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.

2065.1.4 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.

2065.2.1 PURPOSE OF THE ALLOWANCE FOR LOAN LEASE LOSSES

The allowance for loan and lease losses (ALLL) reflects estimated credit losses within a holding company's portfolio of loans and leases. Estimated credit losses are estimates of the current amount of loans that are probable that the holding company will be unable to collect given the facts and circumstances since the evaluation date (generally the date of the holding company's balance sheet). That is, estimated credit losses represent net charge-offs that are likely to be realized for a loan or group of loans as of the evaluation date.

In accordance with U.S. Generally Accepted Accounting Principles (GAAP), a holding company maintains an ALLL at a level that is appropriate to cover estimated credit losses associated with its loan and lease portfolio, that is, loans and leases that the holding company has intent and ability to hold for the foreseeable future or until maturity or payoff. The ALLL is presented on an institution's balance sheet as a contra-asset account that reduces the amount of the loan portfolio reported on the balance sheet. Each holding company should also maintain, as a separate liability account, an ALLL at a level that is appropriate to cover estimated credit losses associated with off-balance sheet credit instruments such as off-balance sheet loan commitments, standby letters of credit, and guarantees. The FR-Y9C report instructions provide more ALLL reporting information for holding companies.

The ALLL also is a component for calculating tier 2 capital, as set forth in Regulation Q (12 CFR 217.20(d)). Tier 2 capital includes surplus related to the issuance of tier 2 capital instruments; limited amounts of total capital minority interest not included in an institution's tier 1 capital; and limited amounts of the ALLL, or adjusted allowances for credit losses (AACL), as applicable, less applicable regulatory adjustments and deductions.[1] An institution calculating its total capital ratio using the standardized approach may include in tier 2 capital the amount of ALLL or AACL that does not exceed 1.25 percent of its standardized total risk-weighted assets.

2065.2.2 DETERMINING AN ADEQUATE LEVEL FOR THE ALLL

In determining the adequacy of an institution's ALLL (including amounts based on an analysis of the commercial real estate portfolio), examiners will consider an institution's process for conducting the analysis and whether management consistently applies this process to the loan and lease portfolio.[2] 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 relevant 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.

1. ALLL means valuation allowances that have been established through a charge against earnings to cover estimated credit losses on loans, lease financing receivables, or other extensions of credit as determined in accordance with GAAP. ALLL excludes "allocated transfer risk reserves." For purposes of Regulation Q, ALLL includes allowances that have been established through a charge against earnings to cover estimated credit losses associated with off-balance-sheet credit exposures as determined in accordance with GAAP.

2. 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.

In addition, this analysis should consider the quality of the institution's systems and management in identifying, monitoring, and addressing asset-quality problems. Further, 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 performance 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 institution and provide for sufficient flexibility to accommodate changing circumstances.

Management should maintain reasonable records to support evaluating the adequacy the ALLL. Further, each institution is responsible for ensuring that controls are in place to consistently determine the allowance for loan and lease losses in accordance with GAAP (including ASC Subtopic 450-20, Contingencies – Loss Contingencies, and ASC Topic 310, Receivables), the institution's policies and procedures, management's best judgment, and relevant supervisory guidance.

2065.2.3 OVERVIEW OF THE 2006 ALLL POLICY STATEMENT

In 2006, the Federal Reserve and the other banking agencies issued a policy statement (2006 policy statement) regarding the ALLL that discusses

- its nature and purpose;
- the responsibilities of boards of directors, the institution's management, and the examiners of institutions; and
- factors to be considered in the estimation of the ALLL.[3]

The 2006 policy statement applies to all depository institutions supervised by the banking agencies, except for U.S. branches and agencies of foreign banks.[4] In addition, the Federal Reserve believes the guidance is broadly applicable to bank holding companies as well as savings and loan holding companies.[5] Accordingly, examiners should apply the policy, as appropriate, during inspections of holding companies and their nonbank subsidiaries, in addition to the examination of state member banks.

The 2006 policy statement indicates that it is the responsibility of an institution's board of directors and management to maintain the ALLL at an appropriate level. Each institution is responsible for developing, maintaining, and documenting a comprehensive, systematic, and consistently applied process for determining the amounts of the ALLL and the provision for loan and lease losses. To fulfill this responsibility, an institution should have controls to consistently determine the ALLL in accordance with GAAP, the institution's policies and procedures, management's best judgment, and relevant supervisory guidance. The 2006 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.[6]

The 2006 policy statement reiterates the policy that Federal Reserve examiners will generally accept management's estimates in their assessment of the appropriateness of the ALLL when management has (1) maintained effective loan review systems and controls for identifying, monitoring, and addressing asset-quality problems in a timely manner; (2) analyzed all significant environmental factors that affect the collectibility of the portfolio as of the evaluation date in a reasonable manner; (3) established an acceptable ALLL-evaluation process for both individual loans and groups of loans that meets the objectives for an appropriate ALLL; and (4) incorporated reasonable and properly supported assumptions, valuations, and judgments into the evaluation process.

The 2006 policy statement emphasizes that an institution should provide reasonable support

3. For the entire text of the 2006 policy statement, see SR-06-17, "Interagency Policy Statement on the Allowance for Loan and Lease Losses."

4. See SR-95-42, "Allowance for Loan and Lease Losses for U.S. Branches and Agencies of Foreign Banking Organizations," and SR-95-4, "Allowance for Loan and Lease Losses for U.S. Branches and Agencies of Foreign Banking Organizations."

5. See SR-14-9, "Incorporation of Federal Reserve Policies into the Savings and Loan Holding Company Supervision Program."

6. Attachment 1, "Loan Review Systems," of the 2006 policy statement has been superseded. For more guidance on effective credit risk review systems. See 85 Fed. Reg. 33,278 (June 1, 2020); SR-20-13, "Interagency Guidance on Credit Risk Review Systems;" and the *Commercial Bank Examination Manual*'s section entitled, "Credit Risk Review Systems."

and documentation of its ALLL estimates, including adjustments to the allowance for qualitative or environmental factors and unallocated portions of the allowance. This emphasis on support and documentation supplements, but does not replace, the guidance in the 2001 Interagency Policy Statement on the Allowance for Loan and Lease Losses Methodologies and Documentation for Banks and Savings Institutions (see SR-01-17).

Additionally, an institution-specific loss estimate generally should not be based solely on a "standard percentage" of loans. While peer group or other benchmark averages are an appropriate tool to evaluate the reasonableness of the allowance, an institution should analyze the collectibility of the loan portfolio to estimate the allowance and not assume a set percentage for loss estimates (that is, 15 percent for loans classified as substandard and 50 percent for loans classified as doubtful).

The 2006 policy statement also includes accounting guidance covering the acceptable methods to measure impairment. Lastly, the 2006 policy statement reminds institutions that allowances related to off-balance-sheet financial instruments such as loan commitments or letters of credit should not be reported as part of the ALLL. Any allowance for these types of instruments is recorded as an "other liability."

2065.2.4 ALLL METHODOLOGIES AND DOCUMENTATION

In 2001, the Federal Financial Institutions Examination Council issued the "Interagency Policy Statement on Allowance for Loan and Lease Losses Methodologies and Documentation for Banks and Savings Institutions" (2001 policy statement).[7] The 2001 policy statement clarifies the agencies' expectations for documentation that supports the ALLL methodology. Additionally, this statement emphasizes the need for an institution to have appropriate ALLL policies and procedures, including an effective loan-review system. The guidance also provides examples of appropriate supporting documentation. While the 2001 policy statement was intended for insured depository institutions, the Federal Reserve believes this guidance is broadly applicable to bank holding companies and to savings and loan holding companies.[8] Accordingly, examiners should consider this policy statement in their inspection of holding companies and their nonbank subsidiaries.

As discussed in the 2001 policy statement, an institution needs to establish its ALLL methodology in accordance with GAAP. 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. Under the direction of the board of directors, an institution's management should implement appropriate procedures and controls to promote 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 institution, the economy, or the lending environment by changing the methodology, when appropriate.

An institution's determination of 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.

2065.2.5 ALLL ESTIMATION PRACTICES FOR LOANS SECURED BY JUNIOR LIENS

In January 2012, the Federal Reserve and the other federal banking agencies issued, "Interagency Supervisory Guidance on Allowance for Loan and Lease Losses Estimation Practices for Loans and Lines of Credit Secured by Junior Liens on 1–4 Family Residential Properties." (See SR-12-3.)

An institution should consider all credit quality indicators relevant to their junior liens. Generally, this information should include the delinquency status of senior liens associated with the institution's junior liens and whether the senior lien has been modified. Further, institutions should ensure that during the ALLL estimation process, sufficient information is gathered to adequately assess the probable loss incurred within junior-lien portfolios. As discussed in the

7. For the entire text of the 2001 policy statement, see SR-01-17, "Final Interagency Policy Statement on Allowance for Loan and Lease Losses (ALLL) Methodologies and Documentation for Banks and Savings Institutions." See also 66 Fed. Reg. 35,629 (July 6, 2001).

8. See SR-14-9.

guidance, an institution should refer to GAAP for recognizing ALLL.

The guidance states that an institution should use reasonably available tools to determine the payment status of senior liens associated with its junior liens, such as credit reports, third-party services, or, in certain cases, a proxy. Typically, large, complex institutions with significant home equity lending activity would find most tools reasonably available and would use proxies in limited circumstances.

More information on risk-management principles for junior-lien loans and home equity lines of credit is available in the May 2005 "Interagency Credit Risk Management Guidance for Home Equity Lending." (See SR-05-11 and section 2010.2.4 of this manual.)

2065.2.6 SUPERVISORY CONSIDERATIONS FOR ASSESSING ALLL

Examiners should assess the credit quality of an institution's loan portfolio, the appropriateness of its ALLL methodology and documentation, and the appropriateness of its ALLL. The Federal Reserve Board, the Federal Deposit Insurance Corporation, the National Credit Union Administration, and the Office of the Comptroller of the Currency issued interagency guidance on credit risk review systems for supervised institutions in 2020.[9] The credit risk review guidance discusses sound management of an institution's credit risk; a system of independent, ongoing credit review; and appropriate communication regarding the performance of the institution's loan portfolio to its management and board of directors. In addition, the *Commercial Bank Examination Manual* provides specific examination objectives and procedures to assist examiners in reviewing the appropriateness of an institution's ALLL.

In their review and classification or grading of the loan portfolio, examiners consider significant factors that affect the collectibility of the loan portfolio, including the value of any collateral. In reviewing the appropriateness of the ALLL, examiners should:

- Consider the effectiveness of board oversight as well as the quality of the institution's loan review system and its management in identifying, monitoring, and addressing asset quality problems. This will include a review of the institution's loan review function and credit grading system. Typically, examiners will test a sample of the institution's loans.[10]
- Evaluate the institution's ALLL policies and procedures and assess the methodology that management uses to arrive at an overall estimate of the ALLL, including whether management's assumptions, valuations, and judgments appear reasonable and are properly supported. If a range of credit losses has been estimated by management, evaluate the reasonableness of the range and management's best estimate within the range. In making these evaluations, examiners should ensure that the institution's historical loss experience and all significant qualitative or environmental factors that affect the collectibility of the portfolio (including changes in the quality of the institution's loan review function and the other factors previously discussed) have been appropriately considered and that management has appropriately applied GAAP.
- Review management's use of loss estimation models or other loss estimation tools to ensure that the resulting estimated credit losses are in conformity with GAAP.
- Review the appropriateness and reasonableness of the overall level of the ALLL. In some instances, this may include a quantitative analysis (for example, using the types of ratio analysis previously discussed) as a preliminary check on the reasonableness of the ALLL. This quantitative analysis should demonstrate whether changes in the key ratios from prior periods are reasonable based on the examiner's knowledge of the collectibility of loans at the institution and its current environment.
- Review the ALLL amount reported in the institution's regulatory reports and financial statements and ensure these amounts reconcile to its ALLL analyses. There should be no material differences between the consolidated loss estimate, as determined by the ALLL methodology, and the final ALLL balance

9. See SR-20-13.

10. An institution may have a credit risk rating framework that differs from the framework for loan classifications used by the federal banking agencies. Such institutions should maintain documentation that translates their risk ratings into the regulatory classification framework used by the federal banking agencies. This documentation will enable examiners to reconcile the totals for the various loan classifications or risk ratings under the institution's system to the federal banking agencies' categories contained in the Uniform Agreement on the Classification and Appraisal of Securities Held by Depository Institutions Attachment 1 — Classification Definitions (SR-13-18). See also SR-20-13 for more information.

reported in the financial statements. Inquire about reasons for any material differences between the results of the institution's ALLL analyses and the institution's reported ALLL to determine whether the differences can be satisfactorily explained.
- Review the adequacy of the documentation and controls maintained by management to support the appropriateness of the ALLL.
- Review the interest and fee income accounts associated with the lending process to ensure that the institution's net income is not materially misstated.

When assessing the appropriateness of the ALLL, examiners should evaluate an institution's related process, methodology, and underlying assumptions that require a substantial degree of management judgment. Even when an institution maintains sound loan administration and collection procedures and an effective loan review system and controls, examiners should not use an institution's estimate of credit losses as a single precise amount due to the wide range of qualitative or environmental factors that should be considered.

An institution's ability to estimate credit losses on specific loans and groups of loans should improve over time as substantive information accumulates regarding the factors affecting repayment prospects. Therefore, examiners should generally accept management's estimates when they assess the appropriateness of the institution's ALLL, and not seek adjustments to the ALLL, when management has

- maintained effective loan review systems and controls for identifying, monitoring and addressing asset quality problems in a timely manner.
- analyzed all significant qualitative or environmental factors that affect the collectibility of the portfolio as of the evaluation date in a reasonable manner.
- established an acceptable ALLL evaluation process for both individual loans and groups of loans that meets the GAAP requirements for an appropriate ALLL.
- incorporated reasonable and properly supported assumptions, valuations, and judgments into the evaluation process.

If the examiner concludes that the level of ALLL is not appropriate or determines that the ALLL evaluation process is based on the results of an unreliable loan review system or is otherwise deficient, the examiner should include recommendations for correcting these deficiencies in their communications to the institution and its board of directors. Additional supervisory action may be necessary to address the weaknesses in the ALLL process, including the materiality of errors in the institution's reported ALLL.

2065.2.6.1 ALLL Level Reflected in Regulatory Reports

When the reported amount of an institution's ALLL is not appropriate, examiners will require an institution to adjust its ALLL by an amount sufficient to bring the ALLL reported on its regulatory reports to an appropriate level as of the balance sheet's evaluation date. This adjustment should be reflected in the current period provision or through the restatement of prior period provisions, as appropriate in the circumstances.

2065.3.1 BACKGROUND ON CURRENT EXPECTED CREDIT LOSSES METHODOLOGY

The Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2016–13, *Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*, as well as amendments since June 2016. These updates are codified in Accounting Standards Codification (ASC) Topic 326, *Financial Instruments—Credit Losses* (FASB ASC Topic 326). FASB ASC Topic 326 introduces the current expected credit losses methodology (CECL), which replaces the incurred loss methodology for financial assets measured at amortized cost; introduces the term "purchased credit-deteriorated (PCD) assets," which replaces the term "purchased credit-impaired (PCI) assets"; and modifies the treatment of credit losses on available-for-sale (AFS) debt securities.

The allowance for credit losses or ACL is a valuation account that is deducted from, or added to, the amortized cost basis of financial assets to present the net amount expected to be collected over the contractual term of the assets, considering expected prepayments. Renewals, extensions, and modifications are excluded from the contractual term of a financial asset for purposes of estimating the ACL, unless there is a reasonable expectation of executing a troubled debt restructuring or the renewal and extension options are part of the original or modified contract and are cancellable by the institution based on the contractual terms in the loan agreement.

In estimating the net amount expected to be collected, management should consider the effects of past events, current conditions, and reasonable and supportable forecasts on the collectibility of the institution's financial assets. FASB ASC Topic 326 requires management to use relevant forward-looking information and expectations drawn from reasonable and supportable forecasts when estimating expected credit losses.

As of the end of each quarter, or more frequently if warranted, each holding company should evaluate the collectibility of its financial assets measured at amortized cost, including, if applicable, any recorded accrued interest receivable (that is, not already reversed or charged off, as applicable), and make adjusting entries to maintain the appropriate balance of each of the separate ACLs reported on the balance sheet. A holding company should measure expected credit losses on a collective or pool basis when financial assets share similar risk characteristics. If a financial asset does not share similar risk characteristics with other assets, expected credit losses for that asset should be evaluated individually. Individually evaluated assets should not be included in a collective assessment of expected credit losses. If a financial asset ceases to share similar risk characteristics with other assets in its pool, the asset should be moved to a different pool with assets sharing similar risk characteristics, if such a pool exists. For more information on ACLs, see the glossary to the Consolidated Financial Statements for Holding Companies (FR Y-9C).

The ACL also is a component for calculating tier 2 capital, as set forth in Regulation Q (12 CFR 217.20(d)). Tier 2 capital includes surplus related to the issuance of tier 2 capital instruments; limited amounts of total capital minority interest not included in a banking organization's tier 1 capital; and limited amounts of the allowance for loan and lease losses (ALLL), or adjusted allowances for credit losses (AACL), as applicable, less applicable regulatory adjustments and deductions. A banking organization calculating its total capital ratio using the standardized approach may include in tier 2 capital the amount of ALLL or AACL that does not exceed 1.25 percent of its standardized total risk-weighted assets.

2065.3.2 APPLICABILITY

FASB ASC Topic 326 applies to all banks, savings associations, credit unions, and financial institution holding companies, regardless of size, that file regulatory reports for which the reporting requirements conform to U.S. generally accepted accounting principles (GAAP).[1]

Further, FASB ASC Topic 326 applies to all financial assets carried at amortized cost (including loans held for investment (HFI) and held-to-maturity (HTM) debt securities, as well as trade

1. See section 37(a) of the Federal Deposit Insurance Act. Under these statutory provisions, the accounting principles are applicable to reports or statements required to be filed by all insured depository institutions with the federal banking agencies (the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, and the Federal Deposit Insurance Corporation).

Table 1. Summary Scope of CECL

Financial assets within the scope of CECL	**The CECL methodology does *not* apply to the following financial assets**
• Financing receivables such as loans held-for-investment • Overdrawn deposit accounts (i.e., overdrafts) that are reclassified as held-for-investment loans • Held-to-maturity debt securities • Receivables that result from revenue transactions within the scope of Topic 606 on revenue from contracts with customers and Topic 610 on other income, which applies, for example, to the sale of foreclosed real estate • Reinsurance recoverables that result from insurance transactions within the scope of Topic 944 on insurance • Receivables related to repurchase agreements and securities lending agreements within the scope of Topic 860 on transfers and servicing • Net investments in leases recognized by a lessor in accordance with Topic 842 on leases • Off-balance-sheet credit exposures including off-balance-sheet loan commitments, standby letters of credit, financial guarantees not accounted for as insurance, and other similar instruments except for those within the scope of Topic 815 on derivatives and hedging	• Financial assets measured at fair value through net income, including those assets for which the fair value option has been elected • Available-for-sale debt securities • Loans held-for-sale • Policy loan receivables of an insurance entity • Loans and receivables between entities under common control • Receivables arising from operating leases.

receivables, reinsurance recoverables, and receivables that relate to repurchase agreements and securities lending agreements), a lessor's net investments in leases, and off-balance-sheet credit exposures not accounted for as insurance or as derivatives, including loan commitments, standby letters of credit, and financial guarantees.

FASB ASC Topic 326 does not apply to trading assets, loans held for sale, financial assets for which the fair value option has been elected, or loans and receivables between entities under common control. Table 1 provides a high-level overview of the scope of key financial assets covered and excluded from CECL.

2065.3.3 KEY ELEMENTS OF THE ACCOUNTING STANDARD

ASU 2016–13 and subsequent amendments revise U.S. GAAP and, consequently, affect regulatory reports based on U.S. GAAP. CECL differs from the incurred loss methodology in several key respects. First, for financial assets measured at amortized cost, CECL requires institutions to recognize lifetime expected credit losses, not just credit losses incurred as of the reporting date. CECL requires the incorporation of reasonable and supportable forecasts in developing an estimate of lifetime expected credit losses, while also maintaining the current requirement that institutions consider past events and current conditions. Furthermore, the probable threshold for recognition of allowances in accordance with the incurred loss methodology is removed under CECL. Taken together, estimating expected credit losses over the life of an asset under CECL, including consideration of reasonable and supportable forecasts but without applying the probable threshold that exists under the incurred loss methodology, results in earlier recognition of credit losses.

CECL replaces multiple impairment approaches in existing U.S. GAAP. CECL allowances generally cover a broader range of financial assets than the ALLL under the incurred loss methodology. Under the incurred loss methodology, ALLL generally covers credit losses on loans held for investment and lease financing receivables, with additional allowances for certain other extensions of credit and allowances for credit losses on certain off-balance-sheet credit exposures (with the latter allowances presented as liabilities).[2] These exposures will be within the scope of CECL.

As previously mentioned, FASB ASC Topic 326 introduces the term PCD assets, which replaces the term PCI assets. The PCD asset definition covers a broader range of assets than the PCI asset definition. CECL requires institutions to estimate and record a credit loss allowance for a PCD asset at the time of purchase. This credit loss allowance is then added to the purchase price to determine the purchase date amortized cost basis of the asset for financial reporting purposes. Post-acquisition changes in credit loss allowances on PCD assets will be established through earnings. This is different from the treatment of PCI assets, for which institutions are not permitted to estimate and recognize credit loss allowances at the time of purchase. Rather, institutions generally estimate credit loss allowances for PCI assets subsequent to the purchase only if there is deterioration in the expected cash flows from such assets.

FASB ASC Topic 326 also introduces new requirements for AFS debt securities. The accounting standard requires that an institution recognize credit losses on individual AFS debt securities through credit loss allowances, rather than through direct write-downs, as was required under U.S. GAAP prior to the adoption of FASB ASC Topic 326. AFS debt securities continue to be measured at fair value, with changes in fair value not related to credit losses recognized in other comprehensive income. Credit loss allowances on an AFS debt security are limited to the amount by which the security's fair value is less than its amortized cost.

2065.3.4 INTERAGENCY POLICY STATEMENT ON ALLOWANCES FOR CREDIT LOSSES

In June 2020, the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the National Credit Union Administration (collectively, the agencies) issued an interagency policy statement on allowances for credit losses (ACLs).[3] The agencies issued the policy statement in response to changes to U.S. GAAP as promulgated by the FASB in FASB ASC Topic 326.

The interagency policy statement on ACLs describes

- the measurement of expected credit losses under the CECL methodology and the accounting for impairment on available-for-sale debt securities in accordance with FASB ASC Topic 326;
- the design, documentation, and validation of expected credit loss estimation processes, including the internal controls over these processes;
- the maintenance of appropriate ACLs;
- the responsibilities of boards of directors and management; and
- examiner reviews of ACLs.

The interagency policy statement becomes applicable to an institution upon that institution's adoption of FASB ASC Topic 326. The following policy statements are no longer effective for an institution upon its adoption of FASB ASC Topic 326: the December 2006 Interagency Policy Statement on the Allowance for Loan and Lease Losses;[4] and the July 2001 Policy Statement on Allowance for Loan and Lease Losses Methodologies and Documentation for Banks and Savings Institutions.[5] The agencies will rescind the ALLL Policy Statements once FASB ASC Topic 326 is effective for all institutions.

2065.3.5 TRANSITION FROM ALLOWANCE FOR LOAN LEASE LOSSES

For all holding companies, early application of the credit losses standard is permitted for fiscal years beginning after December 15, 2018,

2. "Other extensions of credit" includes trade and reinsurance receivables, and receivables that relate to repurchase agreements and securities lending agreements. "Off-balance-sheet credit exposures" includes off-balance-sheet credit exposures not accounted for as insurance, such as loan commitments, standby letters of credit, and financial guarantees. Credit losses for off-balance-sheet credit exposures that are unconditionally cancellable by the issuer are not recognized under CECL.

3. The policy statement in its entirety is available at 85 Fed. Reg. 32,991 (June 1, 2020) and SR-20-12, "Interagency Policy Statement on Allowances for Credit Losses."

4. See SR-06-17, "Interagency Policy Statement on the Allowance for Loan and Lease Losses (ALLL)." The final policy statement attached to SR-20-12 does not affect Attachment 1 to SR-06-17. Attachment 1 has been revised through a separate interagency notice published at 85 Fed. Reg. 33,278 (June 1, 2020). See also SR-20-13, "Interagency Guidance on Credit Risk Review Systems."

5. See SR-01-17, "Final Interagency Policy Statement on Allowance for Loan and Lease Losses (ALLL) Methodologies and Documentation for Banks and Savings Institutions."

including interim financial reporting periods within that fiscal year. On November 15, 2019, the FASB issued ASU No. 2019-10 to defer the effective dates of ASU 2016-13 for certain holding companies. Under this ASU, for holding companies that are Securities and Exchange Commission (SEC) filers, excluding those that are eligible to be "smaller reporting companies" as defined in the SEC's rules, FASB ASC Topic 326 continues to be effective for fiscal years beginning after December 15, 2019, including interim financial reporting periods within those fiscal years (that is, January 1, 2020, for such entities with calendar year fiscal years). For all other holding companies, including those SEC filers that are eligible to be smaller reporting holding companies, FASB Topic 326 will take effect for fiscal years beginning after December 15, 2022, including interim financial reporting periods within those fiscal years (that is, January 1, 2023, for such entities with calendar year fiscal years).

Holding companies must apply FASB ASC Topic 326 for completing the FR Y-9C in accordance with the U.S. GAAP effective dates. A holding company that early adopts FASB ASC Topic 326 for U.S. GAAP financial reporting purposes should also early adopt the standard in the same period for FR Y-9 purposes. Section 4014 of the CARES Act, as amended by section 540 of the Consolidated Appropriations Act, 2021, allows a holding company to delay the adoption of ASC Topic 326 until the earlier of (1) January 1, 2022, or (2) the first day of the institution's fiscal year that begins after the date of the termination of the national emergency concerning the coronavirus outbreak declared by the President on March 13, 2020, under the National Emergencies Act.

The agencies have adopted rules providing institutions the option to phase in the day-one adverse effects on regulatory capital that may result from the adoption of the CECL accounting standard.[6] For institutions that are phasing in the capital impact of implementing the CECL accounting standard, the denominator for concentration calculations is tier 1 capital plus allowance for loan and lease losses or allowance for credit losses adjusted for the amount of CECL phase-in capital included in both allowance and tier 1 capital.[7]

For purposes of determining whether an institution phasing in the capital impact of implementing the CECL methodology is in compliance with its regulatory capital requirements (including capital buffer and prompt corrective action requirements, which apply to state member banks), the agencies will use the institution's regulatory capital ratios as adjusted by the CECL transition provision.[8] Through the supervisory process, the agencies will continue to examine institutions' credit loss estimates and allowance balances regardless of whether the institution has elected to use the CECL transition provision. In addition, the agencies may examine whether the electing institution will have adequate amounts of capital at the expiration of their CECL transition provision period. After all institutions have adopted the CECL methodology and have exited their CECL transition provision periods, it will no longer be necessary to adjust for the amount of CECL phase-in capital included in both the allowance and tier 1 capital.

For the purposes of measuring concentrations at institutions that are phasing in the adoption of the CECL accounting standard, examiners should evaluate the appropriateness of the amounts included in the denominator for the tier 1 capital calculation and confirm that the CECL transitioned amounts, if elected, plus the allowance for credit losses related to loans and leases have been excluded. To calculate the amount to be excluded from tier 1 capital, examiners should use the difference between "retained earnings" as reported on item 26.a of Schedule HC to the Y-9C Report and "retained earnings" as reported on item 2 Schedule HC-R, Part I, to the Y-9C. This resulting difference is the amount of retained earnings that should have been used to calculate tier 1 capital for purposes of measuring concentrations and should equal the retained earnings on the institution's balance sheet.

2065.3.6 SUPERVISORY CONSIDERATIONS FOR ASSESSING ACL

Examiners are expected to assess the appropriateness of management's loss estimation pro-

6. See 84 Fed. Reg. 4222 (February 14, 2019); 85 Fed. Reg. 17,723 (March 31, 2020); and 85 Fed. Reg. 61,577 (September 30, 2020).

7. For more information, see SR-20-8, "Joint Statement on Adjustment to the Calculation for Credit Concentration Ratios Used in the Supervisory Approach."

8. See 84 Fed. Reg. 4222 (February 14, 2019).

cesses and the appropriateness of the institution's ACL balances as part of their supervisory activities. The review of ACLs, including the depth of the examiner's assessment, should be commensurate with the institution's size, complexity, and risk profile. As part of their supervisory activities, examiners generally assess the credit quality and credit risk of an institution's financial asset portfolios, the adequacy of the institution's credit loss estimation processes, the adequacy of supporting documentation, and the appropriateness of the reported ACLs and provisions for credit losses in the institution's regulatory reports and financial statements, if applicable. Examiners may consider the significant factors that affect collectibility, including the value of collateral securing financial assets and any other repayment sources. Supervisory activities may include evaluating management's effectiveness in assessing credit risk for debt securities (both prior to purchase and on an on-going basis). The *Commercial Bank Examination Manual* provides specific examination objectives and procedures to assist examiners in reviewing the appropriateness of an institution's ACL.

Incentive compensation practices in the financial industry were one of many factors that contributed to the financial crisis that began in mid-2007. Banking organizations too often rewarded employees for increasing the organization's revenue or short-term profit without adequate recognition of the risks the employees' activities posed to the organization.[1] These practices exacerbated the risks and losses at a number of banking organizations and resulted in the misalignment of the interests of employees with the long-term well-being and safety and soundness of their organizations. This section provides guidance on sound incentive compensation practices to banking organizations supervised by the Federal Reserve (also the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision (collectively, the "Agencies")).[2] This guidance is intended to assist banking organizations in designing and implementing incentive compensation arrangements and related policies and procedures that effectively consider potential risks and risk outcomes.[3]

Alignment of incentives provided to employees with the interests of shareholders of the organization often also benefits safety and soundness. However, aligning employee incentives with the interests of shareholders is not always sufficient to address safety-and-soundness concerns. Because of the presence of the federal safety net, (including the ability of insured depository institutions to raise insured deposits and access the discount window and payment services of the Federal Reserve), shareholders of a banking organization in some cases may be willing to tolerate a degree of risk that is inconsistent with the organization's safety and soundness. Accordingly, the Federal Reserve expects banking organizations to maintain incentive compensation practices that are consistent with safety and soundness, even when these practices go beyond those needed to align shareholder and employee interests.

To be consistent with safety and soundness, incentive compensation arrangements[4] at a banking organization should:

1. Provide employees incentives that appropriately balance risk and reward;
2. Be compatible with effective controls and risk-management; and
3. Be supported by strong corporate governance, including active and effective oversight by the organization's board of directors.

These principles, and the types of policies, procedures, and systems that banking organizations should have to help ensure compliance with them, are discussed later in this guidance.

The Federal Reserve expects banking organizations to regularly review their incentive compensation arrangements for all executive and non-executive employees who, either individually or as part of a group, have the ability to expose the organization to material amounts of risk, as well as to regularly review the risk-management, control, and corporate governance processes related to these arrangements. Banking organizations should immediately address any identified deficiencies in these arrangements or processes that are inconsistent with safety and soundness. Banking organizations are responsible for ensuring that their incentive compensation arrangements are consistent with the principles described in this guidance and that they do not encourage employees to expose the organization to imprudent risks that may pose a threat to the safety and soundness of the organization.

1. Examples of risks that may present a threat to the organization's safety and soundness include credit, market, liquidity, operational, legal, compliance, and reputational risks.

2. As used in this guidance, the term "banking organization" includes national banks, state member banks, state nonmember banks, savings associations, U.S. bank holding companies, savings and loan holding companies, Edge and agreement corporations, and the U.S. operations of foreign banking organizations (FBOs) with a branch, agency, or commercial lending company in the United States. If the Federal Reserve is referenced, the reference is intended to also include the other supervisory Agencies.

3. This guidance (see 75 *Fed. Reg.* 36395, June 25, 2010, for the entire text) and the principles reflected herein are consistent with the *Principles for Sound Compensation Practices* issued by the Financial Stability Board (FSB) in April 2009, and with the FSB's *Implementation Standards* for those principles, issued in September 2009.

4. In this guidance, the term "incentive compensation" refers to that portion of an employee's current or potential compensation that is tied to achievement of one or more specific metrics (e.g., a level of sales, revenue, or income). Incentive compensation does not include compensation that is awarded solely for, and the payment of which is solely tied to, continued employment (e.g., salary). In addition, the term does not include compensation arrangements that are determined based solely on the employee's level of compensation and does not vary based on one or more performance metrics (e.g., a 401(k) plan under which the organization contributes a set percentage of an employee's salary).

The Federal Reserve recognizes that incentive compensation arrangements often seek to serve several important and worthy objectives. For example, incentive compensation arrangements may be used to help attract skilled staff, induce better organization-wide and employee performance, promote employee retention, provide retirement security to employees, or allow compensation expenses to vary with revenue on an organization-wide basis. Moreover, the analysis and methods for ensuring that incentive compensation arrangements take appropriate account of risk should be tailored to the size, complexity, business strategy, and risk tolerance of each organization. The resources required will depend upon the complexity of the firm and its use of incentive compensation arrangements. For some, the task of designing and implementing compensation arrangements that properly offer incentives for executive and non-executive employees to pursue the organization's long-term well-being and that do not encourage imprudent risk-taking is a complex task that will require the commitment of adequate resources.

While issues related to designing and implementing incentive compensation arrangements are complex, the Federal Reserve is committed to ensuring that banking organizations move forward in incorporating the principles described in this guidance into their incentive compensation practices.[5]

As discussed further below, because of the size and complexity of their operations, Large complex banking organizations (LCBOs)[6] should have and adhere to systematic and formalized policies, procedures, and processes. These are considered important in ensuring that incentive compensation arrangements for all covered employees are identified and reviewed by appropriate levels of management (including the board of directors where appropriate and control units), and that they appropriately balance risks and rewards. In several places, this guidance specifically highlights the types of policies, procedures, and systems that LCBOs should have and maintain, but that generally are not expected of smaller, less complex organizations. LCBOs warrant the most intensive supervisory attention because they are significant users of incentive compensation arrangements and because flawed approaches at these organizations are more likely to have adverse effects on the broader financial system. The Federal Reserve will work with LCBOs as necessary through the supervisory process to ensure that they promptly correct any deficiencies that may be inconsistent with the safety and soundness of the organization.

The policies, procedures, and systems of smaller banking organizations that use incentive compensation arrangements[7] are expected to be less extensive, formalized, and detailed than those of LCBOs. Supervisory reviews of incentive compensation arrangements at smaller, less-complex banking organizations will be conducted by the Federal Reserve as part of the evaluation of those organizations' risk-management, internal controls, and corporate governance during the regular, risk-focused examination process. These reviews will be tailored to reflect the scope and complexity of an organization's activities, as well as the prevalence and scope of its incentive compensation arrangements. Little, if any, additional examination work is expected for smaller banking organizations that do not use, to a significant extent, incentive compensation arrangements.[8]

For all banking organizations, supervisory findings related to incentive compensation will be communicated to the organization and included in the relevant report of examination or inspection. In addition, these findings will be incorporated, as appropriate, into the organiza-

5. In December 2009 the Federal Reserve, working with the other Agencies, initiated a special horizontal review of incentive compensation arrangements and related risk-management, control, and corporate governance practices of large banking organizations (LBOs). This initiative was designed to spur and monitor the industry's progress towards the implementation of safe and sound incentive compensation arrangements, identify emerging best practices, and advance the state of practice more generally in the industry.

6. For supervisory purposes, the Federal Reserve (as well as the other federal bank regulatory agencies) segments the organizations it supervises into different supervisory portfolios based on, among other things, size, complexity, and risk profile. For purposes of this guidance, the LBOs referred to in the guidance are identified in this section as large complex banking organizations to be consistent with the Federal Reserve's other supervisory policies. LBOs are designated by (1) the OCC as the largest and most complex national banks as defined in the Large Bank Supervision booklet of the Comptroller's Handbook; (2) the FDIC, large, complex insured depository institutions (IDIs); and (3) the OTS, the largest and most complex savings associations and savings and loan holding companies.

7. This guidance does not apply to banking organizations that do not use incentive compensation.

8. To facilitate these reviews, where appropriate, a smaller banking organization should review its compensation arrangements to determine whether it uses incentive compensation arrangements to a significant extent in its business operations. A smaller banking organization will not be considered a significant user of incentive compensation arrangements simply because the organization has a firm-wide profit-sharing or bonus plan that is based on the bank's profitability, even if the plan covers all or most of the organization's employees.

tion's rating component(s) and subcomponent(s) relating to risk-management, internal controls, and corporate governance under the relevant supervisory rating system, as well as the organization's overall supervisory rating.

The Federal Reserve (or the organization's appropriate federal supervisor) may take enforcement action against a banking organization if its incentive compensation arrangements or related risk-management, control, or governance processes pose a risk to the safety and soundness of the organization, particularly when the organization is not taking prompt and effective measures to correct the deficiencies. For example, the appropriate federal supervisor may take an enforcement action if material deficiencies are found to exist in the organization's incentive compensation arrangements or related risk-management, control, or governance processes, or the organization fails to promptly develop, submit, or adhere to an effective plan designed to ensure that its incentive compensation arrangements do not encourage imprudent risk-taking and are consistent with principles of safety and soundness. As provided under section 8 of the Federal Deposit Insurance Act (12 U.S.C. 1818), an enforcement action may, among other things, require an organization to take affirmative action, such as developing a corrective action plan that is acceptable to the appropriate federal supervisor to rectify safety-and-soundness deficiencies in its incentive compensation arrangements or related processes. Where warranted, the appropriate federal supervisor may require the organization to take additional affirmative action to correct or remedy deficiencies related to the organization's incentive compensation practices.

Effective and balanced incentive compensation practices are likely to evolve significantly in the coming years, spurred by the efforts of banking organizations, supervisors, and other stakeholders. The Federal Reserve will review and update this guidance as appropriate to incorporate best practices that emerge from these efforts.

2068.0.1 SCOPE OF APPLICATION

The incentive compensation arrangements and related policies and procedures of banking organizations should be consistent with principles of safety and soundness.[9] Incentive compensation arrangements for executive officers as well as for non-executive personnel who have the ability to expose a banking organization to material amounts of risk may, if not properly structured, pose a threat to the organization's safety and soundness. Accordingly, this guidance applies to incentive compensation arrangements for:

1. Senior executives and others who are responsible for oversight of the organization's firm-wide activities or material business lines;[10]
2. Individual employees, including non-executive employees, whose activities may expose the organization to material amounts of risk (e.g., traders with large position limits relative to the organization's overall risk tolerance); and
3. Groups of employees who are subject to the same or similar incentive compensation arrangements and who, in the aggregate, may expose the organization to material amounts of risk, even if no individual employee is likely to expose the organization to material risk (e.g., loan officers who, as a group, originate loans that account for a material amount of the organization's credit risk).

For ease of reference, these executive and non-executive employees are collectively referred to hereafter as ''covered employees'' or ''employees.'' Depending on the facts and circumstances of the individual organization, the types of employees or categories of employees that are outside the scope of this guidance because they do not have the ability to expose the organization to material risks would likely include, for example, tellers, bookkeepers, couriers, or data processing personnel.

In determining whether an employee, or group of employees, may expose a banking organization to material risk, the organization

9. In the case of the U.S. operations of FBOs, the organization's policies, including management, review, and approval requirements for its U.S. operations, should be coordinated with the FBO's group-wide policies developed in accordance with the rules of the FBO's home country supervisor. The policies of the FBO's U.S. operations should also be consistent with the FBO's overall corporate and management structure, as well as its framework for risk-management and internal controls. In addition, the policies for the U.S. operations of FBOs should be consistent with this guidance.

10. Senior executives include, at a minimum, ''executive officers'' within the meaning of the Federal Reserve's Regulation O (see 12 CFR 215.2(e)(1)) and, for publicly traded companies, ''named officers'' within the meaning of the Securities and Exchange Commission's rules on disclosure of executive compensation (see 17 CFR 229.402(a)(3)). Savings associations should also refer to OTS's rule on loans by saving associations to their executive officers, directors, and principal shareholders. (12 CFR 563.43).

should consider the full range of inherent risks arising from, or generated by, the employee's activities, even if the organization uses risk-management processes or controls to limit the risks such activities ultimately may pose to the organization. Moreover, risks should be considered to be material for purposes of this guidance if they are material to the organization, or are material to a business line or operating unit that is itself material to the organization.[11]

For purposes of illustration, assume that a banking organization has a structured-finance unit that is material to the organization. A group of employees within that unit who originate structured-finance transactions that may expose the unit to material risks should be considered "covered employees" for purposes of this guidance even if those transactions must be approved by an independent risk function prior to consummation, or the organization uses other processes or methods to limit the risk that such transactions may present to the organization.

Strong and effective risk-management and internal control functions are critical to the safety and soundness of banking organizations. However, irrespective of the quality of these functions, poorly designed or managed incentive compensation arrangements can themselves be a source of risk to a banking organization. For example, incentive compensation arrangements that provide employees strong incentives to increase the organization's short-term revenues or profits, without regard to the short- or long-term risk associated with such business, can place substantial strain on the risk-management and internal control functions of even well-managed organizations.

Moreover, poorly balanced incentive compensation arrangements can encourage employees to take affirmative actions to weaken or circumvent the organization's risk-management or internal control functions, such as by providing inaccurate or incomplete information to these functions, to boost the employee's personal compensation. Accordingly, sound compensation practices are an integral part of strong risk-management and internal control functions. A key goal of this guidance is to encourage banking organizations to incorporate the risks related to incentive compensation into their broader risk-management framework. Risk-management procedures and risk controls that ordinarily limit risk-taking do not obviate the need for incentive compensation arrangements to properly balance risk-taking incentives.

11. Thus, risks may be material to an organization even if they are not large enough themselves to threaten the solvency of the organization.

2068.0.2 PRINCIPLES OF A SOUND INCENTIVE COMPENSATION SYSTEM

2068.0.2.1 Principle 1: Balanced Risk-Taking Incentives

Incentive compensation arrangements should balance risk and financial results in a manner that does not encourage employees to expose their organizations to imprudent risks.

Incentive compensation arrangements typically attempt to encourage actions that result in greater revenue or profit for the organization. However, short-run revenue or profit can often diverge sharply from actual long-run profit because risk outcomes may become clear only over time. Activities that carry higher risk typically yield higher short-term revenue, and an employee who is given incentives to increase short-term revenue or profit, without regard to risk, will naturally be attracted to opportunities to expose the organization to more risk.

An incentive compensation arrangement is balanced when the amounts paid to an employee appropriately take into account the risks (including compliance risks), as well as the financial benefits, from the employee's activities and the impact of those activities on the organization's safety and soundness. As an example, under a balanced incentive compensation arrangement, two employees who generate the same amount of short-term revenue or profit for an organization should not receive the same amount of incentive compensation if the risks taken by the employees in generating that revenue or profit differ materially. The employee whose activities create materially larger risks for the organization should receive less than the other employee, all else being equal.

The performance measures used in an incentive compensation arrangement have an important effect on the incentives provided employees and, thus, the potential for the arrangement to encourage imprudent risk-taking. For example, if an employee's incentive compensation payments are closely tied to short-term revenue or profit of business generated by the employee, without any adjustments for the risks associated with the business generated, the potential for the arrangement to encourage imprudent risk-taking may be quite strong. Similarly, traders who work with positions that close at year-end could have an incentive to take large risks toward the end of a year if there is no mechanism for factoring how such positions perform over a longer period of time. The same result could ensue if the performance measures themselves lack integrity or can be manipulated inappropriately by the employees receiving incentive compensation.

On the other hand, if an employee's incentive compensation payments are determined based on performance measures that are only distantly linked to the employee's activities (e.g., for most employees, organization-wide profit), the potential for the arrangement to encourage the employee to take imprudent risks on behalf of the organization may be weak. For this reason, plans that provide for awards based solely on overall organization-wide performance are unlikely to provide employees, other than senior executives and individuals who have the ability to materially affect the organization's overall risk profile, with unbalanced risk-taking incentives.

Incentive compensation arrangements should not only be balanced in design, they also should be implemented so that actual payments vary based on risks or risk outcomes. If, for example, employees are paid substantially all of their potential incentive compensation even when risk or risk outcomes are materially worse than expected, employees have less incentive to avoid activities with substantial risk.

- *Banking organizations should consider the full range of risks associated with an employee's activities, as well as the time horizon over which those risks may be realized, in assessing whether incentive compensation arrangements are balanced.*

The activities of employees may create a wide range of risks for a banking organization, such as credit, market, liquidity, operational, legal, compliance, and reputational risks, as well as other risks to the viability or operation of the organization. Some of these risks may be realized in the short term, while others may become apparent only over the long term. For example, future revenues that are booked as current income may not materialize, and short-term profit-and-loss measures may not appropriately reflect differences in the risks associated with the revenue derived from different activities (e.g., the higher credit or compliance risk associated with subprime loans versus prime loans).[12] In addition, some risks (or combinations of risky strategies and positions) may have a low probability of being realized, but would have highly adverse effects on the organization if they were to be realized ("bad tail risks"). While shareholders may have less incentive to guard against bad tail risks because of the infrequency of their realization and the existence of the federal safety net, these risks warrant special attention for safety-and-soundness reasons given the threat they pose to the organization's solvency and the federal safety net.

Banking organizations should consider the full range of current and potential risks associated with the activities of covered employees, including the cost and amount of capital and liquidity needed to support those risks, in developing balanced incentive compensation arrangements. Reliable quantitative measures of risk and risk outcomes ("quantitative measures"), where available, may be particularly useful in developing balanced compensation arrangements and in assessing the extent to which arrangements are properly balanced. However, reliable quantitative measures may not be available for all types of risk or for all activities, and their utility for use in compensation arrangements varies across business lines and employees. The absence of reliable quantitative measures for certain types of risks or outcomes does not mean that banking organizations should ignore such risks or outcomes for purposes of assessing whether an incentive compensation arrangement achieves balance. For example, while reliable quantitative measures may not exist for many bad-tail risks, it is important that such risks be considered given their potential effect on safety and soundness. As in other risk-management areas, banking organizations should rely on informed judgments, supported by available data, to estimate risks and risk outcomes in the absence of reliable quantitative risk measures.

Large complex banking organizations. In designing and modifying incentive compensation arrangements, LCBOs should assess in advance of implementation whether such

12. Importantly, the time horizon over which a risk outcome may be realized is not necessarily the same as the stated maturity of an exposure. For example, the ongoing reinvestment of funds by a cash management unit in commercial paper with a one-day maturity not only exposes the organization to one-day credit risk, but also exposes the organization to liquidity risk that may be realized only infrequently.

arrangements are likely to provide balanced risk-taking incentives. Simulation analysis of incentive compensation arrangements is one way of doing so. Such analysis uses forward-looking projections of incentive compensation awards and payments based on a range of performance levels, risk outcomes, and levels of risks taken. This type of analysis, or other analysis that results in assessments of likely effectiveness, can help an LCBO assess whether incentive compensation awards and payments to an employee are likely to be reduced appropriately as the risks to the organization from the employee's activities increase.

• *An unbalanced arrangement can be moved toward balance by adding or modifying features that cause the amounts ultimately received by employees to appropriately reflect risk and risk outcomes.*

If an incentive compensation arrangement may encourage employees to expose their banking organization to imprudent risks, the organization should modify the arrangement as needed to ensure that it is consistent with safety and soundness. Four methods are often used to make compensation more sensitive to risk. These methods are:

1. *Risk Adjustment of Awards:* The amount of an incentive compensation award for an employee is adjusted based on measures that take into account the risk the employee's activities may pose to the organization. Such measures may be quantitative, or the size of a risk adjustment may be set judgmentally, subject to appropriate oversight.
2. *Deferral of Payment:* The actual payout of an award to an employee is delayed significantly beyond the end of the performance period, and the amounts paid are adjusted for actual losses or other aspects of performance that are realized or become better known only during the deferral period.[13] Deferred payouts may be altered according to risk outcomes either formulaically or judgmentally, subject to appropriate oversight. To be most effective, the deferral period should be sufficiently long to allow for the realization of a substantial portion of the risks from employee activities, and the measures of loss should be clearly explained to employees and closely tied to their activities during the relevant performance period.
3. *Longer Performance Periods:* The time period covered by the performance measures used in determining an employee's award is extended (for example, from one year to two or more years). Longer performance periods and deferral of payment are related in that both methods allow awards or payments to be made after some or all risk outcomes are realized or better known.
4. *Reduced Sensitivity to Short-Term Performance:* The banking organization reduces the rate at which awards increase as an employee achieves higher levels of the relevant performance measure(s). Rather than offsetting risk-taking incentives associated with the use of short-term performance measures, this method reduces the magnitude of such incentives. This method also can include improving the quality and reliability of performance measures in taking into account both short-term and long-term risks, for example improving the reliability and accuracy of estimates of revenues and long-term profits upon which performance measures depend.[14]

These methods for achieving balance are not exclusive, and additional methods or variations may exist or be developed. Moreover, each method has its own advantages and disadvantages. For example, where reliable risk measures exist, risk adjustment of awards may be more effective than deferral of payment in reducing incentives for imprudent risk-taking. This is because risk adjustment potentially can take account of the full range and time horizon of risks, rather than just those risk outcomes that occur or become more evident during the deferral period. On the other hand, deferral of payment may be more effective than risk adjustment in mitigating incentives to take hard-to-measure risks (such as the risks of new activities

13. The deferral-of-payment method is sometimes referred to in the industry as a "clawback." The term "clawback" also may refer specifically to an arrangement under which an employee must return incentive compensation payments previously received by the employee (and not just deferred) if certain risk outcomes occur. Section 304 of the Sarbanes-Oxley Act of 2002 (15 U.S.C. 7243), which applies to chief executive officers and chief financial officers of public banking organizations, is an example of this more specific type of "clawback" requirement.

14. Performance targets may have a material effect on risk-taking incentives. Such targets may offer employees greater rewards for increments of performance that are above the target or may provide that awards will be granted only if a target is met or exceeded. Employees may be particularly motivated to take imprudent risk in order to reach performance targets that are aggressive, but potentially achievable.

or products, or certain risks such as reputational or operational risk that may be difficult to measure with respect to particular activities), especially if such risks are likely to be realized during the deferral period. Accordingly, in some cases two or more methods may be needed in combination for an incentive compensation arrangement to be balanced.

The greater the potential incentives an arrangement creates for an employee to increase the risks associated with the employee's activities, the stronger the effect should be of the methods applied to achieve balance. Thus, for example, risk adjustments used to counteract a materially unbalanced compensation arrangement should have a similarly material impact on the incentive compensation paid under the arrangement. Further, improvements in the quality and reliability of performance measures themselves, for example improving the reliability and accuracy of estimates of revenues and profits upon which performance measures depend, can significantly improve the degree of balance in risk-taking incentives.

Where judgment plays a significant role in the design or operation of an incentive compensation arrangement, strong policies and procedures, internal controls, and ex post monitoring of incentive compensation payments relative to actual risk outcomes are particularly important to help ensure that the arrangements as implemented are balanced and do not encourage imprudent risk-taking. For example, if a banking organization relies to a significant degree on the judgment of one or more managers to ensure that the incentive compensation awards to employees are appropriately risk-adjusted, the organization should have policies and procedures that describe how managers are expected to exercise that judgment to achieve balance and that provide for the manager(s) to receive appropriate available information about the employee's risk-taking activities to make informed judgments.

Large complex banking organizations. Methods and practices for making compensation sensitive to risk are likely to evolve rapidly during the next few years, driven in part by the efforts of supervisors and other stakeholders. LCBOs should actively monitor developments in the field and should incorporate into their incentive compensation systems new or emerging methods or practices that are likely to improve the organization's long-term financial well-being and safety and soundness.

- *The manner in which a banking organization seeks to achieve balanced incentive compensation arrangements should be tailored to account for the differences between employees—including the substantial differences between senior executives and other employees—as well as between banking organizations.*

Activities and risks may vary significantly both across banking organizations and across employees within a particular banking organization. For example, activities, risks, and incentive compensation practices may differ materially among banking organizations based on, among other things, the scope or complexity of activities conducted and the business strategies pursued by the organizations. These differences mean that methods for achieving balanced compensation arrangements at one organization may not be effective in restraining incentives to engage in imprudent risk-taking at another organization. Each organization is responsible for ensuring that its incentive compensation arrangements are consistent with the safety and soundness of the organization.

Moreover, the risks associated with the activities of one group of non-executive employees (e.g., loan originators) within a banking organization may differ significantly from those of another group of non-executive employees (e.g., spot foreign exchange traders) within the organization. In addition, reliable quantitative measures of risk and risk outcomes are unlikely to be available for a banking organization as a whole, particularly a large, complex organization. This factor can make it difficult for banking organizations to achieve balanced compensation arrangements for senior executives who have responsibility for managing risks on an organization-wide basis solely through use of the risk-adjustment-of-award method.

Furthermore, the payment of deferred incentive compensation in equity (such as restricted stock of the organization) or equity-based instruments (such as options to acquire the organization's stock) may be helpful in restraining the risk-taking incentives of senior executives and other covered employees whose activities may have a material effect on the overall financial performance of the organization. However, equity-related deferred compensation may not be as effective in restraining the incentives of lower-level covered employees (particularly at large organizations) to take risks because such employees are unlikely to believe that their actions will materially affect the organization's stock price.

Banking organizations should take account of these differences when constructing balanced compensation arrangements. For most banking organizations, the use of a single, formulaic approach to making employee incentive compensation arrangements appropriately risk-sensitive is likely to result in arrangements that are unbalanced at least with respect to some employees.[15]

Large complex banking organizations. Incentive compensation arrangements for senior executives at LCBOs are likely to be better balanced if they involve deferral of a substantial portion of the executives' incentive compensation over a multi-year period in a way that reduces the amount received in the event of poor performance, substantial use of multi-year performance periods, or both. Similarly, the compensation arrangements for senior executives at LCBOs are likely to be better balanced if a significant portion of the incentive compensation of these executives is paid in the form of equity-based instruments that vest over multiple years, with the number of instruments ultimately received dependent on the performance of the organization during the deferral period.

The portion of the incentive compensation of other covered employees that is deferred or paid in the form of equity-based instruments should appropriately take into account the level, nature, and duration of the risks that the employees' activities create for the organization and the extent to which those activities may materially affect the overall performance of the organization and its stock price. Deferral of a substantial portion of an employee's incentive compensation may not be workable for employees at lower pay scales because of their more limited financial resources. This may require increased reliance on other measures in the incentive compensation arrangements for these employees to achieve balance.

- *Banking organizations should carefully consider the potential for "golden parachutes" and the vesting arrangements for deferred compensation to affect the risk-taking behavior of employees while at the organizations.*

Arrangements that provide for an employee (typically a senior executive), upon departure from the organization or a change in control of the organization, to receive large additional payments or the accelerated payment of deferred amounts without regard to risk or risk outcomes can provide the employee significant incentives to expose the organization to undue risk. For example, an arrangement that provides an employee with a guaranteed payout upon departure from an organization, regardless of performance, may neutralize the effect of any balancing features included in the arrangement to help prevent imprudent risk-taking.

Banking organizations should carefully review any such existing or proposed arrangements (sometimes called "golden parachutes") and the potential impact of such arrangements on the organization's safety and soundness. In appropriate circumstances an organization should consider including balancing features—such as risk adjustment or deferral requirements that extend past the employee's departure—in the arrangements to mitigate the potential for the arrangements to encourage imprudent risk-taking. In all cases, a banking organization should ensure that the structure and terms of any golden parachute arrangement entered into by the organization do not encourage imprudent risk-taking in light of the other features of the employee's incentive compensation arrangements.

Large complex banking organizations. Provisions that require a departing employee to forfeit deferred incentive compensation payments may weaken the effectiveness of the deferral arrangement if the departing employee is able to negotiate a "golden handshake" arrangement with the new employer.[16] This weakening effect can be particularly significant for senior executives or other skilled employees at LCBOs whose services are in high demand within the market.

Golden handshake arrangements present special issues for LCBOs and supervisors. For example, while a banking organization could adjust its deferral arrangements so that departing employees will continue to receive any accrued deferred compensation after departure

15. For example, spreading payouts of incentive compensation awards over a standard three-year period may not appropriately reflect the differences in the type and time horizon of risk associated with the activities of different groups of employees, and may not be sufficient by itself to balance the compensation arrangements of employees who may expose the organization to substantial longer-term risks.

16. Golden handshakes are arrangements that compensate an employee for some or all of the estimated, non-adjusted value of deferred incentive compensation that would have been forfeited upon departure from the employee's previous employment.

(subject to any clawback or malus[17]), these changes could reduce the employee's incentive to remain at the organization and, thus, weaken an organization's ability to retain qualified talent, which is an important goal of compensation, and create conflicts of interest. Moreover, actions of the hiring organization (which may or may not be a supervised banking organization) ultimately may defeat these or other risk-balancing aspects of a banking organization's deferral arrangements. LCBOs should monitor whether golden handshake arrangements are materially weakening the organization's efforts to constrain the risk-taking incentives of employees. The Federal Reserve will continue to work with banking organizations and others to develop appropriate methods for addressing any effect that such arrangements may have on the safety and soundness of banking organizations.

- *Banking organizations should effectively communicate to employees the ways in which incentive compensation awards and payments will be reduced as risks increase.*

In order for the risk-sensitive provisions of incentive compensation arrangements to affect employee risk-taking behavior, the organization's employees need to understand that the amount of incentive compensation that they may receive will vary based on the risk associated with their activities. Accordingly, banking organizations should ensure that employees covered by an incentive compensation arrangement are informed about the key ways in which risks are taken into account in determining the amount of incentive compensation paid. Where feasible, an organization's communications with employees should include examples of how incentive compensation payments may be adjusted to reflect projected or actual risk outcomes. An organization's communications should be tailored appropriately to reflect the sophistication of the relevant audience(s).

17. A malus arrangement permits the employer to prevent vesting of all or part of the amount of a deferred remuneration award. Malus provisions are invoked when risk outcomes are worse than expected or when the information upon which the award was based turns out to have been incorrect. Loss of unvested compensation due to the employee voluntarily leaving the firm is not an example of malus as the term is used in this guidance.

2068.0.2.2 Principle 2: Compatibility with Effective Controls and Risk-Management

A banking organization's risk-management processes and internal controls should reinforce and support the development and maintenance of balanced incentive compensation arrangements.

In order to increase their own compensation, employees may seek to evade the processes established by a banking organization to achieve balanced compensation arrangements. Similarly, an employee covered by an incentive compensation arrangement may seek to influence, in ways designed to increase the employee's pay, the risk measures or other information or judgments that are used to make the employee's pay sensitive to risk.

Such actions may significantly weaken the effectiveness of an organization's incentive compensation arrangements in restricting imprudent risk-taking. These actions can have a particularly damaging effect on the safety and soundness of the organization if they result in the weakening of risk measures, information, or judgments that the organization uses for other risk-management, internal control, or financial purposes. In such cases, the employee's actions may weaken not only the balance of the organization's incentive compensation arrangements, but also the risk-management, internal controls, and other functions that are supposed to act as a separate check on risk-taking. For this reason, traditional risk-management controls alone do not eliminate the need to identify employees who may expose the organization to material risk, nor do they obviate the need for the incentive compensation arrangements for these employees to be balanced. Rather, a banking organization's risk-management processes and internal controls should reinforce and support the development and maintenance of balanced incentive compensation arrangements.

- *Banking organizations should have appropriate controls to ensure that their processes for achieving balanced compensation arrangements are followed and to maintain the integrity of their risk-management and other functions.*

To help prevent damage from occurring, a banking organization should have strong controls governing its process for designing, implementing, and monitoring incentive compensation arrangements. Banking organizations should create and maintain sufficient documentation to permit an audit of the effectiveness of the organization's processes for establishing, modifying, and monitoring incentive compensation arrangements. Smaller banking organizations should incorporate reviews of these processes into their overall framework for compliance monitoring (including internal audit).

Large complex banking organizations. LCBOs should have and maintain policies and procedures that (1) identify and describe the role(s) of the personnel, business units, and control units authorized to be involved in the design, implementation, and monitoring of incentive compensation arrangements; (2) identify the source of significant risk-related inputs into these processes and establish appropriate controls governing the development and approval of these inputs to help ensure their integrity; and (3) identify the individual(s) and control unit(s) whose approval is necessary for the establishment of new incentive compensation arrangements or modification of existing arrangements.

An LCBO also should conduct regular internal reviews to ensure that its processes for achieving and maintaining balanced incentive compensation arrangements are consistently followed. Such reviews should be conducted by audit, compliance, or other personnel in a manner consistent with the organization's overall framework for compliance monitoring. An LCBO's internal audit department also should separately conduct regular audits of the organization's compliance with its established policies and controls relating to incentive compensation arrangements. The results should be reported to appropriate levels of management and, where appropriate, the organization's board of directors.

- *Appropriate personnel, including risk-management personnel, should have input into the organization's processes for designing incentive compensation arrangements and assessing their effectiveness in restraining imprudent risk-taking.*

Developing incentive compensation arrangements that provide balanced risk-taking incentives and monitoring arrangements to ensure they achieve balance over time requires an understanding of the risks (including compliance risks) and potential risk outcomes associated with the activities of the relevant employees. Accordingly, banking organizations should have policies and procedures that ensure that risk-management personnel have an appropriate role in the organization's processes for designing incentive compensation arrangements and for assessing their effectiveness in restraining imprudent risk-taking.[18] Ways that risk managers might assist in achieving balanced compensation arrangements include, but are not limited to

1. reviewing the types of risks associated with the activities of covered employees;
2. approving the risk measures used in risk adjustments and performance measures, as well as measures of risk outcomes used in deferred-payout arrangements; and
3. analyzing risk-taking and risk outcomes relative to incentive compensation payments.

Other functions within an organization, such as its control, human resources, or finance functions, also play an important role in helping ensure that incentive compensation arrangements are balanced. For example, these functions may contribute to the design and review of performance measures used in compensation arrangements or may supply data used as part of these measures.

- *Compensation for employees in risk-management and control functions should be sufficient to attract and retain qualified personnel and should avoid conflicts of interest.*

The risk-management and control personnel involved in the design, oversight, and operation of incentive compensation arrangements should have appropriate skills and experience needed to effectively fulfill their roles. These skills and experiences should be sufficient to equip the personnel to remain effective in the face of challenges by covered employees seeking to increase their incentive compensation in ways that are inconsistent with sound risk-management or internal controls. The compensation arrangements for employees in risk-management and control functions thus should be sufficient to attract and retain qualified per-

18. Involvement of risk-management personnel in the design and monitoring of these arrangements also should help ensure that the organization's risk-management functions can properly understand and address the full range of risks facing the organization.

sonnel with experience and expertise in these fields that is appropriate in light of the size, activities, and complexity of the organization.

In addition, to help preserve the independence of their perspectives, the incentive compensation received by risk-management and control personnel staff should not be based substantially on the financial performance of the business units that they review. Rather, the performance measures used in the incentive compensation arrangements for these personnel should be based primarily on the achievement of the objectives of their functions (e.g., adherence to internal controls).

- *Banking organizations should monitor the performance of their incentive compensation arrangements and should revise the arrangements as needed if payments do not appropriately reflect risk.*

Banking organizations should monitor incentive compensation awards and payments, risks taken, and actual risk outcomes to determine whether incentive compensation payments to employees are reduced to reflect adverse risk outcomes or high levels of risk taken. Results should be reported to appropriate levels of management, including the board of directors where warranted and consistent with Principle 3 below. The monitoring methods and processes used by a banking organization should be commensurate with the size and complexity of the organization, as well as its use of incentive compensation. Thus, for example, a small, noncomplex organization that uses incentive compensation only to a limited extent may find that it can appropriately monitor its arrangements through normal management processes.

A banking organization should take the results of such monitoring into account in establishing or modifying incentive compensation arrangements and in overseeing associated controls. If, over time, incentive compensation paid by a banking organization does not appropriately reflect risk outcomes, the organization should review and revise its incentive compensation arrangements and related controls to ensure that the arrangements, as designed and implemented, are balanced and do not provide employees incentives to take imprudent risks.

2068.0.2.3 Principle 3: Strong Corporate Governance

Banking organizations should have strong and effective corporate governance to help ensure sound compensation practices, including active and effective oversight by the board of directors.

Given the key role of senior executives in managing the overall risk-taking activities of an organization, the board of directors of a banking organization should directly approve the incentive compensation arrangements for senior executives.[19] The board also should approve and document any material exceptions or adjustments to the incentive compensation arrangements established for senior executives and should carefully consider and monitor the effects of any approved exceptions or adjustments on the balance of the arrangement, the risk-taking incentives of the senior executive, and the safety and soundness of the organization.

The board of directors of an organization also is ultimately responsible for ensuring that the organization's incentive compensation arrangements for all covered employees are appropriately balanced and do not jeopardize the safety and soundness of the organization. The involvement of the board of directors in oversight of the organization's overall incentive compensation program should be scaled appropriately to the scope and prevalence of the organization's incentive compensation arrangements.

Large complex banking organizations and organizations that are significant users of incentive compensation. The board of directors of an LCBO or other banking organization that uses incentive compensation to a significant extent should actively oversee the development and operation of the organization's incentive compensation policies, systems, and related control processes. The board of directors of such an organization should review and approve the overall goals and purposes of the organization's incentive compensation system. In addition, the board should provide clear direction to management to ensure that the goals and policies it establishes are carried out in a manner that

19. As used in this guidance, the term "board of directors" is used to refer to the members of the board of directors who have primary responsibility for overseeing the incentive compensation system. Depending on the manner in which the board is organized, the term may refer to the entire board of directors, a compensation committee of the board, or another committee of the board that has primary responsibility for overseeing the incentive compensation system. In the case of FBOs, the term refers to the relevant oversight body for the firm's U.S. operations, consistent with the FBO's overall corporate and management structure.

achieves balance and is consistent with safety and soundness.

The board of directors of such an organization also should ensure that steps are taken so that the incentive compensation system—including performance measures and targets—is designed and operated in a manner that will achieve balance.

- *The board of directors should monitor the performance, and regularly review the design and function, of incentive compensation arrangements.*

To allow for informed reviews, the board should receive data and analysis from management or other sources that are sufficient to allow the board to assess whether the overall design and performance of the organization's incentive compensation arrangements are consistent with the organization's safety and soundness. These reviews and reports should be appropriately scoped to reflect the size and complexity of the banking organization's activities and the prevalence and scope of its incentive compensation arrangements.

The board of directors of a banking organization should closely monitor incentive compensation payments to senior executives and the sensitivity of those payments to risk outcomes. In addition, if the compensation arrangement for a senior executive includes a clawback provision, then the review should include sufficient information to determine if the provision has been triggered and executed as planned.

The board of directors of a banking organization should seek to stay abreast of significant emerging changes in compensation plan mechanisms and incentives in the marketplace as well as developments in academic research and regulatory advice regarding incentive compensation policies. However, the board should recognize that organizations, activities, and practices within the industry are not identical. Incentive compensation arrangements at one organization may not be suitable for use at another organization because of differences in the risks, controls, structure, and management among organizations. The board of directors of each organization is responsible for ensuring that the incentive compensation arrangements for its organization do not encourage employees to take risks that are beyond the organization's ability to manage effectively, regardless of the practices employed by other organizations.

Large complex banking organizations and organizations that are significant users of incentive compensation. The board of an LCBO or other organization that uses incentive compensation to a significant extent should receive and review, on an annual or more frequent basis, an assessment by management, with appropriate input from risk-management personnel, of the effectiveness of the design and operation of the organization's incentive compensation system in providing risk-taking incentives that are consistent with the organization's safety and soundness. These reports should include an evaluation of whether or how incentive compensation practices may increase the potential for imprudent risk-taking.

The board of such an organization also should receive periodic reports that review incentive compensation awards and payments relative to risk outcomes on a backward-looking basis to determine whether the organization's incentive compensation arrangements may be promoting imprudent risk-taking. Boards of directors of these organizations also should consider periodically obtaining and reviewing simulation analysis of compensation on a forward-looking basis based on a range of performance levels, risk outcomes, and the amount of risks taken.

- *The organization, composition, and resources of the board of directors should permit effective oversight of incentive compensation.*

The board of directors of a banking organization should have, or have access to, a level of expertise and experience in risk-management and compensation practices in the financial services industry that is appropriate for the nature, scope, and complexity of the organization's activities. This level of expertise may be present collectively among the members of the board, may come from formal training or from experience in addressing these issues, including as a director, or may be obtained through advice received from outside counsel, consultants, or other experts with expertise in incentive compensation and risk-management. The board of directors of an organization with less complex and extensive incentive compensation arrangements may not find it necessary or appropriate to require special board expertise or to retain and use outside experts in this area.

In selecting and using outside parties, the board of directors should give due attention to potential conflicts of interest arising from other dealings of the parties with the organization or for other reasons. The board also should exercise caution to avoid allowing outside parties to obtain undue levels of influence. While the retention and use of outside parties may be helpful, the board retains ultimate responsibility for ensuring that the organization's incentive compensation arrangements are consistent with safety and soundness.

Large complex banking organizations and organizations that are significant users of incentive compensation. If a separate compensation committee is not already in place or required by other authorities,[20] the board of directors of an LCBO or other banking organization that uses incentive compensation to a significant extent should consider establishing such a committee—reporting to the full board—that has primary responsibility for overseeing the organization's incentive compensation systems. A compensation committee should be composed solely or predominantly of non-executive directors. If the board does not have such a compensation committee, the board should take other steps to ensure that non-executive directors of the board are actively involved in the oversight of incentive compensation systems. The compensation committee should work closely with any board-level risk and audit committees where the substance of their actions overlap.

- *A banking organization's disclosure practices should support safe and sound incentive compensation arrangements.*

If a banking organization's incentive compensation arrangements provide employees incentives to take risks that are beyond the tolerance of the organization's shareholders, these risks are likely to also present a risk to the safety and soundness of the organization.[21] To help promote safety and soundness, a banking organization should provide an appropriate amount of information concerning its incentive compensation arrangements for executive and non-executive employees and related risk-management, control, and governance processes to shareholders to allow them to monitor and, where appropriate, take actions to restrain the potential for such arrangements and processes that encourage employees to take imprudent risks. Such disclosures should include information relevant to employees other than senior executives. The scope and level of the information disclosed by the organization should be tailored to the nature and complexity of the organization and its incentive compensation arrangements.[22]

- *Large complex banking organizations should follow a systematic approach to developing a compensation system that has balanced incentive compensation arrangements.*

At banking organizations with large numbers of risk-taking employees engaged in diverse activities, an ad hoc approach to developing balanced arrangements is unlikely to be reliable. Thus, an LCBO should use a systematic approach—supported by robust and formalized policies, procedures, and systems—to ensure that those arrangements are appropriately balanced and consistent with safety and soundness. Such an approach should provide for the organization effectively to:

1. Identify employees who are eligible to receive incentive compensation and whose activities may expose the organization to material risks. These employees should include
    a. senior executives and others who are responsible for oversight of the organization's firm-wide activities or material business lines;
    b. individual employees, including non-executive employees, whose activities may expose the organization to material amounts of risk; and
    c. groups of employees who are subject to the same or similar incentive compensation arrangements and who, in the aggregate, may expose the organization to material amounts of risk;
2. Identify the types and time horizons of risks to the organization from the activities of these employees;
3. Assess the potential for the performance measures included in the incentive compensation arrangements for these employees to encourage the employees to take imprudent risks;

20. See New York Stock Exchange Listed Company Manual Section 303A.05(a); Nasdaq Listing Rule 5605(d); Internal Revenue Code section 162(m) (26 U.S.C. 162(m)).

21. On the other hand, as noted previously, compensation arrangements that are in the interests of the shareholders of a banking organization are not necessarily consistent with safety and soundness.

22. A banking organization also should comply with the incentive compensation disclosure requirements of the federal securities law and other laws as applicable. See, for example, Proxy Disclosure Enhancements, SEC Release Nos. 33-9089, 34-61175, 74 F.R. 68334 (Dec. 23, 2009) (to be codified at 17 C.F.R. 229 and 249).

4. Include balancing elements, such as risk adjustments or deferral periods, within the incentive compensation arrangements for these employees that are reasonably designed to ensure that the arrangement will be balanced in light of the size, type, and time horizon of the inherent risks of the employees' activities;
5. Communicate to the employees the ways in which their incentive compensation awards or payments will be adjusted to reflect the risks of their activities to the organization; and
6. Monitor incentive compensation awards, payments, risks taken, and risk outcomes for these employees and modify the relevant arrangements if payments made are not appropriately sensitive to risk and risk outcomes.

2068.0.3 CONCLUSION ON SOUND INCENTIVE COMPENSATION

Banking organizations are responsible for ensuring that their incentive compensation arrangements do not encourage imprudent risk-taking behavior and are consistent with the safety and soundness of the organization. The Federal Reserve expects banking organizations to take prompt action to address deficiencies in their incentive compensation arrangements or related risk-management, control, and governance processes.

The Federal Reserve intends to actively monitor the actions taken by banking organizations in this area and will promote further advances in designing and implementing balanced incentive compensation arrangements. Where appropriate, the Federal Reserve will take supervisory or enforcement action to ensure that material deficiencies that pose a threat to the safety and soundness of the organization are promptly addressed. The Federal Reserve also will update this guidance as appropriate to incorporate best practices as they develop over time.

WHAT'S NEW IN THIS REVISED SECTION

Effective July 2014, this section is revised to include a June 13, 2014, interagency Addendum to the 1998 "Interagency Policy Statement on Income Tax Allocation in a Holding Company Structure" (Addendum). The Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency (Agencies) announced the issuance of the Addendum to ensure that insured depository institutions (IDIs) in a consolidated group maintain an appropriate relationship regarding the payment of taxes and treatment of tax refunds. The purpose of the Addendum is to ensure that tax allocation agreements expressly acknowledge an agency relationship between a holding company[1] and its subsidiary IDI to protect the IDI's ownership rights in tax refunds. State member banks and holding companies should implement the guidance as soon as reasonably possible, which the Agency expect would not be later than October 31, 2014. This Addendum clarifies and supplements but does not replace the 1998 Interagency Policy Statement. (Refer to SR-14-6.)

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.

The tax structure of holding companies becomes more complicated when deferred taxes are considered in the intercorporate tax settlements.[2] 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 finan-

1. For the purpose of this guidance, the term, "holding company" refers to a bank holding company or a savings and loan holding company.

2. 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.

cial 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 holding company, income and deductions should theoretically equalize for both book and tax purposes.

Financial Accounting Standards Board Accounting Standards Codification 740-10 Statement No. 109 (FAS 109), "Accounting for Income Taxes," provides guidance on many aspects of accounting for income taxes, including the accounting for deferred tax liabilities and assets. FAS 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 and other holding companies file annual income tax returns. The holding company pays 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.

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. 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 section or page of the inspection report.

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

In 1998, 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.[3] 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 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 the federally supervised bank Consolidated 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,[4] not the extinguishment of a liability. Furthermore, such payments may constitute an unsafe and unsound banking practice.

3. 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.

4. 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.

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 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 carry-forward, 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.[5] 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.

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

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.

2070.0.1.6 Appendix — 2014 Addendum to 1998 Interagency Policy Statement on Income Tax Allocation in a Holding Company Structure

Since the issuance of the 1998 Interagency Policy Statement, courts have reached varying conclusions regarding whether tax allocation agreements create a debtor-creditor relationship between a holding company and its IDI.[6] Some courts have found that the tax refunds in question were the property of the holding company in bankruptcy (rather than property of the sub-

6. Case law on this issue is mixed. *Compare Zucker v. FDIC, as Receiver for BankUnited,* 727 F.3d 1100, 1108-09 (11th Cir. Aug. 15, 2013) ("The relationship between the Holding Company and the Bank is not a debtor-creditor relationship. When the Holding Company received the tax refunds it held the funds intact—as if in escrow—for the benefit of the Bank and thus the remaining members of the Consolidated Group.") with *F.D.I.C. v. Siegel (In re IndyMac Bancorp, Inc.),* F. ____ App'x ____ , 2014 WL 1568759, *2 (9th Cir. Apr. 21, 2014) *(per curiam)* ("The TSA does not create a trust relationship. The absence of language creating a trust relationship is explicitly an indication of a debtor-creditor relationship in California").

sidiary IDI) and held by the holding company as the IDI's debtor.[7]

On June 13, 2014, an Addendum to the 1998 Interagency Policy Statement (Addendum) was issued by the Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency (Agencies). It explains that Consolidated Groups should review their tax allocation agreements to ensure the agreements achieve the objectives of the Interagency Policy Statement. This Addendum also clarifies how certain of the requirements of sections 23A and 23B of the Federal Reserve Act (FRA) apply to tax allocation agreements between IDIs and their affiliates.

In reviewing their tax allocation agreements, Consolidated Groups should ensure the agreements: (1) clearly acknowledge that an agency relationship exists between the holding company and its subsidiary IDIs with respect to tax refunds, and (2) do not contain other language to suggest a contrary intent.[8] In addition, all Consolidated Groups should amend their tax allocation agreements to include the following paragraph or substantially similar language:

The [holding company] is an agent for the [IDI and its subsidiaries] (the "Institution") with respect to all matters related to consolidated tax returns and refund claims, and nothing in this agreement shall be construed to alter or modify this agency relationship. If the [holding company] receives a tax refund from a taxing authority, these funds are obtained as agent for the Institution. Any tax refund attributable to income earned, taxes paid, and losses incurred by the Institution is the property of and owned by the Institution, and shall be held in trust by the [holding company] for the benefit of the Institution. The [holding company] shall forward promptly the amounts held in trust to the Institution. Nothing in this agreement is intended to be or should be construed to provide the [holding company] with an ownership interest in a tax refund that is attributable to income earned, taxes paid, and losses incurred by the Institution. The [holding company] hereby agrees that this tax sharing agreement does not give it an ownership interest in a tax refund generated by the tax attributes of the Institution.

Going forward, the Agencies generally will deem tax allocation agreements that contain this or similar language to acknowledge that an agency relationship exists for purposes of the Interagency Policy Statement, this Addendum, and sections 23A and 23B of the FRA.

All tax allocation agreements are subject to the requirements of section 23B of the FRA, and tax allocation agreements that do not clearly acknowledge that an agency relationship exists may be subject to additional requirements under section 23A of the FRA.[9] In general, section 23B requires affiliate transactions to be made on terms and under circumstances that are substantially the same, or at least as favorable to the IDI, as comparable transactions involving nonaffiliated companies or, in the absence of comparable transactions, on terms and circumstances that would in good faith be offered to nonaffiliated companies.[10] Tax allocation agreements should require the holding company to forward promptly any payment due the IDI under the tax allocation agreement and specify the timing of such payment. Agreements that allow a holding company to hold and not promptly transmit tax refunds received from the taxing authority and owed to an IDI are inconsistent with the requirements of section 23B and subject to supervisory action. However, an Agency's determination of whether such provision, or the tax allocation agreement in total, is consistent with section 23B will be based on the facts and circumstances of the particular tax allocation agreement and any associated refund.

State member banks and holding companies should implement this 2014 Addendum guidance as soon as reasonably possible, which the Agencies expect would not be later than October 31, 2014. See 79 *Fed. Reg.* 35230, June 19, 2014, and SR-14-6, July 15, 2014, "Addendum to the Interagency Policy Statement on Income Tax Allocation in a Holding Company Structure."

7. *See e.g., F.D.I.C. v. Siegel (In re IndyMac Bancorp, Inc.),* F. ____ App'x ____, 2014 WL 1568759 (9th Cir. Apr. 21, 2014) *(per curiam).*

8. This Addendum clarifies and supplements but does not replace the Interagency Policy Statement.

9. Section 23A requires, among other things, that loans and extensions of credit from a bank to its affiliates be properly collateralized. 12 U.S.C. 371c(c).

10. 12 U.S.C. 371c-1(a). Transactions subject to section 23B include the payment of money by a bank to an affiliate under contract, lease, or otherwise and transactions in which the affiliate acts as agent of the bank. *Id.* at § 371c-1(a)(2) & (a)(4).

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[11] 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-96-28.

2070.0.3 Inspection Objectives

1. To determine whether the supervisory and accounting guidance set forth in ASC 740-10 (FASB 109), other tax-accounting standards, and the 1998 interagency policy statement on income tax allocation has been appropriately, equitably, and consistently applied.
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.[12]
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 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

   Holding companies of depository institutions should also have written tax-sharing agreements with their subsidiaries that specify intercorporate tax-settlement policies. The Board encourages these 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

11. Subchapter S corporations are corporations that elect to pass corporate income tax losses, deductions, and credit through to their shareholders for federal income tax purposes.

12. 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 depository institution than would have been made if the depository institution was unaffiliated.

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.
   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 refunds are received no later than the date the institutions would have filed their own returns and that no refund is 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, and the parent will not later require the institution to pay the remainder of the 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 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 or section of the Report of Bank Holding Company Inspection (FR 1225 or FR 1241).

2070.0.5 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Interagency Policy Statement on Income Tax Allocation in a Holding Company Structure			4-870	1999 FRB 111
2014 Addendum to the Interagency Policy Statement on Income Tax Allocation in a Holding Company Structure				

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.

WHAT'S NEW IN THIS REVISED SECTION

Effective July 2010, this section was revised to include a cross reference to section 4066.0 of this manual, which provides the March 17, 2010, interagency policy statement on "Funding and Liquidity Risk Management."

A key principle underlying the Federal Reserve's supervision of bank holding companies (BHCs) 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, BHCs 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.

For more information regarding the Federal Reserve's supervisory expectations on liquidity risk management for BHCs, see section 4066.0, "Consolidated (Funding and Liquidity Risk Management)." This section provides the March 17, 2010, interagency policy statement on "Funding and Liquidity Risk Management." (see also SR-10-6 and its attachment.)

2080.05.1 FUNDING AND LIQUIDITY

A principal objective of a parent BHC'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 BHC'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 BHC 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, BHCs, 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 fund 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.

BHCs 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 BHCs 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, BHCs 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. BHCs 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

BHCs 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, BHCs 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 BHC 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 BHCs 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 BHCs that are experiencing earnings weaknesses or asset-quality problems, or that are otherwise subject to unusual liquidity pressures. In particular, BHCs with less than satisfactory supervisory ratings—composite (C) and the potential impact (I) of the parent company and nondepository entities—(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 BHC 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 rollover 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

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.

not an obligation of the bank and that the quality 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 characteristics, 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, 4020.1, and 4060.9. See section 4070.1 of the *Commercial Bank Examination Manual*.

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 regarding the payment of dividends by state member banks on December 20, 1990, [12 C.F.R. 208.19(a) and 208.19(b)]. The rule was revised, effective October 1, 1998, and replaced as renumbered section 208.5 (see 12 C.F.R. 208.5), "Dividends and other distributions." It sets forth the "Limitation on withdrawal of capital by dividend or otherwise," in subsection 208.5(d). The regulation discusses the elements that are taken into account in determining a state member bank's dividend paying capacity. Two different calculations are performed to measure the amount of dividends that may be paid, a Net Income Test and an Undivided Profits Test.

2080.4.1.1 Net Income Test

The approval of the Federal Reserve is required for dividends declared by a member bank that in any calendar year exceeds the net income of the current year, combined with retained net income for the two preceding years (the "Net Income Test").

2080.4.1.2 Undivided Profits Test

A member bank must receive prior approval of the Federal Reserve, and of at least two-thirds of the shareholders of each class of stock outstanding, before paying dividends in amounts greater than undivided profits.

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.

This manual presents several sections on control and ownership, which describe the concept of control as it is applied by the Federal Reserve under the relevant banking and/or savings and loan-related statutes.

This section defines control and explains why control is important from a supervisory perspective. Specifically, control is a threshold issue that is used to determine which companies and individuals (whether domestic or foreign) are subject to Federal Reserve regulatory oversight due to their relationships with, including ownership interests in, U.S. federally insured depository institutions. The Federal Reserve is responsible for evaluating the control relationships affecting bank holding companies (BHCs), savings and loan holding companies (SLHCs) (including banks and other subsidiaries), and banks. The following subsections specifically address control as it applies to companies, qualified family partnerships, individuals and certain companies, and BHC formations.[1]

2090.0.1 GOVERNING FRAMEWORK FOR COMPANIES

The Bank Holding Company Act (BHC Act) and the Home Owners' Loan Act (HOLA), and the Board's implementing regulations, Regulation Y (12 CFR part 225) and Regulation LL (12 CFR part 238) set forth the standards for what constitutes "control."[2] The standards are substantially similar under both statutes and their respective implementing regulations. Importantly, these control standards apply only to companies and other legal entities, not to individuals.[3] This section will largely focus on the BHC Act and Regulation Y for BHCs, although a similar set of principles and requirements apply under HOLA and Regulation LL for SLHCs. Therefore, the inspection procedures at the end of this section can be used in inspections of both BHCs and SLHCs.

Key definitions under the BHC Act and Regulation Y:

Company—any corporation, partnership, business trust, association, or similar organization, or any other trust unless by its terms it must terminate either within 25 years, or within 21 years and 10 months after the death of individuals living on the effective date of the trust.[4] "Company" does not include any corporation that is majority owned by the United States or any state, or any qualified family partnership.[5]

Bank holding company or BHC—any company that has control over any bank or over any company that is or becomes a BHC.[6]

Bank—includes an insured bank as defined in section 3(h) of the Federal Deposit Insurance Act (12 U.S.C. § 1813(h)); or an institution organized under certain laws specified by statute, which both (1) accepts demand deposits or deposits that the depositor may withdraw by check or similar means for payment to third parties or others; and (2) is engaged in the business of making commercial loans.[7] The statute includes several exceptions from the definition of "bank."[8]

Subsidiary—a bank or other company that is controlled by a BHC.[9]

2090.0.2 IMPORTANCE OF CONTROL

A company that is a BHC is subject to the supervisory and regulatory oversight of the Federal Reserve. Such oversight covers the direct

1. Appendix 1 provides additional information on regulations, interpretations, and orders related to controls and ownership.

2. BHC Act (12 U.S.C. § 1841 et seq.); HOLA (12 U.S.C. § 1467 et seq.).

3. Control is also determined under the Change in Bank Control Act or the CBC Act (see the section of this manual entitled, "Control and Ownership (Change in Control)"). The CBC Act applies to individuals, companies, and other legal entities. The CBC Act's definition of control has elements of the other two statutes, with "control" meaning "the power, directly or indirectly, to direct the management or policies of an insured depository institution or to vote 25 percent or more of any class of voting securities of an insured depository institution." Under the CBC Act, a prior notice generally is required for individuals or companies that seek to control 10 percent or more of a BHC's or SLHC's voting securities. For a bank or thrift that has no parent holding company, the notice is filed with the bank or thrift's primary federal banking regulator. As with the BHC Act and HOLA, exemptions from the prior notice requirements are available under certain circumstances under the CBC Act.

4. The exemption for trusts is narrower for SLHCs due to differences between HOLA and the BHC Act. See 12 CFR 238.2(m)(2)(ii).

5. 12 CFR 225.2(d)1.

6. 12 CFR 225.2(c)(1).

7. 12 U.S.C. § 1841(c)(1); 12 CFR 225.2(b)(1).

8. 12 U.S.C. § 1841(c)(2).

9. 12 CFR 225.2(o).

activities of the BHC, as well as those activities conducted by the BHC through its bank and nonbank subsidiaries. When designated a BHC, various requirements and restrictions come into effect, including examinations and regulatory reporting requirements, capital and liquidity requirements, source of strength obligations, cross-guarantee liability obligations among affiliated insured depository subsidiaries, activity restrictions, and restrictions on certain affiliate transactions involving insured depository subsidiaries.

The Board's authority over BHCs is guided by two key purposes of the BHC Act: (1) to ensure that companies that acquire control of banks (and other insured depository institutions, as under HOLA) have the financial strength and managerial ability to exercise control in a safe and sound manner; and (2) to separate banking from commerce by restricting the nonbanking activities of BHCs and by preventing companies with commercial interests from exercising control over banking organizations.[10]

A company must first obtain the prior approval of the Federal Reserve before becoming a BHC (see section 2090.2 for BHC Formations). In cases where control of a bank is obtained without prior approval of the Federal Reserve (whether intentionally or inadvertently), the controlling company must be brought into conformance with the BHC Act as soon as possible. Such a company will have to apply for BHC status (which may require the company to modify its activities) and/or divest some, or all, of its investment in the acquired bank.

2090.0.3 INVESTMENTS INVOLVING BANKING ORGANIZATIONS

A company (that is not a bank or BHC) can make an investment in a bank or BHC or receive an investment from a bank or BHC. An existing BHC can make an investment in another company, bank, or BHC. Accordingly, investments can be made according to the following scenarios:

Scenario 1: by a company (that is not a bank or BHC) in a bank or BHC,

Scenario 2: by a BHC in a company (that is not a bank or BHC), or

Scenario 3: by a BHC in a bank or BHC.

If the investment is deemed to be a *controlling* investment, then under

Scenario 1: the company (investing company/investor/acquirer) would be required to seek prior Federal Reserve approval to become a BHC,

Scenario 2: the company (investee company/investee/target) would become a subsidiary of a BHC, and

Scenario 3: the target bank or BHC would become a subsidiary of the acquiring BHC.

If the investment is deemed to be a *noncontrolling* investment, then under

Scenario 1: the company (investing company/investor/acquirer) would *not* be required to seek prior Federal Reserve approval to become a BHC,

Scenario 2: the company (investee company/investee/target) would *not* become a subsidiary of a BHC, and

Scenario 3: the target bank or BHC would *not* become a subsidiary of the investing BHC.

Investors and investees often seek to structure their investments in, or by, banks or BHCs in a manner to avoid a determination of control. Otherwise, if control exists, status as a BHC or a subsidiary thereof would result, subjecting the company to the Federal Reserve's oversight, as well as restrictions on certain activities.

An investing company/acquirer that proposes to invest in a bank or BHC often seeks a control determination from the Federal Reserve to understand whether the transaction will result in the company becoming a BHC, and therefore subject to the BHC Act. An existing BHC also may seek a control determination to limit its obligations to the investee company/target in which an investment is being made.

2090.0.4 DEFINITION OF CONTROL

Under section 2(a)(2) of the BHC Act, control is defined by a three-pronged test. A company has "control" of a bank or BHC, if any one of the following three prongs are met:

10. For the purposes of this section, "banking organizations" is a general term that applies to a BHC or an SLHC, and their related subsidiaries.

1. the company directly or indirectly owns, controls, or has power to vote 25 percent or more of any class of voting securities of a bank or a company that is a BHC;
2. the company controls in any manner the election of a majority of the directors or trustees of a bank or a company that is a BHC; or
3. the company directly or indirectly exercises a controlling influence over the management or policies of a bank or a company that is a BHC.

The first and second prongs of the control test are generally straightforward. The third prong, or the "controlling influence" prong, is largely based on a set of tiered presumptions of control (discussed below).

2090.0.5 BACKGROUND ON CONTROLLING INFLUENCE

Under the BHC Act and HOLA, investing companies that own less than 5 percent are presumed not to control, whereas investing companies that own 25 percent or more, absolutely control for purposes of the statute. As a result, evaluation of the controlling influence prong arises for ownership levels in the range of 5 percent to less than 25 percent.

Typically, large noncontrolling investors seek to protect or enhance their investments through multiple forms of engagement with the target company. This approach provides the investor with an opportunity to monitor and influence the target company.

Based on the review of many individual cases over the years, the Board has developed standards that cover the most common factors or investment features that may give rise to controlling influence concerns. For example, these may include

- the size and structure of a company's voting and total equity investment;
- a company's rights to director representation;
- common management, employees, or directors between companies;
- restrictive covenants;
- business relationships; and
- other indicia of the ability or incentive of a company to exercise a controlling influence over a bank or BHC.[11]

In 2020, the Board issued a rule on Control and Divesture Proceedings (2020 rule),[12] which was subsequently codified in Regulations Y and LL. The 2020 rule sets forth standards for investors to rebut the presumption of control under the controlling influence prong, along with other important control-related items. The Board's 2020 rule expands substantially the number of control presumptions and makes some targeted adjustments from past practices. For example, noncontrolling investors may have a greater number of director representatives at their investee company, and investors can terminate an existing control relationship at greater levels of ownership. In addition, the use of passivity commitments are no longer needed, generally.[13] Overall, the 2020 rule provides the banking industry with greater transparency of the Federal Reserve's application of its control rules. As such, the 2020 rule is intended to facilitate and expedite permissible investments in and by banking organizations. Such investments may raise capital for the banking organization or form some type of strategic alliance.

2090.0.6 PRESUMPTIONS OF CONTROL

The 2020 rule establishes and describes a series of tiered presumptions of control based on voting securities and other important relationships or factors. These tiered presumptions and additional presumptions of control are listed in paragraphs (b) through (j) of section 225.32 of Regulation Y and section 238.22 of Regulation LL. See appendix 2 to this section for a summary of tiered presumptions.

The level of investment and all other aspects of the investor/investee relationship are to be considered in the aggregate when determining whether there is a presumption of control. Different standards apply once a company's level of voting securities exceeds 5 percent, 10 percent, and 15 percent. As an investing company's

11. Some of these standards have been codified in the Board's Regulation Y (see e.g., 12 CFR 225.138 and 12 CFR 225.139). In addition, the Board issued guidance through policy statements (see the section of this manual entitled, "Control and Ownership (Policy Statements on Equity Investments in Banks and Bank Holding Companies))."

12. 85 Fed. Reg. 12,398 (March 2, 2020).

13. Passivity commitments are a set of standardized restrictions that are used to support an absence of controlling influence entered between the investing company and the Board. Federal Reserve staff generally had requested passivity commitments when an investing company proposes to control 10 percent or more of a class of voting securities of a BHC or SLHC.

percentage of voting securities increases, the significance of the other relationships generally must decrease to avoid triggering controlling influence concerns.

The subsections below describe some of these investor/investee relationships and how they can represent a controlling influence over the target company.

2090.0.6.1 Director Representation

A company's level of representation on the board of directors of a target company is an important factor for controlling influence. The second prong of the control test (controlling in any manner the election of the majority of the board of directors of a target company) reinforces the importance that director representation has on determining a controlling influence. In addition to the share of director representatives that one company has on the board of directors of a target company, there may be a controlling influence if a particular director representative has an outsized ability to affect the decisions of the target company. For instance, the chair of the board of directors of a company is generally recognized as a leader of the company and its board of directors. Further, the chair may have additional powers, such as the ability to set the agenda for meetings of the board of directors. Similarly, certain committees of the board of directors may have the power to take actions that bind the company without the need for approval by the full board of directors. In these circumstances, such a committee is nearly equivalent to the full board of directors with respect to those decisions that it is empowered to make unilaterally.

2090.0.6.2 Business Relationships

A company's business relationships with another company provide a mechanism through which the investing company could exercise a controlling influence over the target company. For example, a business relationship between an investor and another company that accounts for a substantial portion of the revenues or expenses of the target company may provide a lever by which the investor could attempt to influence the target company. In addition, if a company can enter into a business relationship with a target company on terms that are not market terms, it is likely that the investing company has a significant level of influence over the target company. Business relationship thresholds generally are based on the size of these relationships as compared to total consolidated annual revenues and expenses. The Board also may consider other factors such as relationships that are difficult to replace and are necessary for core functions.

2090.0.6.3 Senior Management Interlocks

The officers of a company wield significant power over the company because they implement the major policies set by the board of directors, make the ancillary policy decisions necessary for implementation of a policy, and operate the company on a day-to-day basis. In addition, officers often make influential recommendations to the board of directors regarding major policy decisions. As a result of this substantial degree of influence, situations where an agent of a significant investor company serves as a management official of another company may provide a considerable avenue for the first company to exercise a controlling influence over the target company.

2090.0.6.4 Contractual Limits on Major Operational or Policy Decisions

A company that controls a material amount of voting securities of a target company also may have contractual arrangements with the target company, such as investment agreements, debt relationships, service agreements, or agreements related to other business relationships. Contractual rights often raise controlling influence concerns as an investor may have the ability to restrict significantly, directly or indirectly, the discretion of another company over operational or policy decisions, whether such decisions are made by management or by the other company's board of directors. The ability of an investor to significantly restrict an important business decision of a company generally provides the investor with the ability to exercise a significant influence over the company.

2090.0.6.5 Total Equity

The overall size of an equity investment, including both voting and nonvoting equity, is an important indicator of the degree of influence an investor may have. A company is likely to pay heed to its large shareholders in order to maintain stability in its capital base, enhance its ability to raise future equity capital, and to prevent the negative market signal that may be created by the sale of a large block of equity by an unhappy shareholder. Under the Board's Regulation Y, a company will be presumed to control a target company when the first company controls one-third or more of the total equity of the target company.[14]

2090.0.6.6 Divestiture

The Board historically has taken the position that a company that has controlled another company may be able to exert a controlling influence over that company even after a substantial divestiture. The 2020 rule establishes that a company that previously controlled a target company during the preceding two years is presumed to continue to control the target company if the first company owned 15 percent or more of any class of voting securities of the target company. The divestiture presumption does not apply if a majority of each class of voting securities of the target company is controlled by a single unaffiliated individual or company after the divestiture by the investor company. Further, the divestiture presumption generally does not apply in cases where a company sells a subsidiary to a third company and receives stock of the third company as consideration for the sale.

2090.0.7 SUPERVISORY CONSIDERATIONS

The determination of whether an investment, or proposed investment, is a controlling or noncontrolling investment is separate and independent from the analysis of whether the investment raises safety-and-soundness concerns. Examiners should review terms of the investment, including all existing or planned relationships, in connection with the review of the investment. While the table in appendix 2 to this section provides guidance as to what is indicative of control, it can be used as a starting point to understand the details or additional elements surrounding an investment and any related relationships or rights between the investor and investee companies that may raise safety-and-soundness concerns. For example, business relationships may be a cause of concern when one company is dependent on the other for funding, regardless of whether it triggers any presumption of control. Similarly, a bank director or management official appointed by the investor company to serve at the target banking organization potentially could wield significant influence over deliberations and decisions of the target perhaps resulting in misaligned interests or new operational risks.

2090.0.8 INSPECTION OBJECTIVES

1. To confirm all 5 percent or greater shareholders (including the combined ownership interests of related parties) at an existing BHC or SLHC.
2. To determine whether any change in control has resulted in a company becoming a BHC in violation of section 3(a)(1) of the BHC Act (or HOLA for SLHCs), or an individual acquiring significant ownership interests in violation of the Change in Bank Control (CBC) Act.
3. To ascertain whether an existing BHC or SLHC has acquired either directly or indirectly additional banking assets in violation of section 3(a)(3) of the BHC Act (or HOLA for SLHCs).
4. To establish whether a BHC which has purchased its own stock is in compliance with section 225.4(b) of Regulation Y. (See this manual's section entitled, "Control and Ownership (Treasury Stock Redemptions).")

2090.0.9 INSPECTION PROCEDURES

1. Review the holding company's stock records and the company's investment portfolio. Also review the holding company's annual filing of form FR Y-6.
2. To assess compliance with the BHC Act, HOLA, and the CBC Act, review transactions involving an equity investment by a BHC or SLHC or by an individual or other company (investments into a BHC, SLHC, bank, or other company) that result in the investor owning 5 percent or more of the voting securities of the target company. Consider whether any such investments raise any safety-and-soundness concerns for the affected parties.

14. 12 CFR 225.32(c). For SLHCs, a lower standard of 25 percent of total equity applies under HOLA. See 12 U.S.C. § 1467a(a)(2)(B).

3. If the holding company has any subsidiaries that are indirectly owned or controlled, determine whether 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.

APPENDIX 1: REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Regulations* [1]	*Interpretations* [2]	*Orders* [3]
Regulation Y	225		
Regulation LL	238		
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. 18,945 (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	4-172.1	1982 FRB 413
Equity investments in banks and BHCs (2008 Policy Statement)	225.144		

1. 12 CFR, unless specifically stated otherwise.
2. Federal Reserve Regulatory Service reference.
3. Federal Reserve Bulletin (FRB) reference, unless specifically stated otherwise.

APPENDIX 2: SUMMARY OF TIERED PRESUMPTIONS

Presumption of control	*Less than 5% voting*	*5–9.99% voting*	*10–14.99% voting*	*15–24.99% voting*
Directors	Less than half	Less than a quarter	Less than a quarter	Less than a quarter
Director Service as Board Chair	N/A	N/A	N/A	No director representative is chair of the board
Director Service on Board Committees	N/A	N/A	A quarter or less of a committee with power to bind the company	A quarter or less of a committee with power to bind the company
Business Relationships	N/A	Less than 10% of revenues or expenses of the second company	Less than 5% of revenues or expenses of the second company	Less than 2% of revenues or expenses of the second company
Business Terms	N/A	N/A	Market terms	Market terms
Officer/ Employee Interlocks	N/A	No more than 1 interlock, never chief executive officer (CEO)	No more than 1 interlock, never CEO	No interlocks
Contractual Powers	No management agreements	No rights that significantly restrict discretion	No rights that significantly restrict discretion	No rights that significantly restrict discretion
Proxy Contests (Directors)	N/A	N/A	No soliciting proxies to replace more than permitted number of directors	No soliciting proxies to replace more than permitted number of directors
Total Equity	BHCs – Less than 1/3 SLHCs – 25% or less	BHCs – Less than 1/3 SLHCs – 25% or less	BHCs – Less than 1/3 SLHCs – 25% or less	BHCs – Less than 1/3 SLHCs – 25% or less

Note: Presumption triggered if any relationship exceeds the amount in the table.

WHAT'S NEW IN THIS REVISED SECTION

This section has been revised to include a Board staff interpretation, pertaining to a qualified family partnership (QFP), that was issued on May 10, 2010. The interpretation considered whether a proposed assignment of an economic interest in the partnership interests of a partnership that is a QFP under section 2(o)(10) of the Bank Holding Company Act would cause the partnership to lose its status as a QFP.

2090.05.1 QUALIFIED FAMILY PARTNERSHIP EXEMPTION

Under the Bank Holding Company Act (the Act), any "company" (including a partnership) that controls a bank is considered a bank holding company (BHC).[1] Section 2(o) of the Act (as amended by section 2610 of the Economic Growth and Regulatory Paperwork Reduction Act of 1996),[2] however, provides a limited exemption from the definition of company for a "qualified family partnership" (QFP), and accordingly, a partnership that qualifies as a QFP is not considered a BHC under the Act.[3] A QFP, under the Act, is able to own and control a BHC without the partnership becoming subject to the registration, source of strength, approval, reporting, and other requirements imposed on a BHC.

In order to qualify for the Act's exemption for a QFP, all the partners of the QFP must be individuals related to each other by blood, marriage, or adoption; or trusts for the primary benefit of those individuals (collectively, "qualified parties"). In addition, the partnership must

- control any bank (its bank investments) through a single registered BHC that remains subject to all of the provisions of the Act;
- control only one registered BHC;
- 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 BHC under section 4(c) of the Act; and
- not be obligated on any debt, either directly or as a guarantor.[4]

Any partnership requesting qualification as a QFP 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 BHC for purposes of enforcement actions by the Board. In addition, while a QFP 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 QFP are (1) exemption from the capital requirements applicable to BHCs, (2) exemption from the reporting requirements applicable to a BHC, and (3) the freedom to make permissible nonbanking investments without prior Board approval. Because the QFP must use a single registered BHC to hold all of its bank investments, there continues to be a BHC 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 QFP.

2090.05.2 ASSIGNMENT OF ECONOMIC PARTNERSHIP INTEREST THAT IS A QFP

Board staff issued a May 10, 2010, interpretation on whether a proposed assignment of an economic interest in the partnership interests of a partnership that is a QFP under section 2(o)(10) of the Act would cause the partnership to lose its status as a QFP.[5] Board staff noted that the QFP exemption does not distinguish between the legal and beneficial ownership of such partnership interest. An assignment of the economic interests in a QFP interest, especially in the case of a limited partnership interest, would effectively give the assignee a beneficial interest in the QFP. Where the assignee is not a family member, Board staff believes that such

1. 12 U.S.C. 1841(a)(1).
2. Pub. L. 104-2089, section 2610; 110 Stat. 3009.
3. 12 U.S.C. 1841(b).
4. The QFP also must commit to examination by the Board and to the notice requirements of the Change in Bank Control Act if it acquires an additional bank.
5. 12 U.S.C. 1841(o)(10).

an assignment would undermine the ‘‘family relationship’’ requirement of the Act and would expand the exemption beyond its limited scope. Accordingly, Board staff believes that an assignment of the economic interests in the partnership interest of a QFP to a non-qualified person would be inconsistent with the ‘‘relationship’’ requirement of the statute. The partnership would not be in compliance with the statutory requirements of a QFP and would be required to register as a BHC.

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.

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.

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:

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,

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.

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.)

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.

2090.2.1 FORMATION OF A BANK HOLDING COMPANY AND CHANGES IN OWNERSHIP

The formation of a bank holding company (BHC) and certain changes in the ownership of banks owned by a BHC come under the provisions of section 3 of the BHC Act. Section 3(a)(1) prohibits the formation of a BHC 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 BHC , 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 BHC's shares without prior Board approval. In addition to the above, section 3(a)(3) serves to prevent an existing BHC from increasing, without prior Board approval, its ownership in an existing subsidiary bank unless the BHC already owns 50 percent of the shares of the bank (section 3(a)(5)(B)). A BHC that owns more than 50 percent of a bank's shares may buy and sell those shares freely without Board approval, provided the ownership remains above 50 percent. If a BHC owns less than 50 percent of a bank's shares, prior Board approval is required before each additional acquisition of shares until the BHC's ownership of the bank reaches more than 50 percent.

2090.2.2 HISTORY OF THE POLICY STATEMENT ON THE FORMATION OF SMALL BANK HOLDING COMPANIES

The Board issued the policy statement in 1980 to facilitate the transfer of ownership of small community-based banks in a manner consistent with bank safety and soundness. The Board has generally discouraged the use of debt by BHCs to finance the acquisition of banks or other companies because high levels of debt can impair the ability of the holding company to serve as a source of strength to its subsidiary banks. The Board has recognized, however, that small BHCs have less access to equity financing than larger BHCs and that the transfer of ownership of small banks often requires the use of acquisition debt. Accordingly, the Board adopted the policy statement to permit the formation and expansion of small BHCs with debt levels that are higher than typically permitted for larger BHCs. The policy statement, which is codified in Regulation Y (12 CFR 225, appendix C), contains several conditions and restrictions designed to ensure that small BHCs that operate with the higher levels of debt permitted by the policy statement do not present an undue risk to the safety and soundness of their subsidiary banks.

2090.2.3 SMALL BANK HOLDING COMPANY AND SAVINGS AND LOAN HOLDING COMPANY POLICY STATEMENT

In acting on applications filed under the BHC Act, the Board has adopted and continues to follow the principle that BHCs should serve as a source of strength for their subsidiary banks. When BHCs 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 BHC to provide financial assistance to its subsidiary bank(s), and, in some cases, the servicing requirements on such debt may be a significant drain on the resources of the bank(s). For these reasons, the Board has not favored the use of acquisition debt in the formation of BHCs 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 BHCs with debt levels higher than would

1. A domestic corporation may be 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; and (2) an 80 percent deduction for dividends received from a corporation that is 20 to less than 80 percent owned, subject to certain limits.

be permitted for larger BHCs. Approval of these applications has been given on the condition that the small BHCs demonstrate the ability to service the acquisition debt without straining the capital of their subsidiary banks and, further, that such companies restore their ability to serve as a source of strength for their subsidiary banks within a relatively short period of time.

In the interest of continuing its policy of facilitating the transfer of ownership in banks without compromising bank safety and soundness, the Board has, as described below, adopted the following procedures and standards for the formation and expansion of small BHCs subject to this policy statement.

2090.2.3.1 Applicability of Policy Statement

The policy statement applies only to BHCs with *pro forma* consolidated assets of less than $3 billion 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 debt or equity securities outstanding (other than trust preferred securities) that are registered with the Securities and Exchange Commission. 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. With the exception of section 4 (Additional Application Requirements for Expedited/Waived Processing), the policy statement applies to savings and loan holding companies as if they were BHCs. While this 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.[2] The criteria are described below.

2. The appropriate Reserve Bank should be contacted to determine the manner in which a specific situation may qualify for treatment under this policy statement.

2090.2.3.2 Ongoing Requirements

The following guidelines must be followed on an ongoing basis for all organizations operating under this policy statement.

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 that these BHCs reach a debt-to-equity ratio of .30 to 1 or less within 12 years after incurrence of the debt.[3] The BHC must also comply with debt-servicing and other requirements imposed by its creditors.

Subordinated debt associated with trust preferred securities generally would be treated as debt for purposes of paragraphs 2.C. (dividend restrictions), 3.A. (minimum down payment), 4.A.i (expedited treatment of certain filings), and 4.B.i (stock redemption filing requirements) 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 BHC’s equity (as defined below) less goodwill 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 the 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.

In addition, notwithstanding any other provision of the policy statement and for purposes of compliance with paragraphs 2.C., 3.A., 4.A.i.,

3. 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.

and 4.B.i. of the policy statement, both a BHC that is organized in mutual form and a BHC that has made a valid election to be taxed under Subchapter S of Chapter 1 of the U.S. Internal Revenue Code may exclude from debt subordinated debentures issued to the United States Department of the Treasury under (1) the Troubled Asset Relief Program established by the Emergency Economic Stabilization Act of 2008. (See 74 *Fed. Reg.* 26,077 (June 1, 2009), Division A of Public Law 110-343, 122 Stat. 3765 (2008)), and (2) the Small Business Lending Fund established by the Small Business Jobs Act of 2010, title IV of Public Law 111-240, 124 Stat. 2504 (2010).

The term *equity* as used in the ratio of debt to equity, means the total stockholders' equity of the BHC, as defined in accordance with generally 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 1.0:1 is not expected to pay corporate dividends until such time as it reduces its debt to equity ratio to 1.0:1 or less and other wise meets the criteria set forth in sections 225.14(c)(1)(ii), 225.14(c)(2), and 225.14(c)(7) of Regulation Y.[4]

Small BHCs formed before August 30, 2018 (the effective date of the policy statement), may switch to a plan that adheres to the intent of the policy statement provided they comply with the requirements set forth above.[5]

2090.2.3.3 Core Requirements for All Applicants

In assessing applications or notices by organizations subject to the policy statement, the Board will continue to take into account a full range of financial and other information about the applicant, and its current and proposed subsidiaries, including the recent trend and stability of earnings, past and prospective growth, asset quality, the ability 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 following requirements:

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.

4. Dividends may be paid by small BHCs with debt to equity at or below 1.0:1 and otherwise meeting the requirements of sections 225.14(c)(1)(ii), 225.14(c)(2), and 225.14(c)(7) if the dividends are reasonable in amount, do not adversely affect the ability of the BHC to service its debt in an orderly manner, and do not adversely affect the ability of the subsidiary banks to be well-capitalized. 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 .30:1 within 12 years of consummation of the proposal or (2) not meeting the requirements of its loan agreement(s).

5. For the interim final rule, see 83 Fed. Reg. 44,195 (August 30, 2018).

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 for reduction in parent company leverage, discussed under "Minimum Down Payment." Failure to meet the criteria would normally result in denial of an application.

2090.2.3.4 Additional Application Requirements for Expedited/Waived Processing

2090.2.3.4.1 Expedited Notices under Sections 225.14 and 225.23 of Regulation Y

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 this policy statement, (2) the BHC meets the previously discussed core requirements for all applicants noted above, and (3) the following requirements are met:

1. The parent BHC has a pro forma debt-to-equity ratio of 1.0:1 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 section 225.4(b)(6) if the following requirements are met:

1. The parent BHC has a *pro forma* debt-to-equity ratio of 1.0:1 or less.
2. The BHC is in compliance with the ongoing requirements of this 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 INSPECTION OBJECTIVES

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

2090.2.5 INSPECTION PROCEDURES

1. Review all commitments made by the company and its shareholders to determine compliance therewith.
2. Determine whether the BHC or SLHC is in compliance with the Small Bank Holding Company and Savings and Loan 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 or the SLHC'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 each insured depository subsidiary of a small BHC is well capitalized or, if not, whether it will be well capitalized within a brief period of time.
5. Determine whether the payment of corporate dividends has been restricted until the BHC's debt-to-equity ratio is 1.0:1 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.

2090.2.6 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws*[1]	*Regulations*[2]	*Interpretations*[3]	*Orders*
Capital adequacy guidelines of BHCs, SLHCs, and state member banks (Regulation Q)		217	3–2100	
Small BHC and SLHC Policy Statement Regulation Y, appendix C		225	4–868	
Expedited action for certain acquisitions by well-run BHCs		225.14	4–024.1	
Expedited action for nonbanking proposals by well-run BHCs		225.23	4–037.1	
Savings and loan holding companies (Regulation LL) — Small BHC Policy Statement		238.9	4–750.8	

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.

Control and Ownership (Policy Statements on Equity Investments in Banks and Bank Holding Companies) Section 2090.4

WHAT'S NEW IN THIS REVISED SECTION

Effective January 2009, this section has been revised to incorporate the Board's September 21, 2008, "Policy Statement on Equity Investments in Banks and Bank Holding Companies." (See the Board's September 22, 2008, Press Release and section 2090.4.4.) The policy statement provides additional guidance on the Board's position on minority equity investments in banks and bank holding companies that generally do not constitute "control" for purposes of the Bank Holding Company Act. This policy updates the guidance found in the Board's July 1982 "Policy Statement on Nonvoting Equity Investments by Bank Holding Companies."

2090.4.1 OVERVIEW AND GUIDING PRINCIPLES

For many years, bank holding companies, nonbank financial companies, private equity funds, and other firms made minority equity investments in banks and bank holding companies. These investments often raised questions about the extent to which the investment would cause the investor to become subject to supervision, regulation, and the other requirements applicable to bank holding companies under the Bank Holding Company Act (BHC Act or the Act) and the Board's Regulation Y. In general, the BHC Act applies to any company that controls a bank or bank holding company (banking organization). The BHC Act provides that a company has control over a banking organization if (1) the 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 the banking organization; (2) the company controls, in any manner, the election of a majority of the directors or trustees of the banking organization; or (3) the Board determines, after notice and opportunity for hearing, that the company directly or indirectly exercises a controlling influence over the management or policies of the banking organization.[1] Minority equity investments in banking organizations are designed not to trigger either of the first two prongs of the definition of control. These investments often raised questions, however, regarding whether the investor would be able to exercise a controlling influence over the management or policies of a banking organization.[2]

The text and legislative history of the control definition in the BHC Act make manifest that possession by an investor of a modicum of influence over a banking organization would not amount to a controlling influence. At the same time, the definition does not require that an investor have absolute control over the management and policies of a banking organization. Instead, the Act requires that an investor be able to exercise an amount of influence over a banking organization's management or policies that is significant but less than absolute control in fact of the banking organization. Notably, the primary definition of control in the Act is based on ownership of 25 percent or more of the voting shares of a banking organization—an amount that does not provide an investor in most cases with complete control over decisions but would allow the investor to play a significant role in the decision-making process.

In assessing whether an investor has the ability to exercise a controlling influence over a banking organization, the Board has been especially mindful of two key purposes of the BHC Act. First, the BHC Act was intended to ensure that companies that acquire control of banking organizations have the financial and managerial strength, integrity, and competence to exercise that control in a safe and sound manner. The BHC Act is premised on the principle that a company that controls a banking organization may reap the benefits of its successful management of the banking organization but also must be prepared to provide additional financial and managerial resources to the banking organization to support the company's exercise of control. In this way, the Act ties the potential upside benefits of having a controlling influence over the management and policies of a banking organization to responsibility for the potential downside results of exercising that controlling influence. By tying control and responsibility together, the Act ensures that

1. 12 U.S.C. 1841(a)(2).

2. Contemporaneous minority investments in the same banking organization by multiple different investors also often raise questions about whether the multiple investors are a group acting in concert for purposes of the Change in Bank Control Act or are a single association for purposes of the BHC Act. These questions are beyond the scope of the 2008 Policy Statement.

companies have positive incentives to run a successful banking organization but also bear the costs of their significant involvement in the banking organization's decision-making process, thus protecting taxpayers from imprudent risk taking by companies that control banking organizations. Minority investors in banking organizations typically seek to limit their potential downside financial exposure in the event of the failure of the banking organization. Concomitantly, the BHC Act requires that minority investors seeking this protection limit their influence over the management and policies of the banking organization.

Second, the BHC Act was intended to limit the mixing of banking and commerce. In particular, the Act effectively prevents commercial firms and companies with commercial interests from also exercising a controlling influence over a banking organization. Many minority investors in banking organizations own commercial investments that conflict with this limitation.

2090.4.2 BOARD'S 1982 POLICY STATEMENT ON NONVOTING EQUITY INVESTMENTS BY BANK HOLDING COMPANIES

On July 8, 1982, the Board issued a Policy Statement on Nonvoting Equity Investments by Bank Holding Companies (the 1982 Policy Statement) to provide guidance on the Board's interpretation of the ''controlling influence'' prong of the control definition in the BHC Act.[3] That statement for the first time outlined the policies that the Board would consider in reviewing whether a minority investment in a banking organization would result in the exercise by the investor of a controlling influence over the management or policies of the banking organization. The 1982 Policy Statement focused on issues of particular concern in the 1980s in the context of investments by bank holding companies in out-of-state banking organizations. For example, the 1982 Policy Statement primarily addressed investments that included a long-term merger or stock purchase agreement between the investor and the banking organization that would be triggered on a change in the interstate banking laws, and so-called ''lock-up'' arrangements designed to prevent another company from acquiring the banking organization without the permission of the investor.

The 1982 Policy 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 recognized 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.

2090.4.2.1 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. 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. 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. 1841(d)).

2090.4.2.2 Review of Agreements

Prior to the permissibility of interstate banking, bank holding companies 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 invest-

3. See 1982 FRB 413, 12 C.F.R. 225.143, or the *F.R.R.S* at 4-172.1.

ments involved 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 were not exercisable by the investing bank holding company until interstate banking was permitted. They were 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 concluded that investments in nonvoting stock, absent other arrangements, could be consistent with the Act. Some of the agreements reviewed appeared consistent with the Act because they were limited to investments of relatively moderate size in nonvoting equity that may become voting equity. . .

However, other agreements reviewed by the Board raised substantial problems of consistency with the control provisions of the Act because the investors. . . 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 substituted contractual agreements for rights normally achieved through voting shares.

For example, various covenants in certain of the agreements sought 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 suggested control by the investing company over the management and policies of the acquiree.

Similarly, certain of the agreements deprived 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 were 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. 225.31(d)(2).

Finally, investors wished 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 took 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.[4] The Board concluded that the ability to transfer rights to large blocks of voting shares, even if nonvoting in the hands of the investing company, could result in such a substantial position of leverage over the management of the acquiree as to involve a structure that would inevitably result in control prohibited by the Act.

2090.4.2.3 Provisions that Avoid Control

In 1982, the context of any particular agreement, provisions of the type described above were acceptable if combined with other provisions that serve to preclude control. The Board believed that such agreements would 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, management had to be free to conduct banking and permissible nonbanking activities. Another step to avoid control included the right of the acquiree to "call" the equity investment and

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

options or warrants to assure that covenants that may become inhibiting can be avoided by the acquiree. This right made 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 arising through the investor's control over the ultimate disposition of rights to substantial amounts of voting shares of the acquiree might have included 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.

The Board concluded 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 was 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.

One effect of the guideline was 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 also made 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, acquirers were to avoid certain arrangements regardless of other provisions in the agreement that were designed to avoid control. These are

1. Agreements that enabled 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 had 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.

2090.4.2.4 Review by the Board

The 1982 Policy Statement did not constitute the exclusive scope of the Board's concerns, nor were the considerations with respect to control outlined in this statement an exhaustive catalog of permissible or impermissible arrangements. The Board 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.

2090.4.3 ACTIVITIES OF BANKING ORGANIZATIONS AND BOARD DETERMINATIONS SUBSEQUENT TO THE 1982 POLICY STATEMENT

Many aspects of the 1982 Policy Statement have broader applicability and have served as the foundation for the Board's review more generally of whether a minority investment in a banking organization would give the investor a controlling influence over the management or policies of the banking organization. In this regard, the 1982 Policy Statement identified a number of structural measures that the Board believed would limit the ability of an investor to exercise a controlling influence over a banking organization. These included restricting the use of covenants that constrain the discretion of banking organization management, limiting the amount of voting and nonvoting shares of the banking organization acquired by the investor, and limiting the ability of the investor to transfer large blocks of voting shares.

The Board made clear in the 1982 Policy Statement that the complexity of legitimate business arrangements precluded establishing rigid rules designed to cover all situations and that decisions regarding the presence or absence of control must take into account the specific facts and circumstances of each case. Accordingly, since the 1982 Policy Statement, the Board has determined whether an equity investor in a banking organization has a controlling influence over the management or policies of the banking organization by considering carefully all the facts and circumstances surrounding the investor's investment in, and relationship with, the banking organization. Large minority investors in a banking organization typically have avoided acquiring a controlling influence over the banking organization by providing the Board with a set of passivity commitments and by avoiding certain control-enhancing mechanisms. Specifically, minority investors have avoided acquiring control over a banking organization by, among other things

- restricting the size of their voting and total equity investment in the banking organization;
- avoiding covenants that would enable the investor to restrict the ability of the banking organization's management to determine the major policies and operations of the banking organization;
- not attempting to influence the banking organization's process for making decisions about major policies and operations;
- limiting director and officer interlocks with the banking organization; and
- limiting business relationships between the investor and the banking organization.

2090.4.4 BOARD'S 2008 POLICY STATEMENT ON EQUITY INVESTMENTS IN BANKS AND BANK HOLDING COMPANIES

Since issuing the 1982 Policy Statement, the Board has reviewed a significant number of noncontrolling investments in banking organizations. The Board believed that it would be useful and appropriate to update its guidance in this area and therefore issued its Policy Statement on Equity Investments in Banks and Bank Holding Companies (the 2008 Policy Statement) on September 21, 2008. (See the Board's September 22, 2008, Press Release.)

2090.4.4.1 Specific Approaches to Avoid Control

The 2008 Policy Statement discusses the Board's views on specific approaches to avoid control.[5]

2090.4.4.1.1 Director Representation

The Board generally has not permitted a company that acquires between 10 and 24.9 percent of the voting stock of a banking organization (a minority investor) to have representation on the board of directors of the banking organization. The principal exception to this guideline has been in situations in which the investor owns less than 15 percent of the voting stock of the banking organization and another person (or group of persons acting together) owns a larger block of voting stock of the banking organization.

The Board has reexamined its precedent in this area and, based on its experience with minority investors and director representation, believes that a minority investor generally should be able to have a single representative on the board of directors of a banking organization without acquiring a controlling influence over the management or policies of the banking organization. Typically, boards of directors of banking organizations have 9 or 10 members. Although having a representative on the board of the banking organization enhances the influence of a minority investor, the Board's experience has shown that, in the absence of other indicia of control, it would be difficult for a minority investor with a single board seat to have a *controlling* influence over the management or policies of the banking organization.[6]

Moreover, a minority investor that has up to two representatives on the board of directors of the banking organization is unlikely, absent other indicia of control, to be able to exercise a controlling influence over the banking organization when the investor's aggregate director representation is proportionate to its total interest in the banking organization[7] but does not exceed 25 percent of the voting members of the board,[8]

5. See the 2008 Policy Statement at 12 C.F.R. 225.144, beginning at paragraph (c).

6. In addition to formal representation on the board of directors of a banking organization, minority investors also frequently seek to have a representative attend meetings of the board of directors of the banking organization in the capacity of a nonvoting observer. Attendance by a representative of a minority investor as an observer at meetings of the board of directors of a banking organization allows the investor access to information and a mechanism for providing advice to the banking organization but has not in previous situations allowed the investor to exercise a controlling influence over the management or policies of the banking organization as long as the observer does not have any right to vote at meetings of the board.

7. An investor's total interest is equal to the greater of the investor's voting interest or total equity interest in the banking organization.

8. For example, an investor with a 10 percent voting interest and a 20 percent total equity interest generally could have two representatives on the board of directors of the banking organization if the investor's director representation does not exceed 20 percent of the board seats. On the other hand, an investor with a 15 percent voting interest and a 33 percent total equity interest generally could have two representatives on the board of directors of the banking organization if the investor's director representation does not exceed 25 percent

and another shareholder of the banking organization is a bank holding company that controls the banking organization under the BHC Act.[9] The presence of another larger, controlling shareholder of the banking organization that has been approved by the Board, is subject to supervision and regulation by the Board, and is obligated to serve as a source of strength for the banking organization should serve as a powerful countervailing force to whatever influence the minority investor may have as a result of its investment and proportional director representation.

The Board continues to believe that a representative of a minority investor that serves on the board of directors of the banking organization should not serve as the chairman of the board of the banking organization or as the chairman of a committee of the board of the banking organization. The Board generally believes, however, that representatives of a noncontrolling minority investor may serve as members of committees of the board of the banking organization when those representatives do not occupy more than 25 percent of the seats on any committee and do not have the authority or practical ability unilaterally to make (or block the making of) policy or other decisions that bind the board or management of the banking organization.

2090.4.4.1.2 Total Equity

The three-prong control test in the BHC Act makes no explicit reference to nonvoting equity investments. Nevertheless, the Board has long subscribed to the view that the overall size of an equity investment, including both voting and nonvoting equity, is an important indicator of the degree of influence an investor may have. Accordingly, the Board traditionally has taken account of the presence and size of nonvoting equity investments in its controlling influence analysis. For example, in the 1982 Policy Statement, the Board set forth a guideline that nonvoting equity investments that exceed 25 percent of the total equity of a banking organization generally raise control issues under the BHC Act.[10] The Board has recognized in a few limited circumstances, however, that ownership by a minority investor of 25 percent or more of a banking organization's total equity may not confer a controlling influence, usually in situations when another controlling investor is present or other extenuating circumstances indicate that the exercise of a controlling influence by the minority investor is unlikely.

The Board continues to believe that an investor that makes a very large equity investment in a banking organization is likely to have a controlling influence over the banking organization's management or policies. Investors with large equity investments have a powerful incentive to wield influence over the banking organization in which they have invested. They have a substantial amount of money at stake in the enterprise, are among the first to absorb losses if the banking organization has financial difficulties, and participate in the profits of the banking organization going forward. Moreover, a banking organization is likely to pay heed to its large shareholders to help ensure it has the ability to raise equity capital in the future and to prevent the negative market signal that would be created by the sale of a large block of equity by an unhappy existing shareholder.

On the other hand, the Board recognizes that nonvoting equity does not provide the holder with voting rights that empower the holder to participate directly in the selection of banking organization management or otherwise in the banking organization's decision-making process. Moreover, as noted above, the BHC Act defines control in terms of ownership of 25 percent or more of a class of voting securities but does not impose an express limit on ownership of nonvoting shares. The Board continues to believe that, in most circumstances, an investor that owns 25 percent or more of the total equity of a banking organization owns enough of the capital resources of a banking organization to have a controlling influence over the management or policies of the banking organization. The Board continues to recognize, however, that the ability of an investor to exercise a controlling influence through nonvoting equity instruments depends significantly on the nature and extent of the investor's overall investment in the banking organization and on the capital structure of the banking organization.

(rather than 33 percent) of the board seats.

9. In determining what amount of director representation is proportional to an investor's voting interest in a banking organization, the investor should round to the nearest whole number. For example, the Board would consider a minority investor that owns 15 percent of the voting stock of a banking organization to have proportionate director representation if it had two representatives on a board of directors with 10 or more members (but not on a board of directors with 9 or fewer members).

10. 12 C.F.R. 225.143(d)(4) and (d)(5).

In particular, the Board would not expect that a minority investor would have a controlling influence over a banking organization if the investor owns a combination of voting shares and nonvoting shares that, when aggregated, represents less than one-third of the total equity of the organization (and less than one-third of any class of voting securities, assuming conversion of all convertible nonvoting shares held by the investor) and does not allow the investor to own, hold, or vote 15 percent or more of any class of voting securities of the organization. In these situations, the limitation on voting rights reduces the potential that the investor may exercise influence that is controlling.

In previous cases, investors that have acquired nonvoting shares often have sought the right to convert those shares to voting shares under various circumstances. The Board continues to believe that nonvoting shares that may be converted into voting shares at the election of the holder of the shares, or that mandatorily convert after the passage of time, should be considered voting shares at all times for purposes of the BHC Act. However, in previous cases, the Board has recognized that nonvoting shares that are convertible into voting shares carry less influence when the nonvoting shares may not be converted into voting shares in the hands of the investor and may only be transferred by the investor: (1) to an affiliate of the investor or to the banking organization; (2) in a widespread public distribution; (3) in transfers in which no transferee (or group of associated transferees) would receive 2 percent or more of any class of voting securities of the banking organization; or (4) to a transferee that would control more than 50 percent of the voting securities of the banking organization without any transfer from the investor. Ownership of this form of nonvoting, convertible shares, within the limits discussed above, allows investors to provide capital to a banking organization in a way that is useful to the organization, minimizes the opportunity for the investor to exercise a controlling influence over the organization, and allows the investor to exit the investment without conveying control to another party outside the parameters of the BHC Act.

2090.4.4.1.3 Consultations with Management

In many previous cases, minority investors have agreed not to attempt to influence the operations, management, or strategies of the banking organization in which they have invested; not to threaten to sell their shares in the banking organization as a method for influencing decisions of banking organization management; and not to solicit proxies on any matter from the other shareholders of the banking organization. These commitments were designed to limit the exercise by a minority investor of a controlling influence over the management or policies of a banking organization.

The Board believes that it would be useful to provide additional guidance on the extent of communications between a minority investor and a banking organization's management that would be consistent with a noncontrol determination. The Board believes that a noncontrolling minority investor, like any other shareholder, generally may communicate with banking organization management about, and advocate with banking organization management for changes in, any of the banking organization's policies and operations. For example, an investor may, directly or through a representative on a banking organization's board of directors, advocate for changes in the banking organization's dividend policy; discuss strategies for raising additional debt or equity financing; argue that the banking organization should enter into or avoid a new business line or divest a material subsidiary; or attempt to convince banking organization management to merge the banking organization with another firm or sell the banking organization to a potential acquirer. These communications also generally may include advocacy by minority investors for changes in the banking organization's management and recommendations for new or alternative management.[11] Although these types of discussions represent attempts by an investor to influence the management or policies of the banking organization, discussions alone are not the type of controlling influence targeted by the BHC Act.

To avoid the exercise of a controlling influence, in all cases, the decision whether or not to adopt a particular position or take a particular action must remain with the banking organization's shareholders as a group, its board of directors, or its management, as appropriate. The role of the minority investor in these decisions must be limited to voting its shares in its discretion at a meeting of the shareholders of the banking

11. As discussed later in the 2008 Policy Statement, a minority investor may not have a contractual right to determine (or a veto right over) any of the major policies and operations of the bank or the composition of the bank's management team.

organization (directly or by proxy, including in connection with a proxy solicitation launched by another shareholder), and by exercising voting privileges as a member of the board of directors of the banking organization (to the extent permitted as discussed above). Importantly, communications by minority investors should not be accompanied by explicit or implicit threats to dispose of shares in the banking organization or to sponsor a proxy solicitation as a condition of action or non-action by the banking organization or its management.

2090.4.4.1.4 Other Indicia of Control

2090.4.4.1.4.1 Business Relationships

The Board traditionally has prohibited a noncontrolling minority investor in a banking organization from having any material business transactions or relationships with the banking organization. The Board historically has taken the view that a major supplier, customer, or lender to a banking organization can exercise considerable influence over the banking organization's management and policies—especially when coupled with a sizeable voting stock investment—by threatening to terminate or change the terms of the business relationship.

The Board has recognized over the years, however, that not all business relationships—even when accompanied by a material investment—provide the investor a controlling influence over the management or policies of the banking organization. Accordingly, the Board has frequently allowed business relationships that were quantitatively limited and qualitatively nonmaterial, particularly in situations where an investor's voting securities percentage in the banking organization was closer to 10 percent than 25 percent. The Board continues to believe that business relationships should remain limited and will continue to review business relationships on a case-by-case basis within the context of the other elements of the investment structure. In that review, the Board will pay particular attention to the size of the proposed business relationships and to whether the proposed business relationships would be on market terms, non-exclusive, and terminable without penalty by the banking organization.

2090.4.4.1.4.2 Covenants

Because the BHC Act explicitly defines control (and many of its other thresholds) in terms that include a percentage of voting securities, companies often have structured their investments in banking organizations in the form of nonvoting securities and have attempted to substitute contractual agreements for the rights that normally are obtained through voting securities. The Board has taken and continues to hold the view that covenants that substantially limit the discretion of a banking organization's management over major policies and decisions suggest the exercise of a controlling influence.[12] In particular, the Board has been concerned about covenants or contractual terms that place restrictions on, or otherwise inhibit, the banking organization's ability to make decisions about the following actions: (1) hiring, firing, and compensating executive officers; (2) engaging in new business lines or making substantial changes to its operations; (3) raising additional debt or equity capital; (4) merging or consolidating; (5) selling, leasing, transferring, or disposing of material subsidiaries or major assets; or (6) acquiring significant assets or control of another firm.[13]

On the other hand, the Board generally has not viewed as problematic for control purposes those covenants that give an investor rights permissible for a holder of nonvoting securities as described in section 2(q)(2) of Regulation Y.[14] These would include covenants that prohibit the banking organization from issuing senior securities or borrowing on a senior basis, modifying the terms of the investor's security, or liquidating the banking organization. Noncontrolling covenants also could include covenants that provide the investor with limited financial information rights and limited consultation rights.

12. See 12 C.F.R. 225.143(d)(2).

13. For an investment to be eligible for inclusion in a banking organization's regulatory capital, it must not contain or be covered by any covenants, terms, or restrictions that are inconsistent with safe and sound banking practices, see 12 C.F.R. 208, Appendix A, II and 12 C.F.R. 225, Appendix A, II.(i). As described in 12 C.F.R. 250.166(b)(3), such provisions include terms that could adversely affect the banking organization's liquidity or unduly restrict management's flexibility to run the organization, particularly in times of financial difficulty, or that could limit the regulator's ability to resolve problem bank situations.

14. 12 C.F.R. 225.2(q)(2).

2090.4.4.2 Conclusion of the 2008 Policy Statement

As noted above, whether a minority investor in a banking organization has a controlling influence over the management or policies of the banking organization depends on all the facts and circumstances surrounding the investor's investment in, and relationship with, the banking organization. This policy statement sets forth some of the most significant factors and principles the Board will consider in determining whether investments in a banking organization are noncontrolling for purposes of the BHC Act.

Importantly, controlling-influence determinations depend not just on the contractual rights and obligations of the investor and the banking organization; they also depend on the amount of influence the investor, in fact, exercises over the banking organization. Accordingly, the Board has and will continue to monitor carefully minority investments in banking organizations to ensure that investors do not, in fact, exercise a controlling influence over the management or policies of the banking organizations in which they invest. The Board also continues to evaluate its policies in this area and will modify them as appropriate going forward to ensure that minority investments in banking organizations remain consistent with the BHC Act.

2090.4.5 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Required Federal Reserve approval if a BHC acquires more than 5 percent (direct or indirect control) of voting shares of a bank	1842(a)(3)			
Federal Reserve approval of a BHC acquiring control of a bank	1842(a)(2)			
BHCs and direct or indirect controlling influence over a bank	1841(d)			
Acquiring a bank outside of the home state of the investing bank holding company	1842(d)(1)			
Long-term restrictions on the rights of a holder of voting securities		225.31(d)(2)		
Specific approaches that avoid control		225.144(c)		
Nonvoting equity investments as a percent of total equity and control issues		225.143(d)(4) and (d)(5)		
Covenants and controlling influence issues		225.143(d)(2)		
Covenants and rights permissible for a holder of nonvoting securities.		225.2(q)(2)		
Nonvoting Equity Investments by BHCs (1982 Policy Statement)		225.143	4-172.1	
Equity investments in banks and BHCs (2008 Policy Statement)		225.144		

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

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.

WHAT'S NEW IN THIS REVISED SECTION

Effective January 2010, this section was revised to delete a discussion of, and references to, section 2(g)(3) of the BHC Act. Section 2(g)(3) was repealed by section 2610 of the Economic Growth and Regulatory Paperwork Reduction Act of 1996 (Public Law No. 104-208).

2090.6.05 CONTROL DETERMINANTS

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. 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, or acting through one or more other persons, owns, controls, or has power to vote 25 percent or more of the voting securities of the bank or company;
2. The company controls in any manner the election of a majority of the directors, trustees, or general partners (individuals exercizing similar functions) of the bank or other company;
3. The Board determines, after notice and opportunity for hearing, that the company directly or indirectly exercises a controlling influence over the management or policies of the bank or company.

Rebuttable presumptions of control are listed in section 225.31(d) of Regulation Y and in sections 2(a)(2)(C) 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.

2090.6.1 INSPECTION OBJECTIVES

1. To determine whether or not a significant voting or ownership interest exists.
2. To determine whether any rebuttable presumptions of control raise any control issues (see section 225.31(d) of Regulation Y).
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 any control issues.

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 any company being divested and the company (and its parent and subsidiaries) acquiring divested property for evidence of a continuing control relationship. 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		
Rebuttable presumptions of control		225.31(d)		
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
"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

Subject	*Laws*[1]	*Regulations*[2]	*Interpretations*[3]	*Orders*
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
Board staff letter on a determination of control after a spin-off transaction				Imperial Bancorp; August 19, 1998

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.

The Federal Reserve has observed an increase in interest by some holding companies to establish arrangements that are designed to benefit certain shareholders, enhance short-term investor returns, and/or provide a distinct disincentive for investors to acquire or increase ownership in a holding company's common stock and other capital instruments. In some instances, supervisory staff has found that these shareholder protection arrangements would have negative implications on a holding company's capital or financial position, limit a holding company's financial flexibility and capital-raising capacity, or otherwise impair a holding company's ability to raise additional capital. These arrangements impede the ability of a holding company to serve as a source of strength to its insured depository subsidiaries[1] and were considered unsafe and unsound.

In December 2015, the Federal Reserve issued the following guidance to explain supervisory concerns related to arrangements structured by bank and savings and loan holding companies (collectively, "holding companies") to protect the financial investments made by shareholders (collectively, "shareholder protection arrangements"). In particular, such arrangements raise concerns because they could have negative implications on a holding company's capital or financial position, or limit the holding company's ability to raise capital in the future.[2] A holding company, regardless of its asset size, should be aware that the Federal Reserve may object to a shareholder protection arrangement based on the facts and circumstances and the features of the particular arrangement. Therefore, a holding company that is engaged in capital raising efforts or is considering the implementation or modification of a shareholder protection arrangement should review this guidance to help ensure that supervisory concerns are addressed. (Refer to SR-15-15)

1. Pursuant to section 616(d) of the Dodd-Frank Wall Street Reform and Consumer Protection Act and the Board's Regulations Y and LL, a holding company is required to serve as a source of financial strength for its insured depository subsidiaries and should not conduct its operations in an unsafe or unsound manner. Specifically, a holding company should stand ready to use available resources to provide adequate capital funds to its subsidiary banks and thrifts during periods of financial stress or adversity. See 12 U.S.C. 1831o-1; 12 C.F.R. 225.4(a); and 12 C.F.R. 238.8(a).

2. As discussed further below, these arrangements may come in many different forms, including all or portions of agreements between shareholders (or other relevant parties), company plans, organizing documents, and other contractual provisions that provide shareholder protections.

2093.0.1 SHAREHOLDER PROTECTION ARRANGEMENTS—SUPERVISORY ISSUES

Examples of shareholder protection arrangements that have raised supervisory issues include, but are not limited to, provisions whereby:

- The holding company agrees to provide an investor with cash payments reflecting the difference between the price paid by the investor and a lower price per share paid by investors in subsequent transactions;[3]
- The holding company agrees to provide an investor with additional shares of stock for minimal or no additional cost in the event that the holding company issues shares at a price below the price paid by the investor;
- Existing shareholders of the holding company are able to acquire additional shares at significant discounts to market value in a new offering if any shareholder crosses a specific ownership threshold;[4]
- Investors with less-than-majority control are granted the contractual right to restrict or prevent the holding company from issuing additional shares; or

3. Provisions of this type and the next example are often referred to as "down-round" provisions. Down-round provisions can take many forms, but all are designed to protect existing shareholders in the event a holding company's stock price declines in a subsequent effort to raise capital or sell the holding company.

4. Provisions of this type are often referred to as "poison pills" and were originally developed as defenses against contested acquisitions. There are multiple common forms, but these provisions generally operate by increasing the ownership interest of shareholders other than a buyer of a significant block of shares, thereby diluting the buyer and preventing the takeover bid.

Poison pill structures have also been applied in the context of tax benefit preservation plans (TBPPs), which, in general terms, are designed to preserve net operating losses within the requirements of section 382 of the Internal Revenue Code. Under section 382, the use of deferred tax assets can be restricted by an "ownership change." Thus, TBPPs and poison pills use similar mechanisms to restrict changes in ownership, despite different underlying purposes. TBPPs may also take forms different from traditional poison pills.

As an example, a TBPP or poison pill may provide all shareholders, other than the shareholder crossing the relevant threshold, the right to acquire shares of the holding company at a substantial discount, reducing the incentive of shareholders to acquire more shares at or above the threshold. These rights may or may not terminate within a set amount of time.

- The holding company's board of directors has the authority to nullify share purchases under certain circumstances, require the holding company to repurchase the shares of the company from a new owner of the shares, or take other actions that would significantly inhibit secondary market transactions in the shares of the holding company.[5]

Arrangements of these types (in whatever form) have the potential to impose additional financial obligations on a holding company or restrict in some way the primary or secondary market for the holding company's shares. Often, these arrangements serve to protect the value of the initial investment made by a particular subset of shareholders rather than the viability of the issuing holding company, or, in other ways, provide current shareholders with an advantage over future, similarly situated, investors.[6]

2093.0.2 SUPERVISORY OVERSIGHT

If supervisory or applications staff determine that a particular shareholder protection arrangement impairs the ability of a holding company to raise or maintain capital, particularly during a period of stress on the firm, or that provisions of the arrangement are in violation of applicable supervisory enforcement actions, Federal Reserve staff should consult with appropriate Federal Reserve Board supervisory staff to determine the appropriate action. This can occur when:

- *Federal Reserve staff become aware of a proposed shareholder protection arrangement (for example, as part of an effort to raise capital or a proposal to expand):* Federal Reserve staff should incorporate a review of such arrangements during consideration of the specific proposal, whether or not there is a formal application or other approval requirement.
- *Federal Reserve staff become aware of an existing shareholder protection arrangement during the course of a supervisory activity (for example, in discussions with the holding company's management):* Federal Reserve staff should incorporate a review of such arrangements in the examination scope or supervisory plan for the holding company and, on limited occasions, in connection with an application filing.[7]

The Federal Reserve may direct a holding company's board of directors to modify or remove a shareholder protection arrangement that gives rise to safety-and-soundness concerns. The corrective actions, if any, will vary depending on the facts and circumstances of the holding company, as well as applicable state and federal laws and regulations, corporate charter and by-laws, and other considerations.[8] The Reserve Bank's communications with the holding company should comply with applicable supervisory guidance, including SR-13-13/CA-13-10, "Supervisory Considerations for the Communication of Supervisory Findings." If a holding company has questions regarding the removal or modification of a shareholder protection arrangement, the holding company should consult with the appropriate Federal Reserve Bank.

5. These arrangements could include complete prohibitions on share transfers, as well as certain forms of buy-sell agreements, rights of first refusal, or similar arrangements that sufficiently restrict the transfer of shares as to effectively prohibit most, if not all, transfers.

6. In general, the right to participate in subsequent offerings to prevent dilution of ownership, when fully paid for, has not raised concerns.

7. This guidance is focused on supervisory actions going forward and is not intended to require active confirmation by a holding company or Federal Reserve staff on a routine basis that a shareholder protection issue does not exist. To facilitate the identification of shareholder protection arrangements that raise supervisory concern, the management and other representatives of holding companies are encouraged to bring all such existing or proposed arrangements to the attention of relevant supervisory and applications staff when appropriate.

8. Holding companies subject to the Board's Regulation Q (12 C.F.R. 217) are subject to additional regulatory requirements that should be considered in connection with shareholder protection arrangements. In particular, common equity tier 1 capital instruments and additional tier 1 capital instruments are required to satisfy eligibility criteria that effectively disqualify instruments with certain features used in some shareholder protection arrangements, such as features that limit or discourage future capital issuances, compensate existing investors if new instruments are issued at a lower price, create incentives to redeem, or interfere with the full discretion of the issuer to cancel dividend payments except under limited circumstances. See 12 C.F.R. 217.20. Further, the Board may require a holding company to exclude capital instruments from regulatory capital if such instruments have characteristics or terms that diminish the instrument's ability to absorb losses, or otherwise present safety-and-soundness concerns. See 12 C.F.R. 217.1(d)(2).