



BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

WASHINGTON, D.C. 20551

DIVISION OF SUPERVISION
AND REGULATION

January 5, 2022

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Re: [] *Request for Final Review*

Dear []:

This letter addresses your November 15, 2021, request for final review of a material supervisory determination submitted on behalf of [a Bank Holding Company] (“[BHC]”), appealing the decision by the Federal Reserve Bank [] (“Reserve Bank”) to assign [the BHC] a RFI Rating System Risk Management component rating of “4” and Composite rating of “3,” as well as to request that [the BHC] adopt a Board Resolution. Following a review of the record, the arguments presented by [the BHC], and consideration of applicable law, regulations, and policy, the final review panel¹ affirms the Reserve Bank’s determinations.

Background

On April 21, 2021, the [State] and the Federal Deposit Insurance Corporation (“FDIC”) issued a joint examination report for [the BHC’s] [state non-member bank subsidiary] ([] or the “Bank”), a [community] bank []. In the report, [the State] and the FDIC downgraded [the Bank’s] Uniform Financial Institutions Rating System (“CAMELS”) Management Component rating to “4” and Composite rating to “3,” and issued several matters requiring board attention. Examiners raised numerous concerns regarding [the Bank], including corporate governance deficiencies, risks related to on-going litigation [], liquidity weaknesses associated with the use of wholesale funding, credit risk management deficiencies, and inadequate capital given the Bank’s risk profile. In addition, the FDIC determined that [the Bank] was in “troubled condition” for purposes of Section 32 of the Federal Deposit Insurance Act, as amended.² [].

On June 14, 2021, the Reserve Bank initiated an off-site examination of [the BHC]. Based on [the State’s] and the FDIC’s ratings and supervisory concerns regarding [the Bank], Reserve Bank examiners concluded that the overall condition of [the BHC] was “less

¹ The final review panel comprises [officers from the Federal Reserve Board’s Division of Supervision and Regulation and Legal Division.]

² See 12 U.S.C. § 1831*i*.

than satisfactory.” The examiners assigned a Risk Management component rating of “4” and a Composite rating of “3,” explaining that these ratings were reflective of [the Bank’s] most recent management and composite ratings. In addition, the examiners required [the BHC’s] board of directors to take immediate action to support [the Bank] by adopting a Board Resolution, which would restrict [the BHC’s] ability to issue dividends, incur additional debt, or purchase or redeem any shares of its stock without prior authorization of the Reserve Bank.

[The BHC] timely filed an appeal of the request to adopt a Board Resolution. In accordance with the Federal Reserve Board’s Appeals Process,³ the director of the Board’s Division of Supervision and Regulation appointed an initial review panel comprising independent members from other Reserve Banks. During the meeting with the initial review panel, [the BHC] clarified that its appeal encompassed both the component and composite ratings, as well as the request to adopt a Board Resolution. On November 2, 2021, the initial review panel affirmed the ratings and the requirement to adopt a Board Resolution. The request for final review timely followed on November 15, 2021.

Analysis

In accordance with the Appeals Process, the authority to decide [the BHC’s] appeal of the initial review panel’s decision is committed to the final review panel. The final review panel determines “whether the decision of the initial review panel is reasonable.”⁴ In making this determination, the final review panel considers “whether the decision was based on a consideration of the applicable law, regulations, and policy, and whether there has been a clear error of judgment.”⁵ The final review panel may affirm the initial review panel’s decision “even if it is possible to draw a contrary conclusion from the record presented on appeal.”⁶

Under applicable guidance, Federal Reserve examiners assign only Risk Management (“R”) and Composite (“C”) ratings for noncomplex holding companies under \$3 billion.⁷ In most circumstances, the R rating “is the Management rating from the subsidiary institution’s CAMELS rating.”⁸ Likewise, the C rating “is the subsidiary depository institution’s composite CAMELS rating.”⁹ Based on the examination record available to the Reserve Bank, it

³ See Internal Appeals Process for Material Supervisory Determinations, 85 Fed. Reg. 15175 (FRB Mar. 17, 2020).

⁴ *Id.* at 15181.

⁵ *Id.*

⁶ *Id.*

⁷ SR 19-4 / CA 19-3: Supervisory Rating System for Holding Companies with Total Consolidated Assets Less than \$100 Billion (Feb. 26, 2019).

⁸ Bank Holding Company Manual (BHC Manual) § 1045.0.4.2; BHC Manual § 1062.0.6.1 *Noncomplex Holding Companies with Assets of \$3 Billion or Less (Shell Holding Companies) Rating: R and C.*

⁹ *Id.*

was reasonable for the Reserve Bank to assign a R rating of “4” and a C rating of “3” to [the BHC]: it is a noncomplex holding company with less than \$3 billion in assets, and [the State] and the FDIC assigned its subsidiary depository institution the same corresponding Management and Composite ratings.

[The BHC] argues that [the State’s] and the FDIC’s examination findings were stale by the time that the Reserve Bank conducted its off-site examination. In particular, [the BHC] explains that [the Bank] had addressed [the State’s] and the FDIC’s concerns regarding certain asset/liability management policies, and had obtained a third party analysis of Interest Rate Risk, which determined that [the Bank] had sufficient liquidity positions to meet its financial obligations. [The BHC] argues that the primary drivers of [the Bank’s] downgrade had been addressed, and therefore the examiners erred in relying on [the State’s] and the FDIC’s findings.

Federal Reserve examiners are required to rely on the examination findings and judgment of the subsidiary insured depository institutions’ (“IDI”) primary regulators in assessing the condition of the IDI. The Bank Holding Company Act makes clear that the Federal Reserve “shall, to the fullest extent possible, rely on . . . examination reports made by other Federal or State regulatory agencies relating to . . . any subsidiary of a bank holding company,” and “to the fullest extent possible, avoid duplication of examination activities, reporting requirements, and requests for information.”¹⁰ The Federal Reserve Board (“Board”) likewise has emphasized that “relying on the work of the IDI regulators is a well-established tenet of Federal Reserve Supervisory policy,” and directed Federal Reserve Banks to evaluate “the condition, performance and prospects of the subsidiary IDI based on the conclusions of the IDI regulator and [to] *not duplicate the work of the other regulator*.”¹¹ In addition, Federal Reserve Banks are expected to “rely substantially on the findings of the IDI regulator to evaluate the overall condition of the holding company.”¹²

The report of examination and ratings are reflective of the condition of the [Bank] at the time of the examination. The fact that [the Bank] has endeavored to address [the State’s] and the FDIC’s findings and arguably made some improvement, does not vitiate the IDI examiner’s stated conclusions from the most recent examination, which the Reserve Bank examiners are required to rely on. Moreover, it is clear from the record that the Reserve Bank examiners were in regular contact with the FDIC throughout the examination process, and there was no indication that their views of [the Bank] conditions had changed. []¹³ In any event, even by [the BHC’s] account, [the Bank] has not yet fully addressed the governance and managerial risk concerns raised by [the State] and the FDIC.

[The BHC] next argues that neither [the BHC’s] condition nor [the Bank’s] condition warrants a Board Resolution restricting dividend payments without the Reserve Bank’s

¹⁰ 12 U.S.C. § 1844(c)(2).

¹¹ SR 16-04.

¹² *Id.*

¹³ []

prior approval.¹⁴ In particular, [the BHC] contends that neither the BHC Manual nor any other relevant guidance or regulation supports a Board Resolution.

It is well-established that a bank holding company must act as a source of strength to their depository institutions. The Board's Regulation Y states that a "bank holding company shall serve as a source of financial and managerial strength to its subsidiary banks and shall not conduct its operations in an unsafe or unsound manner."¹⁵ Likewise, Congress made clear that the bank holding company must "serve as a source of financial strength for any subsidiary of the bank holding company . . . that is a depository institution."¹⁶ This means that a bank holding company must stand ready "to provide financial assistance to such insured depository institution in the event of the financial distress of the insured depository institution."¹⁷ Similarly, when evaluating the payment of dividends, stock redemptions, or stock repurchases, Federal Reserve examiners are required to consider, among other things, the bank holding company's "[a]bility to serve as an ongoing source of financial and managerial strength to [IDI] subsidiaries . . . and the condition of subsidiary depository institutions[.]"¹⁸

[The State] and the FDIC have identified numerous areas of financial and managerial risk at the Bank. Such areas include liquidity risk and inadequate capital given the types of assets held by the Bank, as well as inadequate board of directors oversight and an inadequate risk management framework. Given these risks, the fact that the FDIC has deemed [the Bank] to be in "troubled condition," and that [the BHC] relies upon earnings from [the Bank] to service its debt,¹⁹ it was reasonable of the Reserve Bank to seek the adoption of a Board Resolution.

To be sure, [the BHC] argues that they have resolved the underlying financial conditions concerns at [the Bank] and that [the Bank's] continuing profitability and historic ability to support holding company debt service via dividends show that there is no reason for dividend restrictions. As explained above, however, there is no indication that [the State] and the FDIC have changed their assessment of [the Bank's] overall condition, nor does [the BHC]

¹⁴ A Board Resolution is an informal enforcement tool presented to the institution's board of directors, which is charged with ensuring that management addresses a particular supervisory concern. Enforcement measures may escalate depending on the severity or difficulty of the problem.

¹⁵ 12 C.F.R. § 225.4(a).

¹⁶ 12 U.S.C. § 1831o-1(a).

¹⁷ 12 U.S.C. § 1831o-1(f).

¹⁸ SR 09-4, *Applying Supervisory Guidance and Regulations on the Payment of Dividends, Stock Redemptions, and Stock Repurchases at Bank Holding Companies*, at 4.

¹⁹ The Board has noted that when "bank holding companies incur debt and rely upon the earnings of their subsidiary banks as the means of repaying such debt, a question arises as to the probable effect upon the financial condition of the holding company and its subsidiary bank or banks." 12 C.F.R. § 225, Appx. C.

contend that it has addressed all the areas of financial and managerial risk raised by [the State] and the FDIC.

Finally, the proposed Board Resolution does not prohibit paying dividends, incurring debt, or redeeming shares; instead, it only requires authorization from the Reserve Bank prior to taking these actions to ensure that [the BHC] will remain able to serve as a source of strength to [the Bank]. The Reserve Bank is expected to exercise its discretion in good faith and grant requests that are consistent with the Board's guidance regarding dividend payments.

For these reasons, the panel affirms the Reserve Bank's determinations.

Sincerely,

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