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FEDERAL RESERVE BOARD ISSUES GUIDANCE ON THE SCOPE OF ITS SUPERVISION OF FINANCIAL HOLDING COMPANIES AND THEIR SUBSIDIARIES

[12745] October 16, 2000 TO: ADVISORY GROUP ON BANKING ISSUES COMPLIANCE ADVISORY COMMITTEE No. 35-00 RE: FEDERAL RESERVE BOARD ISSUES GUIDANCE ON THE SCOPE OF ITS SUPERVISION OF FINANCIAL HOLDING COMPANIES AND THEIR SUBSIDIARIES On August 15, 2000, the Director of the Division of Banking Supervision and Regulation of the Federal Reserve issued the attached letter relating to the Federal Reserve's supervision of financial holding companies (FHCs) and their subsidiaries, including their functionally-regulated subsidiaries. This letter is summarized below. SUPERVISORY OVERSIGHT The letter likens the Federal Reserve's supervisory oversight role under the Gramm- Leach-Bliley Act (GLB Act) to "that of an umbrella supervisor concentrating on a consolidated or group-wide analysis of an organization." In the view of the Federal Reserve, the purpose of FHC supervision is "to identify and evaluate, on a consolidated or group-wide basis, the significant risks that exist in a diversified holding company in order to assess how these risks might affect the safety and soundness of depository institution subsidiaries." While the letter notes that "the appropriate bank, thrift, or functional regulator will continue to have primary responsibility for evaluating risks, hedging, and risk management at the legal-entity level for the entity or entity that is supervises," it encourages "strong relationships" between the Federal Reserve and senior management and boards of directors of FHCs, and "heads of significant business lines and key internal audit, control, and risk management officials." It also encourages the Federal Reserve's supervisory staff to interact with functional regulators and review the examination findings of such functional regulators "in order to develop a consolidated picture of the FHC's financial condition and risk profile, the effectiveness of risk management and internal control policies, and the implications for the affiliated depository institutions." EXAMINATION AUTHORITY In fulfilling its role as the "umbrella supervisor," the letter states that the Federal Reserve will rely "to the fullest extent possible on the examination of an FHC's bank and nonbank subsidiaries by their appropriate primary bank, thrift, and functional regulators (and their self- regulatory organizations)." If the staff requires a "specialized report" from a functionally regulated subsidiary of an FHC, the staff will first request it from the subsidiary's appropriate functional regulator. In the event the report is not made available to the staff, the letter states 2that they "may obtain it directly from the functionally regulated subsidiary if it is necessary to assess (i) a material risk to the FHC or any of its depository institution subsidiaries; (ii) compliance with any federal law that the Federal Reserve has specific jurisdiction to enforce against the FHC or a subsidiary; or (iii) the FHC's systems for

monitoring and controlling financial and operational risks that may pose a safety and soundness threat to a depository institution subsidiary." The letter also notes that the Federal Reserve may examine a functionally regulated subsidiary when it has reasonable cause to believe that (i) the subsidiary is engaged in an activity that poses a material risk to an affiliated depository institution; (ii) the examination is necessary to be adequately informed about the FHC's systems for monitoring and controlling the financial and operational risks that may pose a safety and soundness risk to a depository institution subsidiary; or (iii) the subsidiary is not in compliance with any federal law that the Federal Reserve Board has specific jurisdiction to enforce (and the Board cannot determine compliance by examining the FHC or its affiliated depository institutions). According to the letter, where necessary and appropriate, and consistent with (i) - (iii), the Federal Reserve may conduct or participate in reviews at functionally regulated subsidiaries to validate that risk management and internal control policies established at the consolidated level are being implemented effectively. ENFORCEMENT POWERS With respect to the Federal Reserve's enforcement powers, the letter notes that under the GLB Act it may take enforcement action against a functionally regulated subsidiary of an FHC, "but only when such action is necessary to prevent or redress an unsafe or unsound practice or breach of fiduciary duty that poses a material risk either to the financial safety, soundness, or stability of an affiliated depository institution or to the domestic or international payments system." The Federal Reserve may also, under any circumstance, take enforcement action against a functionally regulated subsidiary to enforce compliance with any federal law that the Federal Reserve has specific jurisdiction to enforce against the subsidiary. In the event the Federal Reserve believes that an enforcement action by the Federal Reserve is necessary, the letter states that the Federal Reserve will notify the entity's appropriate functional regulator and will coordinate such action with any action taken by the functional regulator whenever practical. The letter further states that it is expected that the Federal Reserve will not take an enforcement action against a functionally regulated subsidiary (or a person associated with the subsidiary) if the problem involves factors and statutes that are the primary responsibility of the functional regulator. * * * * The Institute encourages members impacted by the functional regulatory provisions of the GLB Act to keep the Institute apprised of any concerns that arise in connection with the implementation of these provisions by the Federal Reserve. Any comments should be directed to the undersigned by phone (202)326-5825 or e-mail (tamara@ici.org). Tamara Reed Associate Counsel Attachment (in .pdf format)