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OF THE
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DIVISION OF BANKING
SUPERVISION AND REGULATION

DIVISION OF CONSUMER AND
COMMUNITY AFFAIRS

SR 13-7

CA 13-4

April 5, 2013

TO THE OFFICER IN CHARGE OF SUPERVISION AT EACH FEDERAL RESERVE BANK AND TO STATE MEMBER BANKS AND BANK HOLDING COMPANIES

SUBJECT: State Member Bank Branching Considerations

Applicability to Community Banking Organizations: This guidance applies to all state member banks and their parent bank holding companies, including community banking organizations, which are defined as institutions supervised by the Federal Reserve with total consolidated assets of $10 billion or less.

The Federal Reserve is issuing this letter to clarify its policy concerning the application process for a state member bank in less-than-satisfactory condition for the establishment of a de novo branch.[1] This letter describes the circumstances under which a state member bank may be permitted to branch on a de novo basis if it or its parent bank holding company (collectively, a "banking organization") is in less-than-satisfactory condition. While this letter explains the criteria for the establishment of a de novo branch, a banking organization's proposal must be consistent with general safety-and-soundness standards and adhere to the Federal Reserve's application process.

A state member bank in less-than-satisfactory condition, or which has a less-than-satisfactory record of consumer compliance or performance under the Community Reinvestment Act ("CRA"), generally should not pursue expansionary proposals and should focus on remediating identified supervisory issues. Expansionary transactions such as mergers and acquisitions require a significant amount of management's time and can distract an organization

[1] Refer to 12 CFR 208.6 (Board's Regulation H, Establishment and maintenance of branches) and 12 CFR 262.3 (Board's Rules of Procedures, Applications). Approval may be warranted for proposals to replace existing branch(es) with a new branch or to complete a branch for which construction had commenced well before the bank was informed of a rating downgrade and such approvals may not necessarily count towards branching limits discussed below. This letter does not apply to proposals by state member banks to acquire existing branches from unaffiliated depository institutions or proposals to establish foreign branches.

from restoring a bank holding company or state member bank to a safe-and-sound condition or establishing an effective consumer compliance program in a timely manner. However, the establishment of a limited number of de novo branches generally should not require a significant amount of time or distract management from continuing to address the organization's supervisory issues. Accordingly, the Federal Reserve is clarifying its criteria for expansionary proposals and will consider proposals involving the establishment of a limited number of de novo branches by state member banks that are in less-than-satisfactory condition or have a less-than-satisfactory consumer compliance record. A state member bank should be able to demonstrate that it can effectively plan and execute branch expansions; absent a history of successful de novo branching, the branching proposal should include an execution plan.

Definitions of Less-than-Satisfactory Condition

For purposes of this letter, "less-than-satisfactory condition" refers to a banking organization with any of the following factors:[2]

- A composite CAMELS supervisory rating of "3" for the state member bank at the most recent safety-and-soundness examination.
- A management component rating of "3" at the most recent safety-and-soundness examination of the state member bank, even if the composite CAMELS rating is "1" or "2."
- A composite consumer compliance rating for the state member bank of "3" at the most recent compliance examination or assessment.[3]
- A less than Satisfactory CRA rating at the most recent performance evaluation.
- A composite RFI rating of "3" at the most recent bank holding company inspection.[4]
- A composite RFI rating of "1" or "2," but with a risk management or financial factors component rating of "3" at the most recent inspection.

The Federal Reserve generally will discourage branching proposals for a banking organization with supervisory ratings that are more severe than those listed above.

De Novo Branching Criteria

In submitting a request to establish a de novo branch, a state member bank should be able to demonstrate that it meets the following criteria:

1. *Well-defined rationale for branching that will not materially increase risk.* Overall, the state member bank should provide a well-defined rationale in the proposal that the branch would not materially increase the bank's risk profile and would not exacerbate existing

[2] For information on the CAMELS rating system, refer to SR letter 96-38, "Uniform Financial Institutions Rating System," and for the RFI/C(D) rating system (commonly known as "RFI"), refer to SR letter 04-18, "Bank Holding Company Rating System."

[3] See the Community Reinvestment Act, 12 U.S.C. 2906(b)(2), and CA letter 80-15, "Uniform Interagency Consumer Compliance Ratings System."

[4] More specifically, this would be the "C" rating in the RFI/C (D) rating system.

supervisory issues at the organization. Furthermore, the proposal must be consistent with the organization's ongoing business strategy and strategic plan as confirmed by the Reserve Bank's examination staff.

2. *Satisfactory progress in remediating outstanding supervisory issues.* The state member bank should be proactively remediating any identified supervisory issues. Additionally, given that a banking organization in less-than-satisfactory condition often is under a supervisory action, the organization also should be in substantial compliance with the majority of the provisions of any such action. If a state member bank is permitted to branch under this policy and subsequently does not remediate outstanding issues prior to its next examination, the bank may be prohibited from branching further until it is in satisfactory condition.

3. *Stable or improving risk management and financial factors at the organization.* A state member bank will be evaluated for stability in its financial performance metrics, comprised of capital, earnings, liquidity, and asset quality measures. Financial performance should be stable or improving, and analysis of financial indicators should demonstrate that the bank is not taking excessive risk (for instance, the state member bank's allowance for loan and lease losses should be adequately funded and its balance sheet should not reflect significant funding mismatches).

   The banking organization's risk management function should be rated satisfactory or clearly moving towards a satisfactory rating. While the organization's risk management framework may need some improvement, as evidenced by Matters Requiring Immediate Attention and/or Matters Requiring Attention cited in examination/inspection reports, the banking organization should be proactively addressing deficiencies, so that any branching activity would not impede the pace of progress in advancing to a satisfactory risk management rating. In all cases, the bank's Bank Secrecy Act/Anti-Money Laundering program needs to be considered satisfactory.

   The Federal Reserve will also consider a state member bank's performance under the CRA in deciding on branch applications. A less-than-satisfactory CRA rating can impede a favorable action on an application. However, consideration may be given for a branch opening to address a particular weakness in the bank's CRA performance identified by examiners or for a branch opening in a low- or moderate-income or minority census tract, provided that the opening of the branch would address an unmet need for banking services.

   For a state member bank with a less-than-satisfactory consumer compliance rating, the Federal Reserve will consider the nature and severity of the weakness(es) that led to its less-than-satisfactory rating, as well as whether the state member bank has received consecutive less than satisfactory consumer compliance ratings. In addition, the Federal Reserve will require examiner documentation indicating substantial and verified corrective action.

4. *Strong or satisfactory capital at the banking organization.* A capital assessment will be based on the adequacy of the banking organization's consolidated capital position as well

as the state member bank's capital component rating from its most recent examination.[5] In the case of a stale inspection or examination rating (for example, if the most recent onsite examination was conducted more than 12 months ago), examiners will be consulted regarding whether capital is strong or satisfactory, considering the organization's risk profile and ability to manage risks. In addition to assessing pre-transaction metrics, the organization's post-transaction capital level will need to remain satisfactory.

5. *Acceptable component supervisory ratings.* Capital must be rated "2" or better and all other financial factors, with the exception of earnings, must be rated no more severely than "3." Given its lagging nature, the earnings component is the only factor that may be rated more severely than "3." While current earnings may be weak, the overall trend of the organization's supervisory rating for earnings needs to be stable or improving and should demonstrate that excessive risks will not threaten or weaken the sustainability of future earnings.

6. *Branching limited to within, or contiguous to, the bank's existing market area.* Consistent with the intent of minimizing risk and absent other overriding factors, the branch proposal should reflect limited geographic expansion. Any geographic expansion should be either within or contiguous to the state member bank's existing market area.

Branching Limits

Absent an overriding supervisory objection, a state member bank that meets the criteria outlined above would be limited to de novo branch expansion of up to one percent of its total number of existing branches per quarter, with a maximum limit of 40 branches annually. In addition, a state member bank whose branch network is not large enough to meet the one percent test would be permitted to expand by at least one branch annually.[6] Also, if a state member bank meets the criteria above and is part of a multi-bank holding company, the state member bank would have its branching limitation calculated independently of its sister state member banks.

Potential applicants should contact Reserve Bank applications staff prior to submitting an application. Any proposals will be reviewed in accordance with all applicable statutory factors and regulatory guidance, including those related to financial condition and future prospects, managerial resources, and convenience and needs of the community.

Federal Reserve Banks should distribute this letter to the state member banks and bank holding companies in their districts and to appropriate supervisory staff. Questions regarding this guidance may be directed to the following Division of Banking Supervision and Regulation staff in the Domestic Banking Acquisitions and Activities section: Katie Cox, Manager, at (202) 452-2721 or Susan Motyka, Manager, at (202) 452-5280; or the following Division of Consumer and Community Affairs staff in the Applications section: Melissa Vanouse, Manager, at (202)

[5] For the state member bank, the "C" component of the CAMELS rating would need to be "1" or "2."

[6] For example, if a state member bank has 50 branches, it would be allowed to open two branches during one year. A state member bank with 100 branches would be allowed to open one branch per quarter or four branches annually.

452-3488, or Charles Fleet, Senior Supervisory Consumer Financial Services Analyst, at (202)-452-2776. In addition, questions may be sent via the Board's public website.[7]

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Cross-References:

- CA letter 80-15, "Uniform Interagency Consumer Compliance Ratings System"
- SR letter 04-18, "Bank Holding Company Rating System"
- SR letter 96-38, "Uniform Financial Institutions Rating System"

[7] http://www.federalreserve.gov/apps/contactus/feedback.aspx.