acquire voting shares of a bank or other company.

If the Board proposes to make a determination based on the above indicators of control, the Board bears the burden of providing evidence that such a control situation exists.

2090.0.5 PROCEDURES FOR DETERMINING CONTROL

The question of whether a control situation exists may arise from information coming to the Board's attention or from a company's seeking to obtain the Board's opinion regarding a specific situation. When this question arises, the Board has instructed each Reserve Bank to make every effort to resolve the matter with the company without resorting to the procedures

outlined in this section. However, if the Reserve Bank is unsuccessful in resolving the matter, it is referred to the Board staff. If the Board staff feels the matter warrants Board consideration, it will recommend that the Board make a preliminary determination of control based on the available facts and so inform the company. (See section 225.31(a).) Following the preliminary determination of control, the company must, within 30 days (or longer as may be permitted by the Board), submit the information required by section 225.31(b).

If the company contests the Board's determination, it is entitled to a formal hearing at its request. (See section 225.31(c).)

Notwithstanding any other provision of the act, a company is not deemed to be a bank holding company by virtue of its control of—

1. ". . . shares [held] in a fiduciary capacity, except as provided in paragraphs (2) and (3) of subsection (g)" (section 2(a)(5)(A) of the act);
2. ". . . shares acquired by it in connection with its underwriting of securities if such shares are held only for such period of time as will permit the sale thereof on a reasonable basis" (section 2(a)(5)(B) of the act);
3. "[a] company formed for the sole purpose of participating in a proxy solicitation if the voting rights of the shares acquired by such company are acquired in the ordinary course of such a solicitation" (section 2(a)(5)(C) of the act);
4. ". . . shares acquired in securing or collecting a debt previously contracted in good faith, until two years after the date of acquisition" (section 2(a)(5)(D) of the act);
   (The Board is authorized upon application by a company to extend, from time to time for not more than one year at a time, the two-year period referred to herein for disposing of any shares acquired by a company in the regular course of securing or collecting a debt previously contracted in good faith, if, in the Board's judgment, such an extension would not be detrimental to the public interest, but no such extension shall in the aggregate exceed three years.)
5. ". . . any State-chartered bank or trust company which
   (i) is wholly owned by thrift institutions or savings banks; and
   (ii) is restricted to accepting—
      (I) deposits from thrift institutions or savings banks;
      (II) deposits arising out of the corporate business of thrift insitutions or savings banks that own the bank or trust company; or
      (III) deposits of public moneys." (section 2(a)(5)(E) of the act); and
6. ". . . a single . . . bank, if such . . . company is a trust company or mutual savings bank located in the same State as the bank and if . . . (i) such ownership or control existed on the date of enactment of the Bank Holding Company Act Amendments of 1970 and is specifically authorized by applicable State law, and (ii) the trust company or mutual savings bank does not after that date acquire an interest in any company that, together with any other interest it holds in that company, will exceed 5 percentum of any class of the voting shares of that company, except that this limitation shall not be applicable to investments of the trust company or mutual savings bank, direct and indirect, which are otherwise in accordance with the limitations applicable to national banks under section 5136 of the Revised Statutes (12 U.S.C. 24)" (section 2(a)(5)(F) of the act).

2090.0.6 INSPECTION OBJECTIVES

1. To determine whether any change in control of a bank holding company has resulted in a company (as defined by section 2(b) of the act) becoming a bank holding company in violation of section 3(a)(1) of the act.
2. To ascertain whether an existing bank holding company has acquired either directly or indirectly additional banking assets in violation of section 3(a)(3) of the act.
3. To establish whether a company which has purchased its own stock is in compliance with section 225.4(b) of Regulation Y. (See section 2090.3.)

2090.0.7 INSPECTION PROCEDURES

1. Review the company's stock records and the company's investment portfolio.
2. If there are any subsidiaries that are indirectly owned or controlled as defined in section 2(g) of the act, determine if such shares are held in a trust and, if so, whether the trust agreement contains any provisions that could potentially expose the holding company or any of its subsidiaries to financial or other liabilities.

2090.0.8 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Regulation Y		225		
Direct control voting securities				1978 FRB 121
Indirect control as trustee			Ltr. 1/14/76 to W. Lloyd, Chicago Fed Ltr. 10/16/73 to W. Lloyd, Chicago Fed	
Acting through others				1970 FRB 350 1974 FRB 865 1972 FRB 717 1974 FRB 130 1974 FRB 131
Transfer of shares				1974 FRB 875
Rebuttable presumption of control				
• nonvoting stock • other indicators of control				1972 FRB 487 136 *Fed. Reg.* 18945 (Sept. 24, 1971)
Procedures for determining control			S-2173 (Sept. 17, 1971) (at 4–191.1)	Patogonia vs. BOG 517 F. 2d 803 (9th Cir. 1975)
Nonvoting equity investments by BHCs		225.143		1982 FRB 413

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. Federal Reserve Regulatory Service reference.

Section 2 (o) of the Bank Holding Company Act (the act) (as amended by section 2610 of the Economic Growth and Regulatory Paperwork Reduction Act of 1996) exempts ''qualified family partnerships'' from the definition of ''company'' in the act.[1] Under this change to the act, a qualified family partnership would be able to own and control a bank holding company without the partnership becoming subject to the registration, source of strength, approval, reporting, or other requirements imposed on a bank holding company.

To qualify for the exemption, a qualified family partnership must have as partners only individuals who are related by blood, marriage, or adoption, or trusts for the primary benefit of those individuals. In addition, the partnership must—

- control any bank through a company that is itself a registered bank holding company subject to all of the provisions of the act;
- control only one registered bank holding company;
- not engage in any business activity except indirectly through ownership of other business entities (that is, the partnership must be an investment vehicle for the family and may not be an operating company);
- limit its investments to those permitted for a bank holding company under section 4 of the act; and
- not be obligated on any debt, either directly or as a guarantor.

Any partnership requesting qualification as a qualified family partnership must commit (1) to be subject to Federal Reserve Board examination to ensure compliance with the conditions for eligibility and (2) to be treated as a bank holding company for purposes of enforcement actions by the Board. In addition, while a qualified family partnership is exempt from the prior-approval requirements of section 3 of the act in connection with a bank acquisition, the partnership continues to be subject to the notice provisions of the Change in Bank Control Act.

As noted above, the primary benefits to becoming a qualified family partnership are (1) exemption from the capital requirements applicable to bank holding companies, (2) exemption from the reporting requirements applicable to a bank holding company, and (3) the freedom to make permissible nonbanking investments without prior Board approval. Because the qualified family partnership must use a single registered bank holding company to hold all of its bank investments, there continues to be a bank holding company subject to the requirements of the act in every case. This structure ensures that the cross-guarantee provisions of the Federal Deposit Insurance Act continue to apply to all banks controlled by a qualified family partnership.

1. Pub. L. 104-2089, section 2610; 110 Stat. 3009.

The Change in Bank Control Act of 1978 (the CBC Act), title VI of the Financial Institutions Regulatory and Interest Rate Control Act of 1978, gives the federal bank supervisory agencies the authority to disapprove changes in control of insured depository institutions.[1] The Federal Reserve Board is the responsible federal banking agency for changes in control of bank holding companies and state member banks, and the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency are responsible for insured state nonmember and national banks respectively.

The CBC Act requires any person (that is, an individual, a partnership, a corporation, a trust, an association, a joint venture, a pool, a sole proprietorship, or an unincorporated organization) seeking to acquire control of any insured depository institution or bank holding company to provide 60 days' prior written notice to the appropriate federal banking agency. The act specifically exempts transactions that are subject to section 3 of the Bank Holding Company Act of 1956 or section 18 of the Federal Deposit Insurance Act because those transactions are covered by existing regulatory approval procedures. Accordingly, changes in control due to acquisitions by bank holding companies and changes in control of insured depository institutions resulting from mergers, consolidations, or other similar transactions are not covered by the CBC Act.

The CBC Act describes the factors that the Federal Reserve and the other federal banking agencies are to consider in determining whether a transaction covered by the CBC Act should be disapproved. These factors include the financial condition, competence, experience, and integrity of the acquiring person (or persons acting in concert); the effect of the transaction on competition; whether the acquiring persons have provided all required information; and whether the proposed transaction would result in an adverse effect on the Bank Insurance Fund or the Savings Association Insurance Fund. The Federal Reserve Board's objectives in its administration of the CBC Act are to enhance and maintain public confidence in the banking system by preventing identifiable, serious adverse effects resulting from anticompetitive combinations of interests, inadequate financial support, and unsuitable management in the institutions. The Board will review each notice to acquire control of a state member bank or bank holding company and will disapprove transactions that are likely to have serious harmful effects. The Board's intention is to administer the CBC Act in a manner that will minimize delays and government regulation of private-sector transactions.

If the Board disapproves a change-in-control filing, the Board will notify the proposed acquiring party in writing within three days after its decision. The notice of disapproval will include a statement of the basis for disapproval. The CBC Act provides that the acquiring party may request a hearing by the Board in the event of a disapproval and provides a procedure for further review by the courts.

Forms for filing notices of proposed transactions covered by the CBC Act are available from the Federal Reserve Banks. Persons contemplating an acquisition that would result in a change in control of a BHC or state member bank should request the appropriate forms and instructions from the Reserve Bank in whose District the affected institution is located. Forms and instructions may also be accessed from the Federal Reserve Board's public web site (www.federalreserve.gov). The primary forms to be completed are the Interagency Biographical and Financial Report and the Interagency Notice of Change in Control. Filers are requested to consult with the appropriate Reserve Bank to confirm what specific information should be included in a particular notice. The Reserve Bank can provide specialized publication material that will assist the filers in placing a complete announcement of the proposed acquisition in the appropriate newspaper of general circulation. The Board of Governors also will publish the notices in the *Federal Register*. (See SR-03-19.)

When a substantially complete notice is received by the Federal Reserve Bank, a letter of acknowledgment will be sent to the acquiring person indicating the date of receipt. After reviewing the submitted information, the Federal Reserve may initiate name checks with certain other U.S. government agencies (including law enforcement) on some or all of the individuals related to the proposal. The information received from those name checks will be used to further the assessment of the relevant statutory factors, including the competence,

1. The term *insured depository institution* includes any depository institution holding company and any *other* company that controls an insured depository institution. The CBC Act is found in 12 U.S.C. 1817(j)(1)–(18).

experience, integrity, and financial ability of the individual filers.

2090.1.1 COMMITMENTS AND CONDITIONS FOR APPROVAL

Approvals granted by the Federal Reserve under the CBC Act may be subject to commitments or conditions that require the filer to consult with appropriate Federal Reserve staff before acquiring further shares of the subject banking organization. The Board or the Reserve Bank may also impose restrictions on the acquisition of additional shares by any person who already controls an institution. The imposition of such commitments, conditions, or limitations is intended to ensure that statutory factors remain consistent with approval.

2090.1.2 COMPLETION OF THE TRANSACTION

The transaction may be completed 61 days after the date of receipt stated in the acknowledgment letter, unless the acquiring person has been notified by the Board that the acquisition has been disapproved or that the 60-day period has been extended as provided for in subparagraph (j)(1) of the CBC Act. To avoid undue interference with normal business transactions, the Board may issue a notice of its intention not to disapprove a proposal, after consulting with the relevant state banking authorities as the CBC Act requires.

2090.1.3 INFORMATION TO BE INCLUDED IN NOTICES

The CBC Act requires a person proposing to acquire control of a bank holding company or state member bank to file a notice with the Federal Reserve Board that includes biographical and financial information on the filers; details of the proposed acquisition; information on any proposed structural, managerial, or financial changes that would affect the banking organization to be acquired; and other relevant information required by the Board.

A current statement of assets and liabilities, a brief income summary, and a statement of any material changes since the effective date of this financial-statement information is required. The Board reserves the right to require up to five years of financial data from any acquiring person. For complete details on the informational requirements of a change-in-control filing, see the Board's public web site at www.federalreserve.gov/generalinfo/applications/afi/. In particular, review the System's Form FR 2081a, Interagency Notice of Change in Control.

2090.1.4 TRANSACTIONS REQUIRING SUBMISSION OF PRIOR NOTICE

The CBC Act defines *control* as the power, directly or indirectly, to vote 25 percent or more of any class of voting securities or to direct the management or policies of a bank holding company or insured depository institution. Therefore, unless exempted by the CBC Act, any transaction that results in the acquiring party having voting control of 25 percent or more of any class of voting securities or that results in the power to direct the management or policies of such an institution would trigger the notice requirement. However, any person who on March 9, 1979, controlled a bank holding company or state member bank shall not be required to file a notice to maintain or increase control positions in the same institution. In addition, the Board's regulation on a rebuttable presumption of control allows persons who on March 9, 1979, fell within a presumption to acquire additional shares of an institution without filing notice so long as they will not have voting control of 25 percent or more of the institution (Regulation Y, 12 C.F.R. 225.41). In connection with transactions that would result in greater voting control, such persons may file the required notice or request that the Board make a determination that they already control the institution.

Section 225.41 of Regulation Y sets forth the specific types of transactions that require prior notice under the CBC Act. Prior notice is required by any person (acting directly or indirectly) that seeks to acquire control of a state member bank or bank holding company. A *person* may include an individual, a group of individuals acting in concert, or certain entities (for example, corporations, partnerships, or trusts) that own shares of banking organizations but that do not qualify as bank holding companies. A person acquires *control* of a banking organization whenever the person acquires ownership, control, or the power to vote 25 percent or more of any class of voting securities of the institution.

2090.1.4.1 Rebuttable Presumption of Control

Persons who have the power to vote less than 25 percent of an institution's shares may be required to file notice under the Board's rebuttable presumption of control, found in section 225.41 of Regulation Y. The Board presumes that an acquisition of voting securities of a state member bank or bank holding company constitutes the acquisition of control under the CBC Act, requiring prior notice to the Board, if, immediately after the transaction, the acquiring person (or persons acting in concert) will own, control, or hold with power to vote 10 percent or more of any class of voting securities of the institution, and if—

1. the institution has registered securities under section 12 of the Securities Exchange Act of 1934 (15 U.S.C. 78*l*); or
2. no other person will own, control, or hold the power to vote a greater percentage of that class of voting securities immediately after the transaction.[2]

Other transactions resulting in a person's control of less than 25 percent of a class of voting shares of a bank holding company or state member bank would not result in control for purposes of the CBC Act. In addition, customary one-time proxy solicitations and the receipt of pro rata stock dividends are not subject to the CBC Act's notice requirements.

In some cases, corporations, partnerships, certain trusts, associations, and similar organizations that are not already bank holding companies may be uncertain whether to proceed under the CBC Act or under the Bank Holding Company Act with respect to a particular acquisition. These organizations should comply with the notice requirements of the CBC Act if they are not required to secure prior Board approval under the Bank Holding Company Act. However, some transactions (described in sections 2(a)(5)(D) and 3(a)(5)(A) and (B) of the Bank Holding Company Act), particularly foreclosures by institutional lenders, fiduciary acquisitions by banks, and increases of majority holdings by bank holding companies, do not require the Board's prior approval. They are considered subject to section 3 of the Bank Holding Company Act and, therefore, do not require notices under the CBC Act.

2090.1.4.2 Rebuttable Presumption of Concerted Action

The following persons are presumed to be acting in concert[3] and must file a CBC Act notice if their share of ownership reaches the required levels:

1. a company and any controlling shareholder, partner, trustee, or management official of the company, if both the company and the person own voting shares of the state member bank or bank holding company
2. an individual and the individual's immediate family
3. companies under common control
4. persons that are parties to an agreement, contract, understanding, relationship, or other arrangement, whether written or otherwise, regarding the acquisition, voting, or transfer of control of voting securities of a state member bank or bank holding company, other than through a revocable proxy
5. persons who have made or propose to make a joint filing under sections 13 and 14 of the Securities Exchange Act of 1934 (15 U.S.C. 78m), and the rules promulgated thereunder by the Securities and Exchange Commission
6. any person and any trust for which the person serves as trustee

If there is any doubt whether a proposed transaction requires a notice, the acquiring person should consult the Federal Reserve Bank for guidance. The CBC Act places the burden of providing notice on the prospective acquiring person.

2090.1.5 TRANSACTIONS NOT REQUIRING ANY NOTICE

Section 225.42 of Regulation Y sets forth the transactions that do not require any notice under the CBC Act or that require after-the-fact notice. The following transactions do not require any notice to the Federal Reserve:

2. If two or more persons, not acting in concert, each propose to acquire simultaneously equal percentages of 10 percent or more of a class of voting securities of the state member bank or bank holding company, each person must file prior notice to the Board.

3. *Acting in concert* includes knowing participation in a joint activity or parallel action towards a common goal of acquiring control of a state member bank or bank holding company whether or not pursuant to an express agreement.

1. *Existing control relationships.* The acquisition of additional shares if the acquirer is deemed to already have control of the banking organization.
2. *An increase in previously authorized acquisitions.* The acquisition of additional shares of a class of voting securities of a state member bank or bank holding company by any person (or persons acting in concert) who acquired and maintained control of the institution after complying with federal requirements.
3. *Any acquisition subject to approval under the Bank Holding Company Act or the Bank Merger Act.* Any acquisition of voting securities subject to approval under section 3 of the BHC Act or under the Bank Merger Act (section 18(c) of the Federal Deposit Insurance Act).
4. *Transactions exempt under the BHC Act.*
5. *A proxy solicitation.* Receipt of a revocable proxy in connection with a proxy solicitation for the purpose of conducting business at a regular or special meeting of the institution if the proxy terminates within a reasonable time.
6. *Stock dividends.* Receipt of voting securities as a result of a stock dividend (if the proportional interest of the recipient remains substantially the same).
7. *Acquisition of voting securities of a foreign banking organization.* The acquisition of voting securities of a qualifying foreign banking organization.

2090.1.6 TRANSACTIONS NOT REQUIRING PRIOR NOTICE

The transactions that require after-the-fact notice include the acquisition of voting securities (1) through inheritance, (2) as a bona fide gift, or (3) in satisfaction of a debt previously contracted in good faith. In these situations, the appropriate Reserve Bank must be notified within 90 days after the acquisition, and the acquirer must provide any relevant information requested by the Reserve Bank.

2090.1.7 UNAUTHORIZED OR UNDISCLOSED CHANGES IN BANK CONTROL

In some instances, a person acquires control of a banking organization without submitting the prior or after-the-fact notice required by Regulation Y. These unauthorized or undisclosed changes in bank control may not be known to the person, the state member bank, or the bank holding company but are discovered by Reserve Bank examiners during an inspection or examination of the affected institution. In most cases, such a violation of the CBC Act is addressed by having the person immediately file a notice with the Federal Reserve requesting authority to retain the acquired shares.[4] The filing should include an explanation of the circumstances that resulted in the violation and a description of the actions that have been (or will be) taken by the filers to ensure no further violations of the statute. Although the burden to file a timely change in bank control notice is on the persons who are acquiring control or causing a change in control of a banking organization, an acquired banking organization or a banking organization undergoing a change in control may have better information regarding current ownership positions, including shareholder lists, than the acquiring individuals or individuals who propose a change in control. Therefore, it is important that state member banks and bank holding companies be familiar with the regulations and policies governing changes in bank control and, when possible, share such information with shareholders who have significant ownership positions.

2090.1.8 CHANGES OR REPLACEMENT OF AN INSTITUTION'S CHIEF EXECUTIVE OFFICER OR ANY DIRECTOR

Institutions must report promptly any changes or replacement of its chief executive officer or of any director, in accordance with paragraph 12 of the CBC Act. Under section 225.42(a)(7) of Regulation Y, acquisitions of control of foreign bank holding companies are also exempt from the prior-notice requirements of the CBC Act, but this exemption does not extend to the reports and information required under paragraphs 9, 10, and 12 of the act. (See section 2090.1.5.)

4. A violation may be addressed through two other means. The affected party may either (1) submit, for the Federal Reserve's approval, a specific plan for the prompt termination of the control relationship or (2) contest the preliminary determination of a control relationship by filing a response that sets forth the facts and circumstances in support of the party's position that no control exists or, if appropriate, presenting such views orally to Federal Reserve staff.

2090.1.9 DISAPPROVAL OF CHANGES IN CONTROL

The CBC Act sets forth various factors to be considered in the evaluation of a proposal. The Board is required to review the competitive impact of the transaction; the financial condition of the acquiring person; and the competence, experience, and integrity of that person and the proposed management of the institution. In assessing the financial condition of the acquiring person, the Board will weigh any debt-servicing requirements in light of the acquiring person's overall financial strength and the institution's earnings performance, asset condition, capital adequacy, and future prospects, as well as the likelihood of an acquiring party making unreasonable demands on the resources of the institution.

2090.1.10 ADDITIONAL REPORTING REQUIREMENTS

Paragraph 12 of the CBC Act requires that whenever a change in control of a bank holding company occurs, each insured depository institution is required to report promptly to the appropriate federal banking agency any changes or replacement of its chief executive officer or of any director occurring in the next 12-month period. A statement of the past and current business and professional affiliations of the new chief executive officer or directors should be included in each institution's report.

Paragraph 9 of the CBC Act indicates that whenever any insured depository institution makes a loan secured by 25 percent or more of the outstanding voting stock of an insured depository institution (or bank holding company), the president or other chief executive officer of the lending bank shall promptly report such fact to the appropriate federal banking agency of the bank (or bank holding company) whose stock secures the loan. However, no report need be made when the borrower has been the owner of record of the stock for a period of one year or more or when the stock is that of a newly organized bank before its opening. Reports required by this paragraph shall contain information similar to the informational requirements of the Notice of Change in Control.

2090.1.11 STOCK REDEMPTIONS

A stock redemption by a BHC may result in an existing shareholder (or shareholders) owning 25 percent or more of a class of voting securities, which would require the filing of both a change-in-control and treasury stock notification. Furthermore, a stock redemption by a BHC may result in an existing shareholder (or shareholders) owning between 10 percent and 25 percent of the outstanding shares and being the largest shareholder, thereby resulting in a rebuttable presumption of control. For additional information, see section 2090.3 "Treasury Stock Redemptions."

2090.1.12 CORRECTIVE ACTION

The Federal Reserve has enforcement jurisdiction over those persons who file or *should file* notices under the CBC Act. Accordingly, violations of the requirement to file a change in bank control notice may result in the Federal Reserve taking enforcement action against the relevant persons in appropriate circumstances, including those involving willful or negligent misconduct. Violations may result in the persons being subject to a variety of sanctions, including the assessment of a civil money penalty.

Violations of the CBC Act are addressed through the same type of investigative and enforcement authority and formal corrective actions that are used in other administrative remedies (12 U.S.C. 1818(b)–(n)). The CBC Act also authorizes the assessment of civil money penalties for any violation of the CBC Act (12 U.S.C. 1817(j)(16)) and allows the Board to seek divestiture of a BHC or bank from any person or company who violates the CBC Act (12 U.S.C. 1817(j)(15)).

2090.1.13 INSPECTION OBJECTIVES

1. To determine that the BHC has complied with the prior-notification requirements of the CBC Act and that changes in ownership between 10 percent and 25 percent have been reviewed for *rebuttable presumption* considerations.
2. To determine that the BHC has complied with the reporting requirements of paragraph 12 of the CBC Act regarding changes in its board of directors or its chief executive officer that occur within 12 months of a change in control.
3. To determine that the BHC has complied with the reporting requirements of paragraph

9 of the CBC Act regarding loans made directly by the BHC secured by 25 percent or more of the outstanding voting stock of an insured depository institution (or bank holding company).

2090.1.14 INSPECTION PROCEDURES

1. Review the BHC's stock certificate register or log to determine if any person (or group of persons acting in concert) has acquired 10 percent or more of any class of voting securities.
2. Review changes in control of between 10 percent and 25 percent of any class of voting securities to determine if the controlling party is the single largest shareholder.
3. When inspecting a BHC that was the subject of a change in control and when a prior notification was filed, review the notification to determine that information submitted on the management of the BHC is still valid. When changes in directors or the chief executive officer occurred within 12 months of the change in control, determine if the BHC has reported such changes in compliance with paragraph 12 of the CBC Act.
4. When inspecting a BHC that has redeemed any of its own shares subsequent to March 9, 1979, thereby lowering the number of shares outstanding, determine whether the holdings of any individual shareholder have increased proportionally to greater than 10 percent, which might trigger the rebuttable presumption of control and may require prior notification of a change in control.
5. Review any loans made directly by the BHC that are secured by 25 percent or more of the outstanding shares of a bank (or bank holding company) and determine if the BHC has complied with the reporting requirements of paragraph 9 of the CBC Act.

WHAT'S NEW IN THIS REVISED SECTION

Effective July 2006, this revised section incorporates the Board's February 16, 2006, revision of Regulation Y (effective March 30, 2006). The revised rule increased the asset-size threshold from $150 million to $500 million in consolidated assets and amended the related eligibility criteria for determining whether a bank holding company (BHC) may qualify for the Board's Small Bank Holding Company Policy Statement (the policy statement) and the capital guidelines. The revised rule includes an exemption from the capital guidelines; modified the qualitative criteria used in determining if a BHC, that is under the asset-size threshold, would not qualify for the policy statement or the exemption from the capital guidelines; and clarified the treatment under the policy statement of subordinated debt associated with trust preferred securities.

2090.2.1 FORMATION OF A BANK HOLDING COMPANY AND CHANGES IN OWNERSHIP

The formation of a bank holding company and certain changes in the ownership of banks owned by a bank holding company come under the provisions of section 3 of the BHC Act. Section 3(a)(1) prohibits the formation of a bank holding company without prior Board approval. A company may receive approval pursuant to section 3(a)(1) to become either a one-bank holding company or a multibank holding company.

A primary reason for the formation of a one-bank holding company is to obtain income tax benefits.[1] These benefits include offsetting operating/capital losses of one corporation against the profits/capital gains of another.

Once a company becomes a bank holding company, either by the formation of a one-bank or multibank holding company, section 3(a)(3) of the act prohibits the direct or indirect acquisition of over 5 percent of any additional bank's or bank holding company's shares without prior Board approval. In addition to the above, section 3(a)(3) serves to prevent an existing bank holding company from increasing, without prior Board approval, its ownership in an existing subsidiary bank unless greater than 50 percent of the shares are already owned (section 3(a)(B)). A bank holding company which owns more than 50 percent of a bank's shares may buy and sell those shares freely without Board approval, provided the ownership never drops to 50 percent or less. If a bank holding company owns 50 percent or less of a bank's shares, prior Board approval is required before each additional acquisition of shares takes place until the ownership reaches more than 50 percent.

2090.2.2 HISTORY OF APPLYING THE CAPITAL ADEQUACY GUIDELINES TO THE POLICY STATEMENT ON THE FORMATION OF SMALL BANK HOLDING COMPANIES

On March 28, 1980, the Board issued a policy statement with regard to the formation of small one-bank holding companies. The policy statement was included with the revision of Regulation Y (12 C.F.R. 225, appendix C) on January 5, 1984. Subsequent to this policy statement, capital adequacy standards were adopted for large multibank holding companies (on a consolidated basis[2]) in December 1981 (amended in June 1983, April 1985, and November 1986) that set minimum capital levels and capital zones relating to primary and total capital.[3] These were replaced in January 1989 (amended in October 1991) by the current minimum capi-

1. A corporation is entitled to a special deduction from gross income for dividends received from a taxable domestic corporation. There is (1) a 70 percent deduction for dividends received from a corporation that is less than 20 percent owned; (2) an 80 percent deduction for dividends received from a corporation that is 20 to less than 80 percent owned; (3) a 100 percent deduction for dividends received from members of the same affiliated group (i.e., a corporation that is 80 percent or more commonly owned); and (4) a 100 percent deduction for dividends received from small business investment corporations. There is also an overall limitation on dividends received. The recipient's aggregate amount is limited to 70 percent (80 percent for those corporations that are 20 to less than 80 percent owned) of taxable income. The manner in which the deduction is computed is also subject to further limitation.

2. Capital adequacy is evaluated on a bank-only basis for small bank holding companies.

3. Primary capital included common stockholders' equity, contingency and other capital reserves, the allowances for loan and lease losses, and the minority interest in the equity accounts of consolidated subsidiaries. It also included limited amounts of perpetual preferred stock, mandatory convertible securities, and perpetual debt.

tal adequacy standards that use the risk-based capital and leverage capital measures.

Typically, a small bank holding company's capital position has not been evaluated on a consolidated basis. The capital adequacy evaluation of applications for the formation of small bank holding companies initially followed an 8 percent gross capital to total assets standard.[4] Subsequently, the 1981 guidelines established minimum 5.5 percent primary and 6.0 percent total capital ratios and the concept of capital zones above the minimum capital ratios. When analyzing bank capital for small bank holding company formations, December 1981's 7 percent (zone 1) total capital to assets leverage ratio (after adjusting for the addition of the allowance for loan and lease losses to the ratio's numerator and denominator) became the financial equivalent of 1980's 8 percent gross capital standard. For the bank, the change resulted in evaluating applications for capital adequacy based on a 7 percent total capital to total assets ratio. Since most small banks did not have qualifying secondary capital, the practical effect of the change was that both the zone 1 primary and total capital ratios were at least 7 percent. In September 1990, a minimum tier 1 leverage ratio became effective. A tier 1 to total assets leverage ratio of 6 percent was applied as the financial equivalent of the former 7 percent total capital ratio.

Even though the components of the various capital ratios have changed over time, the capital standards used to evaluate capital positions of banks for small bank holding formations have not. The fundamental policy is still the same. In both instances, approximately the same percentage of small banks meets both ratios. It also should be noted that, if at any time, state or federal banking authorities or loan agreements require the banks of small bank holding company formations to satisfy higher capital standards, those standards will be used when evaluating capital adequacy.

Effective April 21, 1997, revisions to Regulation Y included revisions to the Board's one-bank holding company policy statement. The policy statement was revised to generalize its applicability beyond the formation of a bank holding company to include acquisitions by qualifying small bank holding companies.

On February 16, 2006, the Board approved a revision to Regulation Y (effective March 30, 2006) that increased the asset-size threshold from $150 million to less than $500 million in pro forma consolidated assets for determining if (1) a BHC may qualify under the Board's Small Bank Holding Company Policy Statement (the policy statement) and (2) the BHC qualifies for an exemption from the Board's risk-based and leverage capital guidelines for BHCs. The Board also established eligibility qualitative criteria for determining if a BHC that otherwise meets the asset threshold should not qualify for the policy statement and the exemption from the capital guidelines. The qualitative criteria emphasize that a BHC should *not*: (1) be engaged in significant nonbanking activities through a nonbank subsidiary, (2) conduct significant off-balance-sheet activities through a nonbank subsidiary, or (3) have a material amount of SEC-registered debt or equity securities outstanding.

2090.2.3 SMALL BANK HOLDING COMPANY POLICY STATEMENT

In acting on applications filed under the act, the Board follows the principle that bank holding companies should serve as a source of strength for their subsidiary banks. When bank holding companies incur debt and rely on the earnings of their subsidiary banks as the means of repaying such debt, a question arises as to the probable effect on the financial condition of the holding company and its subsidiary bank or banks.

The Board believes that a high level of debt at the parent holding company level impairs the ability of a bank holding company to provide financial assistance to its subsidiary bank or banks, and, in some cases, the servicing requirements on such debt may be a significant drain on the bank's resources. For these reasons, the Board has not favored the use of acquisition debt in the formation of bank holding companies or in the acquisition of additional banks. Nevertheless, the Board has recognized that the transfer of ownership of small banks often requires the use of acquisition debt. The Board therefore has permitted the formation and expansion of small bank holding companies with debt levels that are higher than what would be permitted for larger bank holding companies. Approval of these applications has been given on the condition that the small bank holding companies demonstrate the ability to service the acquisition debt without straining the capital of

4. The allowance for loan and lease losses was not added back to total assets. In other words, the ''total assets'' were net of the allowance for loan and lease losses, a contra asset.

their subsidiary banks and, further, that such companies restore their ability to serve as a source of strength for their subsidiary bank within a relatively short period of time.

In the interest of facilitating the transfer of ownership in banks without compromising bank safety and soundness, the Board has adopted the procedures and standards for the formation and expansion of small bank holding companies subject to the small bank holding company policy statement.

The policy statement focuses on the relationship between debt and equity at the parent holding company. The holding company has the option of improving the relationship of debt-to-equity by repaying the principal amount of its debt or through the retention of earnings, or both. Under these procedures, newly organized small one-bank holding companies are expected to reduce the relationship of their debt-to-equity over a reasonable period of time to a level that is comparable to that maintained by many large and multibank holding companies.

2090.2.3.1 Applicability of Policy Statement

The policy statement applies only to BHCs with pro forma consolidated assets of less than $500 million that (1) are not engaged in significant nonbanking activities either directly or through a nonbank subsidiary, (2) do not conduct significant off-balance-sheet activities (including securitization and asset management or administration) either directly or through a nonbank subsidiary, and (3) do not have a material amount of SEC-registered debt or equity securities outstanding (other than trust preferred securities). The Board may, in its discretion, exclude any BHC, regardless of asset size, from the policy statement if such action is warranted for supervisory purposes. Although the policy statement primarily applies to the formation of small BHCs, it also applies to existing BHCs that wish to acquire an additional bank or company and to transactions involving changes in control, stock redemptions, or other shareholder transactions. The criteria are described below.

2090.2.3.2 Ongoing Requirements

All organizations operating under the policy statement must meet the requirements set forth below on an ongoing basis.

2090.2.3.2.1 Reduction in Parent Company Leverage

Small BHCs are to reduce their parent company debt consistent with the requirement that all debt be retired within 25 years of being incurred. The Board expects these BHCs to reach a debt-to-equity ratio of .30 to 1 or less within 12 years after incurrence of the debt. The bank holding company must also comply with debt-servicing and other requirements imposed by its creditors. The term *debt* as used in the ratio of debt to equity, means any borrowed funds (exclusive of short-term borrowings that arise out of current transactions, the proceeds of which are used for current transactions) and any securities issued by, or obligations of, the holding company that are the functional equivalent of borrowed funds.

Subordinated debt associated with trust preferred securities generally would be treated as debt for purposes of this policy statement. See paragraphs 2.C., 3.A., 4.A.i, and 4.B.i of the policy statement. A BHC, however, may exclude from debt an amount of subordinated debt associated with trust preferred securities that is up to 25 percent of the bank holding company's equity (as defined below) less goodwill[5] on the parent company's balance sheet, in determining compliance with the requirements of such paragraphs of the policy statement. In addition, a BHC subject to this policy statement that has not issued subordinated debt associated with a new issuance of trust preferred securities after December 31, 2005, may exclude from debt any subordinated debt associated with trust preferred securities until December 31, 2010. BHCs subject to this policy statement may also exclude from debt until December 31, 2010, any subordinated debt associated with refinanced issuances of trust preferred securities originally issued on or prior to December 31, 2005, provided that the refinancing does not increase the BHC's outstanding amount of subordinated debt. Subordinated debt associated with trust preferred securities will not be included as debt in determining compliance with any other requirements of this policy statement.

The term *equity* as used in the ratio of debt to equity, means total stockholders' equity of the BHC, as defined in accordance with generally

5. *Goodwill* is defined as the excess of purchase price of any acquired company or asset over the sum of the fair market values assigned to identifiable assets or asset acquired, less the fair market values of the liabilities assumed, accounted for in accordance with generally accepted accounting principles.

accepted accounting principles. In determining the total amount of stockholders' equity, the BHC should account for its investments in the common stock of subsidiaries by the equity method of accounting.

Ordinarily, the Board does not view redeemable preferred stock as a substitute for common stock in a small BHC. Nevertheless, to a limited degree and under certain circumstances, the Board will consider redeemable preferred stock as equity in the capital accounts of the holding company if the following conditions are met: (1) the preferred stock is redeemable only at the option of the issuer and (2) the debt-to-equity ratio of the holding company would be at or remain below .30:1 following the redemption or retirement of any preferred stock. Preferred stock that is convertible into common stock of the holding company may be treated as equity.

2090.2.3.2.2 Capital Adequacy

Each insured depository subsidiary of a small BHC is expected to be well capitalized. Any institution that is not well capitalized is expected to become well capitalized within a brief period of time.

2090.2.3.2.3 Dividend Restrictions

A small BHC whose debt-to-equity ratio is greater than 1:1 is not expected to pay any corporate dividends on common stock until it reduces its debt-to-equity ratio to 1:1 or less and otherwise meets the requirements in sections 225.14(c)(1)(ii), 225.14(c)(2), and 225.14(c)(7) of Regulation Y. Dividends may be paid by small BHCs with debt-to-equity of at or below 1:1, provided all of the following conditions are met: the dividends are (1) reasonable in amount, (2) do not adversely affect the ability of the BHC to service its debt in an orderly manner, and (3) do not adversely affect the ability of the subsidiary banks to be well capitalized.[6] Also, it is expected that dividends will be eliminated if the holding company is (1) not reducing its debt consistent with the requirement that the debt-to-equity ratio be reduced to 30 percent within 12 years of consummation of the proposal or (2) not meeting the requirements of its loan agreement(s).

2090.2.3.3 Core Requirements for All Applicants

When an organization subject to the policy statement (1) files an application or notice pursuant to the BHC Act, as amended, and (2) intends to incur debt to finance the acquisition of a small bank or company, the Board will assess the application or notice and take into account a full range of financial and other information. The Board will consider the recent trend and stability of the bank's or company's earnings, prospective growth of the bank or company to be acquired, asset quality, the ability of the applicant to meet debt-servicing requirements without placing an undue strain on the resources of the bank(s), and the record and competency of management. In addition, the Board will require applicants to meet the minimum requirements set forth below. As a general rule, failure to meet any of these requirements will result in denial of an application; however, the Board reserves the right to make exceptions if the circumstances warrant.

2090.2.3.3.1 Minimum Down Payment

The amount of acquisition debt should not exceed 75 percent of the purchase price of the bank(s) or company to be acquired. When the owner(s) of the holding company incurs debt to finance the purchase of the bank(s) or company, such debt will be considered acquisition debt even though it does not represent an obligation of the BHC, unless the owner(s) can demonstrate that such debt can be serviced without reliance on the resources of the bank(s) or BHC.

2090.2.3.3.2 Ability to Reduce Parent Company Leverage

The BHC must clearly be able to reduce its debt-to-equity ratio and comply with its loan agreement(s) as stated within the ongoing requirements discussed previously. Failure to

6. For BHCs with consolidated assets under $500 million, *well-capitalized* means that the BHC meets the requirements for expedited/waived processing of the policy statement and that, on a consolidated basis, the BHC (1) maintains a total risk-based capital ratio (as defined in appendix A of Regulation Y) of 10.0 percent or greater; (2) maintains a tier 1 risk-based capital ratio of 6.0 percent or greater; and (3) is not subject to any written agreement, order, capital directive, or prompt-corrective-action directive issued by the Board to meet and maintain a specific capital level for any capital measure.

meet the criteria would normally result in denial of an application.

2090.2.3.4 Additional Application Requirements for Expedited Processing

2090.2.3.4.1 Expedited Notices

A small BHC proposal will be eligible for the expedited processing procedures set forth in sections 225.14 and 225.23 of Regulation Y if (1) the BHC is in compliance with the ongoing requirements of the policy statement, (2) the BHC meets the previously discussed core requirements for all applicants, and (3) the following requirements are met:

1. The parent BHC has a pro forma debt-to-equity ratio of 1:1 or less.
2. The BHC meets all the criteria for expedited action of sections 225.14 and 225.23 of Regulation Y.

2090.2.3.4.2 Waiver of Stock-Redemption Filing

A small BHC will be eligible for the stock-redemption filing exemption for well-capitalized BHCs that is found in sections 225.14(c)(2) and 225.14(c)(6) if the following requirements are met:

1. The parent BHC has a pro forma debt-to-equity ratio of 1:1 or less.
2. The BHC is in compliance with the ongoing requirements of the policy statement and meets the requirements of sections 225.14(c)(1)(ii), 225.14(c)(2), and 225.14(c)(7) of Regulation Y.

2090.2.4 CAPITAL CONSIDERATIONS IN SMALL MULTIBANK AND CHAIN BANK HOLDING COMPANY APPLICATIONS

Multibank holding companies and chain banking organizations (whether or not the chain members are banks or bank holding companies) with less than $500 million in combined assets that meet certain conditions will not be consolidated or combined for capital adequacy purposes. Rather, such organizations will be analyzed in the context of the standards described in the Board's policy statement on small bank holding companies (appendix C of Regulation Y) discussed previously in this section. A bank holding company application that seeks to expand a small bank holding company with or without creating or expanding a chain controlling assets of less than $500 million would be evaluated on the basis of the policy statement in the same manner as if the proposed bank holding company was not part of a chain.

The above application would be evaluated on the basis of the financial and managerial condition of the entire organization. Although the policy statement would generally be applied, the focus of the analysis would be as much on the organization as an operating entity as on the instant proposal. For example, it would be expected that the condition of the applicant organization and that of its subsidiaries would be consistent with expansion, one aspect of which is that each banking subsidiary generally would be expected to maintain capital well above the minimum levels. The policy statement would generally govern the payment of dividends by the applicant organization and any prospective use of preferred stock. The bank to be acquired would be expected to maintain above-minimum capital ratios consistent with those contemplated by the Board's capital adequacy guidelines.

An acquisition debt retirement period would apply with respect to each proposal and the acquisition debt/purchase price ratio limitation of 75 percent would generally apply to the instant application. A specific parent-only debt/equity limit would not be applied. However, it would be expected that the ratio would decline over time.

In addition, the financial and managerial condition of the members of any chain thereby formed or expanded (including compliance considerations and general consistency with the capital adequacy guidelines, giving consideration to the need to maintain capital positions well above the minimum ratios) would be evaluated. The chain would not have to meet a specific, combined parent-only debt/equity standard. However, there would be a general presumption that the debt/equity level of the chain would tend to decline after the initial leveraged approval. Although individual bank holding companies might be leveraged up to .30:1, over time the combined leverage of the chain would tend to be less than this level through increases in the equity or reductions in the debt of the organization. Proposals by banking organizations whose combined banking

assets exceed $500 million would be evaluated for capital adequacy on the basis of an analysis of the consolidated organization. (The term *consolidated* as used with the analysis of large chains would involve actually consolidating each parent bank holding company with its subsidiary (or subsidiaries), and then combining each such consolidated entity as well as any other bank in the chain). An analysis of the capital adequacy of each constituent entity in a large banking organization would also continue to be assessed to determine whether the holding company would serve as a source of strength to its subsidiary banks.

2090.2.5 INSPECTION OBJECTIVES

1. To determine compliance with all commitments made in the application/notification process.
2. To determine if the BHC is in compliance with the Small Bank Holding Company Policy Statement (Regulation Y, appendix C), including whether the BHC's debt is being reduced within the required or expected time periods.

2090.2.6 INSPECTION PROCEDURES

1. Review all commitments made by the company and its shareholders to determine compliance therewith.
2. Determine if the BHC is in compliance with the Small Bank Holding Company Policy Statement (Regulation Y, appendix C) by—
   a. verifying that the board of directors and senior management have established and regularly maintain a plan to
      - retire the BHC's debt within 25 years of incurring the debt and
      - reach a debt-to-equity ratio of .30:1 or less within 12 years of incurring the debt.
3. Ascertain if the BHC uses a regular periodic monitoring process to ensure the full retirement of the holding company's debt within the above-stated required or expected periods.
4. Determine whether the BHC is well capitalized or, if not, whether it will be well capitalized within a brief period of time.
5. Determine if the payment of corporate dividends has been restricted until the BHC's debt-to-equity ratio is 1:1 or less and until the BHC otherwise meets the criteria set forth in sections 225.14(c)(1)(ii), 225.14(c)(2), and 225.14(c)(7) of Regulation Y.

2090.2.7 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws*[1]	*Regulations*[2]	*Interpretations*[3]	*Orders*
Capital adequacy guidelines Regulation Y, appendixes A and D		225	4–797 4–798 4–855	
Small BHC Policy Statement Regulation Y, appendix C		225	4–856	

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. *Federal Reserve Regulatory Service* reference.

''Bootstrapping'' is the term generally used to describe a treasury stock transaction in which a company incurs debt to purchase or redeem its own outstanding shares. Bootstrapping is often used to facilitate a change in control whereby a shareholder or shareholder group need only buy few or no shares in order to gain control. The repurchase or redemption is often made in accordance with a written agreement made between a former controlling shareholder(s) and the new controlling shareholder(s).

Section 225.4(b) of Regulation Y requires a bank holding company to file prior written notice with the Board before a purchase or redemption of any of its own equity securities if the gross consideration for the purchase or redemption, when aggregated with the net consideration paid by the company for all such purchases or redemptions during the preceding 12 months, is equal to 10 percent or more of the company's consolidated net worth. (Net consideration is the gross consideration paid by the company for all of its equity securities purchased or redeemed during the period minus the gross consideration received for all of its equity securities sold during the period other than as a part of a new issue.)

Each notice shall furnish the following information:

- The purpose of the transaction, a description of the securities to be purchased or redeemed, the total number of each class outstanding, the gross consideration to be paid, and the terms of any debt incurred in connection with the transaction.
- A description of all equity securities redeemed within the preceding 12 months, the net consideration paid, and the terms of any debt incurred in connection with those transactions.
- A current and pro forma consolidated balance sheet if the bank holding company has total assets of over $150 million, or a current and pro forma parent-company-only balance sheet if the bank holding company has total assets of $150 million or less.

2090.3.1 CHANGE IN CONTROL ACT CONSIDERATIONS

As indicated earlier, treasury stock redemptions are often intended to facilitate a change in control of a bank holding company. By redeeming the shares held by an existing shareholder(s), the remaining shareholder(s) increases his proportionate ownership. If a ''person's'' share ownership should rise above 25 percent or more of the remaining outstanding shares (subsequent to March 9, 1979), that person would then ''control'' the BHC. Under these circumstances, a change in control notification would have to be filed. If the treasury stock redemption is for an amount sufficient to trigger the requirement for a prior notification of redemption, then dual notifications are called for (change in control and redemption of treasury shares).

Similarly, prior notification is also required if a treasury stock redemption should result in a shareholder's holdings rising to between 10 percent and 25 percent of the remaining outstanding shares, and if (a) that shareholder is the firm's largest single shareholder immediately after the acquisition; or (b) the institution is registered under section 12 of the Securities Exchange Act of 1934 (i.e., corporations having assets exceeding $1 million, more than 500 shareholders, and securities that are publicly traded). For additional information on change in control notification requirements, see section 2090.1.

Additional notices under the CIBC Act do not have to be filed if regulatory clearance had already been received to acquire 10 percent or more of the voting shares of a bank holding company, and subsequent treasury stock redemptions resulted in ownership of between 10 and 25 percent of the shares of the bank holding company. Refer to section 225.41(a)(2) of Regulation Y.[1]

2090.3.2 INSPECTION OBJECTIVES

1. To determine that a BHC that has redeemed shares of its own stock has complied with section 225.4(b) of Regulation Y.

2. To determine that any new controlling shareholder of a BHC that has redeemed shares of its own stock has complied with section 225.41(a) of Regulation Y.

3. To determine if a treasury stock transaction has taken place for the purpose of depleting the original 25 percent equity investment in the purchase price.

1. Revised by the Board, effective November 9, 1990.

2090.3.3 INSPECTION PROCEDURES

1. Review the BHC's reconcilement of stockholders' equity to determine if shares have been redeemed.

2. If shares have been redeemed, review for compliance with treasury stock redemption approval and reporting requirements.

3. Determine whether the BHC is using, repeatedly, the less than 10 percent ownership exemption to avoid notice requirements, thus undermining the capital position of the banking organization, resulting in an unsafe and unsound practice.

4. Determine if the less than 10 percent ownership exemption is being used by the bank holding company when it does not satisfy the requirements of the Board's capital guidelines for redemptions.

The exemption should not be used by a bank holding company that does not meet the Board's capital guidelines for redemptions. Redemptions of permanent equity or other capital instruments before stated maturity could have a significant impact on an organization's overall capital structure. Use of the exemption could significantly reduce its capital. Consequently, an organization considering such a step should consult with the Federal Reserve before redeeming any equity (prior to maturity) if such redemption could have a material effect on the level or composition of the organization's capital base.

The exemption should not be used by a small one-bank holding company if it would increase its debt-to-equity ratios significantly above those relied on by the Board in approving its application to become a bank holding company.

5. If shares have been redeemed, determine if any shareholder's holdings have risen to 25 percent or more of the outstanding shares.

6. If shares have been redeemed, determine if any shareholder's holdings have risen to between 10 percent and 25 percent of the outstanding shares. Furthermore, determine whether the shareholder is then the largest shareholder or the institution has registered securities under section 12 of the Securities Exchange Act of 1934.

7. If a stock redemption occurred recently in a bank holding company, determine if the shareholders have maintained a 25 percent equity investment.

On July 8, 1982, the Board issued a policy statement setting forth its concerns and providing guidance with respect to investments by bank holding companies in nonvoting shares of other bank holding companies or banks (refer to F.R.R.S. 4–172.1, 1982 FRB 413, and 12 C.F.R. 225.143). The statement notes considerations the Board will take into account in determining whether such investments are consistent with the Bank Holding Company Act, and describes the general scope of arrangements to be avoided in these agreements. The Board's statement was occasioned by the fact that a number of bank holding companies have made substantial equity investments in banks or bank holding companies located across state lines, in expectation of statutory changes that might make interstate banking permissible. The following is the text of the Board's statement:

In recent months, a number of bank holding companies have made substantial equity investments in a bank or bank holding company (the ''acquiree'') located in states other than the home state of the investing company through acquisition of preferred stock or nonvoting common shares of the acquiree. Because of the evident interest in these types of investments and because they raise substantial questions under the Bank Holding Company Act (the ''Act''), the Board believes it is appropriate to provide guidance regarding the consistency of such arrangements with the Act.

This statement sets out the Board's concerns with these investments, the considerations the Board will take into account in determining whether the investments are consistent with the Act, and the general scope of arrangements to be avoided by bank holding companies. The Board recognizes that the complexity of legitimate business arrangements precludes rigid rules designed to cover all situations and that decisions regarding the existence or absence of control in any particular case must take into account the effect of the combination of provisions and covenants in the agreement as a whole and the particular facts and circumstances of each case. Nevertheless, the Board believes that the factors outlined in this statement provide a framework for guiding bank holding companies in complying with the requirements of the Act.

2090.4.1 STATUTORY AND REGULATORY PROVISIONS

Under section 3(a) of the Act, a bank holding company may not acquire direct or indirect ownership or control of more than 5 percent of the voting shares of a bank without the Board's prior approval (12 U.S.C. Para. 1842(a)(3)). In addition, this section of the Act provides that a bank holding company may not, without the Board's prior approval, acquire control of a bank: that is, in the words of the statute, ''for any action to be taken that causes a bank to become a subsidiary of a bank holding company'' (12 U.S.C. Para. 1842(a)(2)). Under the Act, a bank is a subsidiary of a bank holding company if:

1. The company directly or indirectly owns, controls, or holds with power to vote 25 percent or more of the voting shares of the bank;

2. The company controls in any manner the election of a majority of the board of directors of the bank; or

3. The Board determines, after notice and opportunity for hearing that the company has the power, directly or indirectly, to exercise a controlling influence over the management or policies of the bank (12 U.S.C. Para. 1841(d)).

In intrastate situations, the Board may approve bank holding company acquisitions of additional banking subsidiaries. However, where the acquiree is located outside the home state of the investing bank holding company, section 3(d) of the Act prevents the Board from approving any application that will permit a bank holding company to ''acquire, directly or indirectly, any voting shares of, interest in, or all or substantially all of the assets of any additional bank'' (12 U.S.C. 1842(d)(1)).

2090.4.2 REVIEW OF AGREEMENTS

In apparent expectation of statutory changes that might make interstate banking permissible, bank holding companies have sought to make substantial equity investments in other bank holding companies across state lines, but without obtaining more than 5 percent of the voting shares or control of the acquiree. These investments involve a combination of the following arrangements:

1. Options on, warrants for, or rights to convert nonvoting shares into substantial blocks of voting securities of the acquiree bank holding company or its subsidiary bank(s);

2. Merger or asset acquisition agreements

with the out-of-state bank or bank holding company that are to be consummated in the event interstate banking is permitted;

3. Provisions that limit or restrict major policies, operations or decisions of the acquiree; and

4. Provisions that make acquisitions of the acquiree or its subsidiary bank(s) by a third party either impossible or economically impracticable.

The various warrants, options, and rights are not exercisable by the investing bank holding company unless interstate banking is permitted, but may be transferred by the investor either immediately or after the passage of a period of time or upon the occurrence of certain events.

After a careful review of a number of these arrangements, the Board believes that investments in nonvoting stock, absent other arrangements, can be consistent with the Act. Some of the agreements reviewed appear consistent with the Act since they are limited to investments of relatively moderate size in nonvoting equity that may become voting equity only if interstate banking is authorized.

However, other agreements reviewed by the Board raise substantial problems of consistency with the control provisions of the Act because the investors, uncertain whether or when interstate banking may be authorized, have evidently sought to assure the soundness of their investments, prevent takeovers by others, and allow for sale of their options, warrants, or rights to a person of the investor's choice in the event a third party obtains control of the acquiree or the investor otherwise becomes dissatisfied with its investment. Since the Act precludes the investors from protecting their investments through ownership or use of voting shares or other exercise of control, the investors have substituted contractual agreements for rights normally achieved through voting shares.

For example, various covenants in certain of the agreements seek to assure the continuing soundness of the investment by substantially limiting the discretion of the acquiree's management over major policies and decisions, including restrictions on entering into new banking activities without the investor's approval and requirements for extensive consultations with the investor on financial matters. By their terms, these covenants suggest control by the investing company over the management and policies of the acquiree.

Similarly, certain of the agreements deprive the acquiree bank holding company, by covenant or because of an option, of the right to sell, transfer, or encumber a majority or all of the voting shares of its subsidiary bank(s) with the aim of maintaining the integrity of the investment and preventing takeovers by others. These long-term restrictions on voting shares fall within the presumption in the Board's Regulation Y that attributes control of shares to any company that enters into any agreement placing long-term restrictions on the rights of a holder of voting securities (12 C.F.R. Para. 225.31(d)(2).

Finally, investors wish to reserve the right to sell their options, warrants or rights to a person of their choice to prevent being locked into what may become an unwanted investment. The Board has taken the position that the ability to control the ultimate disposition of voting shares to a person of the investor's choice and to secure the economic benefits therefrom indicates control of the shares under the Act.[1] Moreover, the ability to transfer rights to large blocks of voting shares, even if nonvoting in the hands of the investing company, may result in such a substantial position of leverage over the management of the acquiree as to involve a structure that inevitably results in control prohibited by the Act.

2090.4.3 PROVISIONS THAT AVOID CONTROL

In the context of any particular agreement, provisions of the type described above may be acceptable if combined with other provisions that serve to preclude control. The Board believes that such agreements will not be consistent with the Act unless provisions are included that will preserve management's discretion over the policies and decisions of the acquiree and avoid control of voting shares.

As a first step towards avoiding control, covenants in any agreement should leave management free to conduct banking and permissible nonbanking activities. Another step to avoid control is the right of the acquiree to "call" the equity investment and options or warrants to assure that covenants that may become inhibiting can be avoided by the acquiree. This right makes such investments or agreements more like a loan in which the borrower has a right to escape covenants and avoid the lender's influence by prepaying the loan.

A measure to avoid problems of control aris-

1. See Board letter dated March 18, 1982, to C.A. Cavendes, Sociedad Financiera.

ing through the investor's control over the ultimate disposition of rights to substantial amounts of voting shares of the acquiree would be a provision granting the acquiree a right of first refusal before warrants, options or other rights may be sold and requiring a public and dispersed distribution of those rights if the right of first refusal is not exercised.

In this connection, the Board believes that agreements that involve rights to less than 25 percent of the voting shares, with a requirement for a dispersed public distribution in the event of sale, have a much greater prospect of achieving consistency with the Act than agreement involving a greater percentage. This guideline is drawn by analogy from the provision in the Act that ownership of 25 percent or more of the voting securities of a bank constitutes control of the bank.

The Board expects that one effect of this guideline would be to hold down the size of the nonvoting equity investment by the investing company relative to the acquiree's total equity, thus avoiding the potential for control because the investor holds a very large proportion of the acquiree's total equity. Observance of the 25 percent guideline will also make provisions in agreements providing for a right of first refusal or a public and widely dispersed offering of rights to the acquiree's shares more practical and realistic.

Finally, certain arrangements should clearly be avoided regardless of other provisions in the agreement that are designed to avoid control. These are:

1. Agreements that enable the investing bank holding company (or its designee) to direct in any manner the voting of more than 5 percent of the voting shares of the acquiree;

2. Agreements whereby the investing company has the right to direct the acquiree's use of the proceeds of an equity investment by the investing company to effect certain actions, such as the purchase and redemption of the acquiree's voting shares; and

3. The acquisition of more than 5 percent of the voting shares of the acquiree that "simultaneously" with their acquisition by the investing company become nonvoting shares, remain nonvoting shares while held by the investor, and revert to voting shares when transferred to a third party.

2090.4.4 REVIEW BY THE BOARD

This statement does not constitute the exclusive scope of the Board's concerns, nor are the considerations with respect to control outlined in this statement an exhaustive catalog of permissible or impermissible arrangements. The Board has instructed its staff to review agreements of the kind discussed in this statement and to bring to the Board's attention those that raise problems of consistency with the Act. In this regard, companies are requested to notify the Board of the terms of such proposed merger or asset acquisition agreements or nonvoting equity investments prior to their execution or consummation.

Pursuant to Section 3 of the Bank Holding Company Act, a bank holding company, directly or through its subsidiary banks, may not acquire more than 5 percent of the shares of an additional bank without the Board's prior approval. However, it is recognized that banks acting as trustee may acquire such shares without prior notice. Therefore, the Act requires a bank or banks which are subsidiaries of bank holding companies and acquire in excess of the 5 percent threshold limit, to file an application with the Board within 90 days after the shares exceeding the limit are acquired. The limit generally applies *only* to other bank shares over which the acquiring fiduciary exercises sole discretionary voting authority. Nevertheless, the Board has waived this application requirement under most circumstances in Section 225.12 of Regulation Y, unless—

1. the acquiring bank or other company has sole discretionary authority to vote the securities and retains the authority for more than two years; or

2. the acquisition is for the benefit of the acquiring bank or other company, or its shareholders, employees, or subsidiaries.

In determining whether the threshold limits have been reached, shares acquired prior to January 1, 1971 can ordinarily be excluded. On the other hand, shares of another bank held under the following circumstances should, in certain instances, be included in the 5 percent threshold, even though sole discretionary voting authority is not held:

1. Shares held by a trust which is a "company", as defined in Section 2(b) of the Bank Holding Company Act; and,

2. Shares held as trustee for the benefit of the acquiring bank or bank holding company, or its shareholders, employees or subsidiaries.

A bank holding company should have procedures for monitoring holdings of the stock of other banks and bank holding companies for compliance with the foregoing application requirements of the Act, for compliance with reporting requirements on form Y–6, and for compliance with certain similar reporting requirements under the federal securities laws. A general 5 percent threshold applies in all three situations, although differing requirements and exemptions apply.

Examiners specifically trained in trust examinations may need to conduct this portion of an inspection and, in appropriate circumstances, the examiner may need to consult with Federal Reserve Bank legal counsel. Trust examiners routinely review such matters in connection with individual trust examinations. The inspection objectives will be to determine whether the holdings of shares of other banks or bank holding companies, in a fiduciary capacity, are appropriately monitored to comply with section 3(a) of the Bank Holding Company Act with other reporting requirements for such holdings.

The spin-off or sale of property by a bank holding company may not sever the bank holding company's control relationship over such property for purposes of the Bank Holding Company Act. The factors which are normally considered in determining whether control has ceased include the presumptions of control listed in section 225.31(a) of Regulation Y and in sections 2(a)(2) and 2(g) of the Act, and certain ownership and voting rights.

Most of the irrebuttable and rebuttable presumptions of control were written to establish initially a control relationship between two companies. Only the provisions of section 2(g)(3) relate solely to a continued control relationship after an attempt has been made to end that control. However, all of the presumptions of control must be considered before presuming that a divestiture is effective. Irrebuttable control relationships are established, or continue to be recognized, when any of the conditions listed in section 225.2(e) of Regulation Y or sections 2(a)(2)(A), 2(a)(2)(B), 2(g)(1), or 2(g)(2) of the Act exist. Thus, a company is assumed to have irrebuttable control over a bank or another company without a Board determination if:

1. The company directly or indirectly owns, controls, or has power to vote 25 percent or more of the voting securities of the bank or other company;

2. The company controls in any manner the election of a majority of the directors or trustees of the bank or other company;

3. Trustees directly or indirectly hold or control shares of the bank or other company for the benefit of the company, the shareholders or members of the company, or the employees of the company.

Rebuttable presumptions of control are listed in section 225.31(d) of Regulation Y and in sections 2(a)(2)(C) and 2(g)(3) of the Act. These sections describe situations which are not as clearly defined as the irrebuttable presumptions. For example, a company which enters into a management contract that gives the company significant control over the operations or management of a bank or other company may be deemed to exercise a controlling influence over that bank or other company. Section 225.31(c) of Regulation Y and section 2(a)(2)(C) of the Act require a Board determination to establish that a company directly or indirectly exercises a controlling influence over the management or policies of a bank or other company. Thus, it is assumed that no control exists unless the Board determines that it does. Section 2(g)(3) of the Act, however, is ''automatic'' in the sense that an effective control relationship is assumed to continue without the need for a determination by the Board if certain conditions are met. This presumption is ''rebuttable'' because, at the request of the company, the Board later may determine that the control relationship in fact does not exist.

Section 2(g)(3) was added to the Act with the 1966 Amendments to provide the Board with an opportunity to consider the consequences of a transfer before it is deemed to be effective. It states that:

> ''shares transferred after January 1, 1966, by any bank holding company (or by any company which, but for such transfer, would be a bank holding company) directly or indirectly to any transferee that is indebted to the transferor, or has one or more officers, directors, trustees, or beneficiaries in common with or subject to control by the transferor, shall be deemed to be indirectly owned or controlled by the transferor unless the Board, after opportunity for hearing, determines that the transferor is not in fact capable of controlling the transferee.''

Section 2(g)(3) contains the factors most commonly cited as reasons for a control determination; i.e., the purchaser is indebted to the divesting company or has officers or directors in common with the divesting company. If the transferee is indebted to or has personnel in common with the transferor, an effective control relationship is assumed to continue at the date of the transfer without the need for an order or a determination by the Board. Control will continue to be presumed until either the condition causing the presumption is removed or the Board determines, that ''the transferor is not in fact capable of controlling the transferee.''

Although section 2(g)(3) refers to transfers of ''shares'' it is not limited to the disposition of corporate stock, but includes any transfer of a ''significant volume of assets.'' Thus, when the transfer constitutes the disposition of all or substantially all of the assets of a subsidiary or a separate activity of the company, it is deemed to represent a transfer of ''shares.'' General or limited partnership interests are included in this definition. A determination of whether the vol-

ume of assets transferred is ″significant'' will be made on an *ad hoc* basis. Included in the definition of ''shares'' are shares or other assets acquired in satisfaction of a debt previously contracted, or acquired as an incident to an essentially separate transaction.

The term ''transferor'' includes the bank holding company, its parent, and its subsidiaries. Likewise, ''transferee'' includes the parent and subsidiaries of any company to which assets are transferred. Thus, when the transferee, its parent, or its subsidiary is indebted to or has common personnel with the transferor, its parent, or its subsidiary, a presumption under section 2(g)(3) arises. For example, if a subsidiary of the transferee is indebted to the parent of the transferor, the presumption arises.

The term ''transferee'' has been interpreted also to include individuals. Thus, if property is transferred to an individual who holds a position with or is indebted to the transferor, its parent, or its subsidiaries, the presumption arises.

The indebtedness to which section 2(g)(3) refers may be debt incurred in connection with the transfer, or pre-existing debt. For instance, if a bank holding company transfers to an outside individual a subsidiary to which it had made a working capital loan, the presumption of control arises as a result of that debt. Although a presumption arises even when the debt was previously in existence, this factor may not be viewed as an indication of control in determinations pursuant to section 2(g)(3).

The statutory presumption of control in section 2(g)(3) will not apply in certain cases if the indebtedness of the transferee to the transferor or a subsidiary involves certain routine loans to companies (as defined in section 2(b) of the Act) in an aggregate amount not exceeding 10 percent of the total purchase price of the transferred asset; or certain personal loans to an individual such as a credit card balance, student loan or home mortgage loan. Such loans must have been made on normal terms in the ordinary course of business, and may not be secured by the transferred asset.

The phrase ''officers, directors, trustees, or beneficiaries'' has been interpreted to include policy-making employees or consultants, general partners in a partnership, or limited partners having a right to participate in management, and any person who performs (directly or through an agent, representative, or nominee) functions comparable to those normally associated with the foregoing offices or positions. The presumption is valid even if the position is held in an honorary or advisory capacity. The presumption is also valid even if the person involved does not hold the same type of position with the transferor as with the transferee or the transferred company. For example, if a bank holding company sells assets to a trust whose trustee is an officer of the holding company, the presumption is applicable.

When a divestiture takes place through the distribution of shares, quite often officers and directors will receive a portion of the shares. Because these individuals are considered to be transferees and because they are officers or directors of the transferor, a presumption of control under section 2(g)(3) results. However, the presumption will be of legal significance only when the shares subject to this presumption constitute more than 5 percent of the voting stock of a nonbanking company or 25 percent or more of the voting stock of a bank (5 percent if the transferor continues to be a bank holding company without reference to the shares transferred).

Finally, section 2(g)(3) provides that a Board determination will be made after opportunity for hearing. When the Board's General Counsel, acting under delegated authority, has determined that a control situation does continue to exist, the case will be referred to the Board for a decision and an opportunity for hearing will be made through publication of a notice in the *Federal Register.*

In addition to the review of the applicability of each of the conclusive and rebuttable presumptions of control, a review of certain ownership and voting rights will be made before a divestiture is considered effective. Generally, the Board has not regarded a divestiture of holdings of voting shares to less than 25 percent, but more than 5 percent, as effective though in most cases an acquisition of less than 25 percent of a company would not result in that company being regarded as a subsidiary. This policy pertains because the retention of such an economic interest in such a company could provide an incentive for the transferor to influence the management of the company. However, the reduction of ownership to less than 5 percent of the outstanding voting stock of a company usually is considered to be an effective divestiture. In addition, due to its continuing economic interest, a bank holding company cannot effectively divest of a company by converting its holdings of the company's voting shares to nonvoting shares or by agreeing not to vote the shares.

2090.6.1 INSPECTION OBJECTIVES

1. To determine whether or not the divesting company retained a significant voting or ownership interest in the divested property.
2. To determine whether section 2(g)(3) of the Act or any of the rebuttable presumptions of control listed in section 225.31(d) of Regulation Y raise a control issue with regard to the transferor and the transferee or the transferred property.
3. To determine whether section 2(g)(2) of the Act or any of the other irrebuttable presumptions of control listed in section 225.2(e) of Regulation Y raise a control issue with regard to the transferor and the transferee or the transferred property.

2090.6.2 INSPECTION PROCEDURES

The examiner should review the stock records of the transferor, the transferee, and the transferred entity, if possible. Management contracts, trust agreements, and any pertinent agreements among these parties also should be reviewed for any evidence of a control relationship. When following these procedures for a bank holding company which has divested or will divest of property, the examiner should be aware that the criteria for establishing a continuing control relationship are more stringent than those for establishing an initial control relationship. Thus, the examiner should review all ownership and voting rights rather than just those above 5 or 25 percent.

The examiner should review the records of the bank holding company, its parents, and its subsidiaries as well as the records of the company being divested and the company (and its parent and subsidiaries) acquiring the divested property for evidence of a continuing control relationship as described in section 2(g)(3) of the Act. If the transferee is an individual or if the records of the transferee are not available, the examiner should inquire whether any of the specific control relationships exist. Specifically, the examiner should determine whether the transferee, its parent, or its subsidiaries, are indebted to or have common personnel (officers, directors, trustees, beneficiaries, policy making employees, consultants, etc.) with the transferor, its parent, or its subsidiaries.

2090.6.3 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Presumptions of control	Sections 2(g)(1) and 2(g)(2) of the act	225.31(a) 225.139		
Statement of policy concerning divestitures		225.138		
Divestiture proceedings		225.32		
Rebuttable presumptions of control	Section 2(g)(3) of the act	225.31(d) 225.139		
Requirements placed on transferee and transferor to ensure a complete separation				Alfred I. duPont Testamentary Trust; September 21, 1977
Control is not terminated if a rebuttable presumption of control is applicable				Alfred I. duPont Testamentary Trust; October 3, 1977
Explanation of ‘‘transferor,’’ ‘‘transferee,’’ ‘‘shares,’’ and procedures		225.139(c)(1)		1978 FRB 211

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
"Transferee" includes individuals		225.139 (footnote 4)		Summit Home Insurance Company, Minneapolis, Minnesota; August 30, 1978 The Moody Foundation, Galveston, Texas; January 16, 1968
Presumption of control through common directors, officers, etc.		225.139		GATX Corporation, Chicago, Illinois; February 21, 1978
Reduction of ownership to less than 5 percent of a subsidiary is an effective divestiture				Financial Securities Corporation, Lake City, Tennessee; August 29, 1972
Individual may be a transferee; an insignificant debt relationship may exist		225.139		Mercantile National Corporation, Dallas, Texas; June 2, 1975
Control terminated although shares were pledged as collateral on a note representing part of purchase price				Equimark Corporation, Pittsburgh, Pennsylvania; February 4, 1977
Application to retain control pursuant to rebuttable presumption; approved, but company not authorized to acquire additional shares				First Bancorp, Inc., Dallas, Texas; February 22, 1977
Application to divest control pursuant to rebuttable presumption; approved				Commanche Land and Cattle Company, Commanche, Texas; January 15, 1980
Indebtedness of transferee to transferor		225.139(c)(4)		1980 FRB 237

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. *Federal Reserve Regulatory Service* reference.

WHAT'S NEW IN THIS REVISED SECTION

This section has been revised to include a March 21, 2006, Board staff legal opinion that confirms that a direct conversion from a state-chartered bank to a national bank would not, by itself, cause a parent company to lose its grandfather rights maintained under section 4(f) of the BHC Act. The BHC Act prevents a grandfathered nonbank BHC from acquiring control of an additional bank or thrift as a limited-purpose trust company, which would not be a bank *for the purposes of the BHC Act.*

2090.7.1 CEBA AND FIRREA PROVISIONS FOR NONBANK BANKS

The Competitive Equality Banking Act (CEBA), effective August 10, 1987, amended section 2(c) of the BHC Act by expanding the definition of *bank* to include all FDIC-insured depository institutions. The definition also includes any other institution that (1) accepts demand deposits or other deposits that the depositor may make payable to third parties (demand deposits) and (2) is engaged in the business of making commercial loans. The new definition covers institutions that were not previously covered by the BHC Act (nonbank banks). Thrift institutions that remain primarily residential mortgage lenders continue to be excepted from the definition of bank.

CEBA amended section 4 of the BHC Act by adding a grandfather provision that permits a nonbanking company that on March 5, 1987, controlled an institution that became a bank under CEBA to retain the institution and not be treated as a bank holding company. A grandfathered company will lose its exemption, however, if it violates any of several prohibitions governing its activities. Among these prohibitions, a grandfathered company may not acquire control of an additional bank or a thrift institution or acquire more than 5 percent of the assets or shares of an additional bank or thrift.[1] In addition, no bank subsidiary of the grandfathered company may commence to accept demand deposits and engage in the business of making commercial loans. A bank subsidiary of the grandfathered company may also not permit an overdraft[2] (including an interday overdraft) or incur an overdraft on behalf of an affiliate[3] at a Federal Reserve Bank.[4]

If a grandfathered company no longer qualifies for an exemption, the company must divest control of all the banks it controls within 180 days after the date that the company receives notice from the Board that it no longer qualifies for the exemption. The exemption may be reinstated if, before the end of the 180-day notice period, the company (1) corrects the condition or ceases the activity that caused its exemption to end or submits a plan to the Board for approval to correct the condition or cease the activity within one year and (2) implements procedures reasonably adapted to avoid a recurrence of the condition or activity.

The Board may examine and require reports of grandfathered companies and of the nonbank banks they control but only to monitor or enforce compliance with the grandfather restrictions. The Board also may use civil enforcement powers, including cease-and-desist orders, to enforce compliance.

Grandfathered companies, their affiliates, and their nonbank banks are also subject to the

1. An exception to this prohibition is made for cases involving the acquisition of a failing thrift provided that (1) the thrift is acquired in an emergency acquisition and is either located in a state where the grandfathered company already controls a bank or has total assets of $500 million or more at the time of the acquisition or (2) the thrift is acquired from the RTC, FDIC, or director of the OTS in an acquisition in which federal or state authorities find the institution to be in danger of default.

2. Section 225.52 of Regulation Y further defines the restrictions on overdrafts.

3. Section 225.52(b)(2)(ii) of Regulation Y provides that a nonbank bank (or an industrial bank) incurs an overdraft on behalf of an affiliate when (1) the nonbank bank holds an account at a Federal Reserve bank for an affiliate from which third-party payments can be made and (2) the posting of an affiliate's transactions to the nonbank bank's or industrial bank's account creates an overdraft or increases the amount of an existing overdraft in the account.

4. The overdraft prohibition does not apply if the overdraft (1) results from an inadvertent computer or accounting error that is beyond the control of both the bank and the affiliate; (2) is permitted or incurred on behalf of an affiliate that is monitored by, reports to, and is recognized as a primary dealer by the Federal Reserve Bank of New York and is fully secured, as required by the Board, by direct U.S. obligations, obligations fully guaranteed as to principal and interest by the United States, or securities or obligations eligible for settlement by the Federal Reserve book-entry system; or (3) is permitted or incurred by or on behalf of an affiliate in connection with an activity that is financial in nature or incidental to a financial activity and does not cause the bank to violate any provision of sections 23A or 23B of the Federal Reserve Act directly or indirectly or by virtue of section 18(j) of the Federal Deposit Insurance Act.

anti-tying restrictions of the BHC Act and to the insider-lending restrictions of section 22(h) of the FRA and in Regulation O. Thus, for example, a nonbank bank may not condition a grant of credit on the purchase of a product or service from its grandfathered holding company, or vice versa, and it may not extend credit to insiders of the nonbank bank or its grandfathered holding company on preferential terms.

A bank holding company that controls a nonbank bank may retain it as long as the nonbank bank does not (1) engage in an activity[5] that would have caused it to be a bank before the effective date of CEBA or (2) increase the number of locations from which it does business after March 5, 1987. These limitations do not apply if (1) the nonbank bank is viewed as an additional bank subsidiary of the bank holding company and (2) the BHC's acquisition of the nonbank bank would be permissible under the interstate banking provisions of the BHC Act.

2090.7.2 RETAINING GRANDFATHER RIGHTS UNDER SECTION 4(F) OF THE BHC ACT

A state nonmember bank (Bank A) that became a ''bank'' for purposes of the BHC Act as a result of CEBA requested a determination that its conversion to a national bank and merger with a limited-purpose trust company would not cause its parent company to lose certain grandfather rights that it maintains under section 4(f) of the BHC Act. (See 12 U.S.C. 1843(f).)

The parent company could retain ownership of Bank A and not be treated as a bank holding company, but only if it and Bank A abided by the conditions set forth in section 4(f) of the BHC Act. One of these conditions generally prohibits the parent company from acquiring control of more than 5 percent of the shares or assets of an additional bank or savings association. (See 12 U.S.C. 1843(f)(2)(A)(i) and (ii).)

The parent company wished to convert Bank A into a national bank. The conversion would be effected directly, and the parent company would not establish, or acquire any shares of, a separate bank or savings association as part of the conversion process. Simultaneously with the conversion process, however, the parent company would establish a new, limited-purpose national bank trust company (trust company). It was represented that the trust company would comply with the limitations and restrictions in, and would qualify for, the trust company exception from the definition of *bank* under section 2(c)(2)(D) of the BHC Act. (See 12 U.S.C. 1841.) The parent company would then cause the trust company to merge into Bank A, with Bank A being the entity that survives the merger. Bank A would then change its name (new bank) and the location of its headquarters.

Under the proposed transaction, the parent company would remain the sole shareholder of new bank. It was represented that, prior to its merger with Bank A, the trust company would not be an operating company and would have no assets or liabilities. It was also represented that the proposal would not result in any change in ownership or control of Bank A.

The Board's legal staff concluded that the direct conversion of Bank A from a state-chartered bank to a national bank would not, by itself, cause the parent company to lose its grandfather rights under section 4(f) of the BHC Act.[6] Also, the BHC Act would not prevent the parent company from chartering the trust company. Although the BHC Act prevents a grandfathered nonbank bank from acquiring control of an additional bank or thrift (12 U.S.C. 1843(f)(2)(A)), the trust company as a limited-purpose trust company would not be a *bank* for the purposes of the BHC Act.

The Board's Legal Division staff stated that it would not recommend that the Board determine that the transactions described in the request would cause the parent company to lose its grandfather rights under section 4(f) of the BHC Act. New bank is required to comply with the conditions applicable to a nonbank bank and a grandfathered holding company, respectively, under the BHC Act. (See the Board staff legal opinion dated March 21, 2006.)

5. Previously, a nonbank bank could accept demand deposits *or* engage in the business of making commercial loans, but could not engage in both activities.

6. See letter from the general counsel of the Board, dated October 12, 2004.

2090.7.3 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws*[1]	*Regulations*[2]	*Interpretations*[3]	*Orders*
Limitations on nonbank banks	1843(f)	225.52		

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. *Federal Reserve Regulatory Service* reference.

The Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA), effective August 9, 1990, provided [12 U.S.C. 1815 (e)] that any insured depository institution will be liable for any actual or reasonably anticipated loss incurred or to be incurred by the FDIC in connection with:

1. The default of a commonly controlled[1] depository institution; or
2. Any assistance provided by the FDIC to any commonly controlled insured depository institution.

2090.8.1 FIVE YEAR PROTECTION FROM LIABILITY (5-YEAR TRANSITION RULE)

Sister banks, for five years from the enactment of the law, are protected against losses due to the default of a thrift acquired before enactment. The law also grants a five- year protection to thrifts for loss due to the default of a bank acquired before the law's enactment.

2090.8.2 CROSS-GUARANTEE PROVISIONS

FIRREA contains cross-guarantee provisions. These provisions enable the FDIC to obtain reimbursement from insured depository institutions, in the event that the FDIC incurs a loss due to any assistance provided to, or a default of, a commonly controlled bank or thrift.

The FDIC will provide written notice when an insured depository institution is being held liable for losses sustained by the FDIC in connection with assistance to a commonly controlled bank or thrift. Upon receipt of the written notice from the FDIC, the insured depository institution is required to pay the amount specified. An insured depository institution is not liable for losses incurred by the FDIC, in connection with a commonly controlled institution, if the written notice is not received within two years from the date of the FDIC's loss.

The liability the insured depository institution has to the FDIC is senior to shareholders' claims and any obligation or liability owed to any affiliate of the depository institution.[2] Claims of the FDIC against the depository institution are subordinate to any deposit liabilities, secured obligations and obligations that are subordinated to depositors (i.e. subordinated debt).

The FDIC may grant an insured depository institution a waiver of the cross-guarantee provisions, if it determines that such an exemption is in the best interests of the either the Bank or Savings Association Insurance Funds. Limited partnerships and affiliates of limited partnerships (other than an insured depository institution, which is a majority owned subsidiary of such partnership) may also be exempted from the provisions, if the limited partnership or its affiliate has filed a registration statement with the Securities and Exchange Commission, on or before April 10, 1989. The registration statement must indicate that as of the date of the filing, the partnership intended to acquire one or more insured depository institutions. If an insured depository institution is granted an exemption from the cross-guarantee provisions, then the institution and all of its insured depository institution affiliates must comply with the restrictions of sections 23A and 23B of the Federal Reserve Act without regard to section 23A(d)(1) which provides for certain exemptions.

2090.8.3 EXCLUSION FOR INSTITUTIONS ACQUIRED IN DEBT COLLECTIONS

FIRREA provides an exclusion from the cross-guarantee provisions for an institution acquired in securing or collecting a debt previously contracted in good faith. However, during the entire exclusion period, the controlling bank and all of its insured depository institution affiliates must comply with sections 23A and 23B of the Federal Reserve Act (FRA),[3] for transactions with the insured depository institution involving acquisitions as a result of debts previously contracted in good faith.

1. Depository institutions are commonly controlled if:
   a. Such institutions are controlled by the same depository institution holding company (including any company, such as nonbank banks, that are required to file reports under [12 U.S.C. 1843(f)(6)]; or
   b. One depository institution is controlled by another depository institution.

2. Does not apply to any obligation to affiliates secured as of May 1, 1989.

3. Without regard to section 23A(d)(1) of the FRA.