5

Supervision and Regulation

The Federal Reserve has supervisory and regulatory authority over a wide range of financial institutions and activities. It works with other federal and state financial authorities to ensure safety and soundness in the operation of financial institutions, stability in the financial markets, and fair and equitable treatment of consumers in their financial transactions.

THE FEDERAL RESERVE HAS PRIMARY RESPONSIBILITY for supervising and regulating several types of banking organizations:

- All bank holding companies, their nonbank subsidiaries, and their foreign subsidiaries
- State-chartered banks that are members of the Federal Reserve System (state member banks) and their foreign branches and subsidiaries
- Edge Act and agreement corporations, through which U.S. banking organizations conduct operations abroad.

It also shares important responsibilities with state supervisors and with other federal supervisors, including overseeing both the operations of foreign banking organizations in the United States and the establishment, examination, and termination of branches, agencies, commercial lending subsidiaries, and representative offices of foreign banks in the United States.

Other supervisory and regulatory responsibilities of the Federal Reserve include

- Regulating margin requirements on securities transactions
- Implementing certain statutes that protect consumers in credit and deposit transactions
- Monitoring compliance with the money-laundering provisions contained in the Bank Secrecy Act
- Regulating transactions between banking affiliates.

The hands-on experience of supervision and regulation provides the Federal Reserve with a base of essential knowledge for monetary policy deliberations. Further, its supervisory and regulatory roles enable the Federal Reserve to forestall financial crises or to manage crises once they occur. In the past decade, the experience and knowledge of examiners and supervisory staff proved instrumental in the Federal Reserve's responsiveness to the Mexican debt crisis of 1982, the collapse in 1985 of privately insured thrift institutions in Ohio and Maryland, the stock market crash of 1987, and the 1990 failure of the Drexel–Burnham investment firm.

SUPERVISORY FUNCTIONS

Although the terms *bank supervision* and *bank regulation* are often used interchangeably, they actually refer to distinct, but complementary, activities. Bank supervision involves the monitoring, inspecting, and examining of banking organizations to assess their condition and their compliance with relevant laws and regulations. When an institution is found to be in noncompliance or to have other problems, the Federal Reserve may use its supervisory authority to take formal or informal action to have the institution correct the problems. Bank regulation entails making and issuing specific regulations and guidelines governing the structure and conduct of banking, under the authority of legislation.

The Federal Reserve shares supervisory and regulatory responsibilities with the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), and the Office of Thrift Supervision (OTS) at the federal level, with the banking agencies of the various states, and with foreign banking authorities for the international operations of U.S. banks and the operations of foreign banks in the United States (see table 5.1). This structure has evolved partly out of the complexity of the U.S. financial system, with its many kinds of depository institutions and numerous chartering authorities. It has also resulted from a wide variety of federal and state laws and regulations designed to remedy problems that the U.S. commercial banking system has faced over its history.

In recent years, several factors—including rapidly changing conditions in the banking industry, problems within the savings and loan and banking industries, and legislative requirements—have

Table 5.1
Federal supervisor and regulator of corporate components of banking organizations in the United States

Component	*Supervisor and Regulator*
Bank holding companies	FR
National banks	OCC
State banks	
Members	FR
Nonmembers	FDIC
Cooperative banks	FDIC/FR
Industrial banks (if insured)[1]	FDIC
Section 20 affiliates	SEC/FR
Thrift holding companies	OTS
Savings banks	OTS/FDIC/FR
Savings and loan associations	OTS
Edge Act and agreement corporations	FR
Foreign banks[2]	
Branches and agencies[3]	
State licensed	FR/FDIC
Federally licensed	OCC/FR/FDIC
Representative offices	FR

Note. FR = Federal Reserve; OCC = Office of the Comptroller of the Currency; FDIC = Federal Deposit Insurance Corporation; SEC = Securities and Exchange Commission; OTS = Office of Thrift Supervision

1. Uninsured industrial banks are supervised by the states.
2. Applies to direct operations in the United States. Foreign banks may also have indirect operations in the United States through their ownership of U.S. banking organizations.
3. The FDIC has responsibility for branches that are insured.

necessitated the increased coordination of regulatory efforts. An important element in such coordination is the Federal Financial Institutions Examination Council (FFIEC), established by statute in 1978, consisting of the Chairpersons of the FDIC and the National Credit Union Administration, the Comptroller of the Currency, the Director of the OTS, and a Governor of the Federal Reserve Board appointed by the Board Chairman. The FFIEC's purposes are to prescribe uniform federal principles and stan-

dards for the examination of depository institutions, to promote coordination of bank supervision among the federal agencies that regulate financial institutions, and to encourage better coordination of federal and state regulatory activities. Through the FFIEC, state and federal regulatory agencies may exchange views on important regulatory issues. Among other things, the FFIEC has developed uniform financial reporting forms for use by all federal and state banking regulators.

Domestic Operations of U.S. Banking Organizations

The Federal Reserve's off-site supervision of banking institutions involves the periodic review of financial and other information about banks and bank holding companies. Information that the Federal Reserve reviews includes reports of recent examinations and inspections, information published in the financial press and elsewhere, and, most important, the standard financial regulatory reports that are filed by institutions. The reports for banks are referred to as the Consolidated Reports of Condition and Income (Call Reports) and those for bank holding companies, as the Consolidated Financial Statements for Bank Holding Companies (FR Y-9 Series). The number and the type of report forms that must be filed depend on the size of an institution, the scope of its operations, and the types of financial entities that it includes. Therefore, the report forms filed by larger institutions that engage in a wider range of activities are generally more numerous and more detailed than those filed by smaller organizations.

Supervision includes off-site monitoring of financial reports and on-site examination visits.

In its ongoing, off-site supervision of banks and bank holding companies, the Federal Reserve uses automated screening systems to identify organizations that have poor or deteriorating financial profiles and to help detect adverse trends developing in the banking industry. The System to Estimate Examinations Ratings (SEER) statistically estimates an institution's supervisory rating based on information that institutions provide in their quarterly Call Report filings. When SEER and other supervisory tools identify an organization that has problems, a plan for correcting the problems—which may include sending examiners to the institution—is developed.

In on-site examinations of state member banks and inspections of bank holding companies and their nonbank subsidiaries, the supervisory staffs of the Federal Reserve Banks generally

- Evaluate the soundness of the institution's assets and the effectiveness of its internal operations, policies, and management
- Analyze key financial factors such as the institution's capital, earnings, liquidity, and sensitivity to interest rate risk
- Assess the institution's exposure to off-balance-sheet risks
- Check for compliance with banking laws and regulations
- Determine the institution's overall soundness and solvency.

The Federal Reserve also evaluates transactions between a bank and its affiliates to determine the effect of the transactions on the institution's condition and to ascertain whether the transactions are consistent with sections 23A and 23B of the Federal Reserve Act. Section 23A prohibits, among other things, a bank from purchasing the low-quality assets of an affiliate and limits asset purchases, extensions of credit, and other enumerated transactions by a single bank from a single affiliate to 10 percent of the bank's capital, or from all affiliates combined to 20 percent of its surplus. Moreover, section 23B requires that all transactions with affiliates be on terms substantially the same as, or at least as favorable as, those prevailing at the time with comparable non-affiliated companies. The Federal Reserve is the only banking agency that has the authority to exempt any bank from these requirements.

All insured depository institutions must be examined annually.

The Federal Reserve Board has consistently emphasized the importance of its on-site examinations and inspections in the supervisory process. Policies regarding the frequency of examinations and inspections are reviewed regularly to address concerns of safety and soundness as well as of regulatory burden on institutions under Federal Reserve supervision. In response to banking and other financial problems that developed in the 1980s, the Board in 1985 adopted a policy requiring the Reserve Banks to examine every state member bank and inspect all large bank holding companies at least once every year. Subsequently, in 1991, Congress passed the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), which imposed the legal requirement that all insured depository institutions be examined once every twelve months. (Certain small banks may be examined once every eighteen months.) The Board's policy is that large banks are to be ex-

amined by a Reserve Bank or jointly by a Reserve Bank and the responsible state banking agency; for smaller institutions, the Reserve Banks may alternate years with the responsible state banking agency. Board policy also requires that problem banks be examined more frequently by Reserve Banks.

The Board's policy regarding on-site inspections of bank holding companies also requires that companies that are large, have significant credit-extending nonbank subsidiaries or debt outstanding to the general public, or have severe problems be inspected annually. The remaining companies must be inspected at least once every three years, except for the smallest, least-complex bank holding companies, which may be inspected on a sample basis.

The Federal Reserve also conducts special on-site examinations of banking organizations' securities trading activities. Generally, securities trading activities of banking organizations are conducted in separately incorporated, nonbank entities directly or indirectly owned by bank holding companies. Such activities are governed by section 20 of the Banking Act of 1933 (the Glass–Steagall Act), which prohibits banks that are members of the Federal Reserve System from affiliating with entities that are "engaged principally" in underwriting (that is, purchasing for resale) or otherwise dealing in securities. In 1987, the Board ruled that a company would not be engaged principally in these activities if no more than 5 percent of its revenues were derived from underwriting or dealing in certain types of securities that banks are not eligible to trade (referred to as bank-ineligible securities). The subsidiaries in which such activities are conducted are commonly referred to as section 20 subsidiaries. As a result of the 1987 ruling, the Board approved proposals by banking organizations to underwrite and deal in specific types of securities (commercial paper, municipal revenue bonds, conventional residential mortgage-related securities, and securitized consumer loans) on a limited basis and in a manner consistent with existing banking statutes. Before the ruling, banking organizations were restricted to underwriting and dealing in bank-eligible securities, such as government securities, general municipal obligations, and money market instruments. In 1989, the Board raised the percentage of permissible trading in bank-ineligible securities to 10 percent of revenues. It also expanded the range of permitted activities and approved applications by

five banking organizations to underwrite and deal in any debt or equity security (except mutual funds), subject to several conditions, including reviews of the organization's management and operations. By year-end 1993, thirty-one foreign and domestic banking organizations had established section 20 subsidiaries.

The Federal Reserve conducts on-site examinations of other bank and nonbank activities: consumer affairs (see chapter 6 for a discussion of this area); trust activities; securities transfer agency activities; activities by government and municipal securities dealers; and electronic data processing.

If the Federal Reserve determines that a bank or bank holding company has problems that affect the institution's safety and soundness or is out of compliance with laws and regulations, it may take a supervisory action to ensure that the organization undertakes corrective measures. Typically, such findings are communicated to the management and directors of a banking organization in a written report. The management and directors are then requested to address all identified problems voluntarily and to take measures to ensure that the problems are corrected and will not recur. Most problems are resolved promptly after they are brought to the attention of an institution's management and directors. In some situations, however, the Federal Reserve may need to take an informal supervisory action, by requesting that an institution adopt a broad resolution or agree to the provisions of a memorandum of understanding to address the problem.

If necessary, the Federal Reserve may take formal enforcement actions to compel the management and directors of a troubled banking organization or persons associated with it to address the organization's problems. For example, if an institution has significant deficiencies or fails to comply with an informal action, the Federal Reserve may enter into a written agreement with the troubled institution, or may issue a cease and desist order against the institution or against an individual associated with the institution, such as an officer or director. The Federal Reserve may also assess a fine, or remove an officer or director from office and permanently bar him or her from the banking industry, or both. All written agreements issued after November 1990 and all cease and desist orders, civil money penalty orders, and removal and prohibition orders issued after August 1989 are available to the public.

International Operations of U.S. Banking Organizations

The Federal Reserve's supervision and regulation of the international operations of banking organizations that are members of the Federal Reserve System entail four principal statutory responsibilities:

- Authorizing the establishment of foreign branches of member banks and regulating the scope of their activities
- Chartering and regulating the activities of Edge Act and agreement corporations
- Authorizing overseas investments by member banks, Edge Act and agreement corporations, and bank holding companies, and regulating the activities of foreign firms acquired by such investments
- Establishing supervisory policy and practices with respect to the foreign lending of member banks.

Under federal law, U.S. banks may conduct a wider range of activities abroad than they may pursue in this country. The Federal Reserve Board has broad discretionary powers to regulate the overseas activities of member banks and bank holding companies so that, in financing U.S. trade and investments overseas, U.S. banks can be fully competitive with institutions of the host country. In addition, through Edge Act and agreement corporations, banks may conduct deposit and loan business in U.S. markets outside their home states, provided that the operations of these corporations are related to international transactions.

The foreign activities of U.S. banking organizations are also supervised by the Federal Reserve.

The International Lending Supervision Act of 1983 directed the Federal Reserve and other U.S. banking agencies to consult with the supervisory authorities of other countries to adopt effective and consistent supervisory policies and practices with respect to international lending. It also directed the banking agencies to strengthen the international lending procedures of U.S. banks by, among other things, requiring an institution either to write off assets or to maintain special reserves when potential or actual impediments to the international transfer of funds make it likely that foreign borrowers will be unable to make timely payments on their debts.

U.S. Activities of Foreign Banking Organizations

Although foreign banks have been operating in the United States for more than a century, before 1978 the U.S. branches and agencies of these banks were not subject to supervision or regulation by any federal banking agency. When Congress enacted the International Banking Act of 1978 (IBA), it created a federal regulatory structure for the U.S. branches and agencies of foreign banks. The IBA established a policy of "national treatment" for foreign banks operating in the United States to promote competitive equality between them and domestic institutions. This policy gives foreign banking organizations operating in the United States the same powers, and subjects them to the same restrictions and obligations, that apply to the domestic operations of U.S. banking organizations.

Foreign banks operating in the United States must adhere to U.S. laws.

Under the IBA, primary responsibility for the supervision and regulation of branches and agencies remained with the state or federal licensing authorities. The Federal Reserve was assigned residual authority to ensure national oversight of the operations of foreign banks. Congress gave the Federal Reserve examination authority over state-licensed U.S. branches and agencies and state-chartered banking subsidiaries of foreign banks but instructed it to rely, to the extent possible, on the examinations conducted by the licensing authorities.

The Federal Reserve may not approve an application by a foreign bank to establish a branch, agency, or commercial lending company unless it determines that (1) the foreign bank and any parent foreign bank engage directly in the business of banking outside the United States and are subject to comprehensive supervision or regulation on a consolidated basis by their home country supervisors and (2) the foreign bank has furnished to the Federal Reserve the information that the Federal Reserve requires in order to assess the application adequately. The Federal Reserve may take into account other factors such as (1) whether the home country supervisor of the foreign bank has consented to the proposed establishment of the U.S. office, (2) the financial and managerial resources of the foreign bank and the condition of any U.S. office of the foreign bank, (3) whether the foreign bank's home country supervisor shares material information regarding the op-

erations of the foreign bank with other supervisory authorities, (4) whether the foreign bank and its U.S. affiliates are in compliance with applicable U.S. law, and (5) whether the foreign bank has provided the Federal Reserve with adequate assurances that information will be made available on the operations or activities of the foreign bank and any of its affiliates that the Federal Reserve deems necessary to determine and enforce compliance with applicable federal banking statutes. In approving the establishment of a representative office by a foreign bank, the Federal Reserve is required to take these standards into account to the extent deemed appropriate.

The Foreign Bank Supervision Enhancement Act of 1991 (FBSEA) increased the responsibility and the authority of the Federal Reserve to examine regularly the U.S. operations of foreign banks. Under the FBSEA, all branches and agencies of foreign banks must be examined on-site at least once every twelve months. These examinations are coordinated with state and other federal banking agencies, as appropriate. Supervisory actions resulting from such examinations may be taken by the Federal Reserve acting alone or with other agencies.

Under the authority of the Bank Holding Company Act and the IBA, the Federal Reserve is also responsible for approving, reviewing, and monitoring the U.S. nonbanking activities of foreign banking organizations. In addition, under an FBSEA amendment to the Bank Holding Company Act, a foreign bank must obtain Federal Reserve approval to acquire more than 5 percent of the shares of a U.S. bank or bank holding company.

REGULATORY FUNCTIONS

As a bank regulator, the Federal Reserve establishes standards designed to ensure the safe and sound operation of financial institutions. These standards may take the form of regulations, rules, policy guidelines, or supervisory interpretations and may be established under specific provisions of a law or under more general legal authority. Regulatory standards may be either restrictive (limiting the scope of a banking organization's activities) or permissive (authorizing banking organizations to engage in certain activities). (A complete list of Federal Reserve regulations is given in appendix B.)

In response to the financial difficulties that the banking industry faced in the late 1980s, Congress enacted several laws to improve the condition of individual institutions and of the overall banking industry, including the Competitive Equality Banking Act of 1987; the Financial Institutions Reform, Recovery, and Enforcement Act of 1989; and the Federal Deposit Insurance Corporation Improvement Act of 1991. Because of the savings and loan crisis and a general decline in the level of bank capital during the same period, efforts to regulate the banking industry focused heavily on defining the level of capital that is sufficient to enable an institution to absorb reasonably likely losses. In 1989, the federal banking regulators adopted a common standard for measuring capital adequacy that is based on the riskiness of an institution's investments. This common standard, in turn, was based on the 1988 agreement International Convergence of Capital Measurement and Capital Standards (commonly known as the Basle Accord) developed by the international Basle Committee on Banking Regulations and Supervisory Practices.

The risk-based capital standards require institutions that assume greater risk to hold higher levels of capital. Moreover, the risk-based capital framework takes into account risks associated with activities that are not included on a bank's balance sheet, such as the risks arising from commitments to make loans. Because they have been accepted by the bank supervisory authorities of most of the countries with major international banking centers, the risk-based capital standards promote safety and soundness and reduce competitive inequities among banking organizations operating within an increasingly global market.

Acquisitions and Mergers

Under the authority assigned to the Federal Reserve by the Bank Holding Company Act of 1956, as amended, the Bank Merger Act of 1960, and the Change in Bank Control Act of 1978, the Federal Reserve Board maintains broad supervisory authority over the structure of the banking system in the United States.

The Bank Holding Company Act of 1956 assigned primary responsibility for supervising and regulating the activities of bank holding companies to the Federal Reserve. This act was designed to achieve two basic objectives. First, by controlling the expansion

of bank holding companies, the act sought to avoid the creation of a monopoly or the restraint of trade in the banking industry. Second, it sought to keep banking and commerce separate by restricting the activities of bank holding companies to banking and closely related endeavors.

Bank Acquisitions

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

Acquisitions by bank holding companies must be approved by the Federal Reserve.

The Bank Holding Company Act limits the interstate operations of bank holding companies by preventing them from acquiring a bank in a second state unless the second state specifically authorizes the acquisition by statute. In recent years, most states have authorized such acquisitions, generally on a reciprocal basis with other states.

In considering applications to acquire a bank or a bank holding company, the Federal Reserve, carrying out legislative mandates, takes into account the likely effects of the acquisition on competition, the convenience and needs of the community to be served, and the financial and managerial resources and future prospects of the bank holding company and its banking subsidiaries.

Nonbanking Activities and Acquisitions

Through the Bank Holding Company Act, Congress prevented bank holding companies from engaging in nonbanking activities or from acquiring nonbanking companies, with certain exceptions. The exceptions allow holding companies to undertake certain activities that the Federal Reserve determines to be so closely related to banking or to managing or controlling banks as to be a

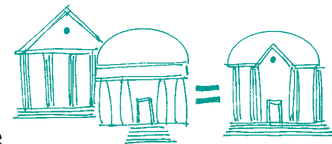
"proper incident" to banking. In making this determination, the Federal Reserve considers whether the exception to the prohibition can reasonably be expected to produce public benefits, such as greater convenience or gains in efficiency, that outweigh possible adverse effects, such as conflicts of interest or decreased competition.

Community consequences are evaluated when applications for acquisitions and mergers are considered.

By late 1993, the Federal Reserve had approved more than two dozen activities for bank holding companies that are closely related to banking, including making, acquiring, or servicing loans or other extensions of credit; supplying data processing and transmission services; providing investment advice; and engaging in securities brokerage activities.

Bank Mergers

Another responsibility of the Federal Reserve is to act on proposed bank mergers when the resulting institution is a state member bank. During the 1950s, the number of bank mergers, several of which involved large banks in the same metropolitan area, rose sharply. Fearing that a continuation of this trend could seriously impair competition in the banking industry and lead to an excessive concentration of financial power, Congress in 1960 passed the Bank Merger Act.



This act requires that all proposed bank mergers between insured banks receive prior approval from the agency under whose jurisdiction the surviving bank will fall. It also requires that the responsible agency request reports from the other banking agencies addressing applicable competitive factors and from the Department of Justice to ensure that all merger applications are evaluated in a uniform manner.

The Bank Merger Act sets forth the factors to be considered in evaluating merger applications. These factors include the financial and managerial resources and the prospects of the existing and proposed institutions, and the convenience and needs of the community to be served. The Federal Reserve may not approve any merger that could substantially lessen competition or tend to create a monopoly unless it finds that the anticompetitive effects of the transaction are outweighed by the transaction's probable beneficial effects regarding the convenience and needs of the community to be served.

Other Changes in Bank Control

The Change in Bank Control Act of 1978 authorizes the federal bank regulatory agencies to deny proposals from a person acting directly or indirectly, or in concert with other persons, to acquire control of an insured bank or a bank holding company. The Federal Reserve is responsible for changes in the control of bank holding companies and state member banks, and the FDIC and the OCC are responsible for such changes in the control of insured state nonmember and national banks respectively. In considering a proposal under the act, the Federal Reserve must review factors such as the financial condition, competence, experience, and integrity of the acquiring person or group of persons; the effect of the transaction on competition; and the adequacy of the information provided by the party proposing the change.

Other Regulatory Responsibilities

The Federal Reserve is also responsible for enforcing various laws and regulations that are related to fair and equitable treatment in financial transactions (see chapter 6), to margin requirements in securities and futures markets, and to recordkeeping and reporting by depository institutions.

Securities Regulation

The Securities Exchange Act of 1934 requires the Federal Reserve to regulate the margin requirements in securities markets (that is, requirements regarding purchase of securities on credit). Such regulation was established in an effort to reduce price volatility caused by speculation, to protect unsophisticated investors, and to diminish the amount of credit used for speculation. However, with the contemporary understanding of the dynamics of financial markets, the focus of margin requirements has become mainly prudential, that is, to protect the soundness of the markets. In fulfilling its responsibility under the act, the Federal Reserve limits the amount of credit that may be provided by securities brokers and dealers (Regulation T), by banks (Regulation U), and by other lenders (Regulation G). These regulations generally apply to credit-financed purchases of securities traded on securities exchanges and certain securities traded over the counter when the credit is collateralized by such securities. In addition, Regulation X prohibits borrowers who are subject to U.S. laws from ob-

taining such credit overseas on terms more favorable than could be obtained from a domestic lender.

In general, compliance with the margin regulations is enforced by several federal regulatory agencies. In the case of banks, the federal agencies regulating financial institutions check for Regulation U compliance during examinations. Compliance with Regulation T is verified during examinations of broker–dealers by the securities industry's self-regulatory organizations under the general oversight of the Securities and Exchange Commission. Compliance with Regulation G is checked by the National Credit Union Administration, the Farm Credit Administration, the OTS, or the Federal Reserve.

Futures Trading Practices Act

In 1992, section 501 of the Futures Trading Practices Act amended the Commodity Exchange Act to require that any rule establishing or changing the margin for a stock index futures contract or for an option on such a futures contract be filed with the Federal Reserve. The purpose of this requirement is to foster the integrity of the contract markets and to limit systemic risk that might result from a disturbance in the stock index futures market spilling over to other markets. Consistent with the provisions of the act, the Federal Reserve has delegated its authority with regard to such activities to the Commodity Futures Trading Commission.

Bank Secrecy Act

The Bank Secrecy Act, enacted in 1970, requires financial institutions doing business in the United States to report large currency transactions and to retain certain records. It also prohibits the use of foreign bank accounts to launder illicit funds or to avoid U.S. taxes and statutory restrictions. The Department of the Treasury maintains primary responsibility for issuance of regulations implementing this statute and for enforcement. However, the Treasury Department has delegated responsibility for monitoring the compliance of banks to the federal financial regulatory agencies. Therefore, during examinations of state member banks and of Edge Act and agreement corporations, Federal Reserve examiners verify an institution's compliance with the recordkeeping and reporting requirements of the act and with related regulations. ■