



**BOARD OF GOVERNORS**  
OF THE  
**FEDERAL RESERVE SYSTEM**

WASHINGTON, D.C. 20551

DIVISION OF BANKING  
SUPERVISION AND REGULATION

DIVISION OF CONSUMER AND  
COMMUNITY AFFAIRS

**SR 14-2**

**CA 14-1**

**February 24, 2014**

**TO THE OFFICER IN CHARGE OF SUPERVISION  
AT EACH FEDERAL RESERVE BANK AND TO FINANCIAL INSTITUTIONS  
SUPERVISED BY THE FEDERAL RESERVE**

**SUBJECT: Enhancing Transparency in the Federal Reserve's Applications Process**

**Applicability:** This guidance applies to all financial institutions supervised by the Federal Reserve, including those with \$10 billion or less in consolidated assets.

The purpose of this letter is to provide financial institutions<sup>1</sup> and the general public with a better understanding of the Federal Reserve's approach to applications and notices that may not satisfy statutory requirements for approval of the proposal or otherwise raise supervisory or regulatory concerns. The matters discussed herein are intended to improve transparency in the applications process.

When Federal Reserve staff identifies substantive issues under the statutory factors that must be evaluated in an application or notice, staff typically will inform the applicant or notificant and request additional information. Often, these issues are resolved through the provision of additional information about or changes to the proposal, and the Federal Reserve ultimately approves or does not object to the application or notice. However, there are instances when substantive issues are not resolved during the application review process, and Federal Reserve staff recommends that the Board deny the proposal. In such cases, the Federal Reserve's general practice has been to inform the filer before final Board action that staff would recommend denial of the proposal to the Board in order to provide the filer the option to

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<sup>1</sup>For purposes of this guidance, "financial institutions" refers to state member banks, bank and savings and loan holding companies (including their nonbank subsidiaries), and foreign banks with operations in the United States.

withdraw the application or notice. Typically, the application or notice is withdrawn and the withdrawal is noted on the Federal Reserve's public H.2 Release.<sup>2</sup>

To enhance transparency in the Federal Reserve's applications process and provide the banking industry and general public with better insight into the issues that could prevent the Federal Reserve from acting favorably on a proposal, the Federal Reserve will start publishing a semi-annual report that provides pertinent information on applications and notices filed with the Federal Reserve. The report will include statistics on the length of time taken to process various applications and notices and the overall volume of approvals, denials, and withdrawals, and provide the primary reasons for withdrawals. The first report will be released in the second half of 2014 and include filings acted on from January through June 2014.

From 2009 to 2012, there were approximately 7,000 applications and notices filed with the Federal Reserve. Over the same time period, approximately 700 applications and notices were withdrawn. The majority of the filings were withdrawn at the prerogative of the filer; however, more than a third of the withdrawals were due to significant issues identified by Federal Reserve staff during the application review process that would have led to staff recommending denial to the Board. The issues identified have most often been related to the safety and soundness of the financial institution or consolidated organization, or to a failure to meet another statutory requirement for approval. The common issues identified by the Federal Reserve that have resulted in applications and notices being withdrawn are discussed below.

### **Organizations with Less-than-Satisfactory Ratings or Enforcement Actions**

The Federal Reserve has received applications from organizations with issues that have resulted or will result in a less-than-satisfactory rating for safety and soundness, Community Reinvestment Act ("CRA"), or consumer compliance, and/or the issuance of a formal enforcement action. Organizations rated less than satisfactory or operating under a formal enforcement action are expected to resolve the issues that led to the less-than-satisfactory rating or the enforcement action prior to seeking approval from the Federal Reserve to engage in any expansionary activities, including mergers, acquisitions, asset purchases, investments, new activities, and branching.<sup>3</sup> As part of the application review process, the Federal Reserve considers the examination ratings of an organization in its evaluation of relevant statutory factors, such as financial, managerial, and convenience and needs factors. When these issues at the organization are evaluated under the applicable statutory requirements of a proposal, the application or notice usually is not consistent with the requirements for approval.

#### *Safety and Soundness*

Applications and notices filed by organizations in less-than-satisfactory condition face significant barriers to approval and generally have been discouraged. In addition, applications and notices, particularly for expansionary activities, filed by holding companies with less-than-

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<sup>2</sup> <http://www.federalreserve.gov/releases/h2/>

<sup>3</sup> See SR letter 13-7/ CA letter 13-4, "State Member Bank Branching Considerations" for further guidance on the Federal Reserve's policy for branching activities by state member banks in less than satisfactory condition.

satisfactory ratings for the risk management or financial condition components, or banks with less-than-satisfactory ratings for the management or capital components, generally have been viewed unfavorably despite having a satisfactory composite rating. In the majority of such cases, the financial and managerial considerations of the proposal were not consistent with approval. Under very limited circumstances, the Federal Reserve may consider proposals from organizations with one or more component ratings of “3” or a composite rating of “3” for safety and soundness. In addition to convincingly demonstrating that the proposal would not distract management from addressing the existing problems of the organization or further exacerbate these problems, the applicant or notificant would have to demonstrate that the proposed acquisition would strengthen the organization. The organization also must be responding appropriately to and must have made notable progress in addressing supervisory concerns.

### *Consumer Compliance and CRA*

The Federal Reserve considers an institution’s record of complying with consumer protection laws and regulations as part its assessment of managerial factors. Proposals involving institutions with less-than-satisfactory consumer compliance ratings or other significant consumer compliance issues face barriers to approval and have been discouraged.<sup>4</sup> Under limited circumstances when such proposals have been submitted, however, the Federal Reserve considers a number of factors, including:

- The nature and severity of the issues that led to the less-than-satisfactory rating or weaknesses in the consumer compliance program.
- Whether the less-than-satisfactory rating was consecutive or whether the identified weaknesses or issues are of a repeat nature.
- The corrective action taken to date, including the primary federal regulator’s view of such action and examiner documentation indicating substantial and verified corrective action.
- The size of the institution with less-than-satisfactory ratings or other significant consumer compliance issues relative to the organization’s consolidated assets.
- Whether the proposal would pose a material distraction to management in its efforts to achieve corrective action.

A less-than-satisfactory CRA rating has been an impediment to favorable action on an application or notice. 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 and not detract from efforts to address any non-branch related CRA deficiencies.

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<sup>4</sup> Near term or in process consumer compliance or CRA examinations could cause a delay in the applications decision process.

## **Other Financial Factors**

Relevant banking statutes and the Board's regulations generally require the Federal Reserve to consider financial factors when evaluating an application or notice. In order for the Federal Reserve to approve or not object to a proposal, an organization is expected to be in sound financial condition on a current and pro forma basis. Applications and notices for proposals that raise concerns with respect to asset quality, liquidity, or capital, or that otherwise would significantly weaken the financial condition of a financial institution have not been viewed favorably. Common financial issues that have made applications and notices problematic include the following:

- **Capital** – Proposals in which the resulting organization's capital levels or structure do not provide adequate support to the organization have been viewed as deficient. Pro forma capital levels are expected to be commensurate with the organization's risk profile. Insured depository institutions ("IDIs") and holding companies subject to the Board's capital adequacy guidelines are expected to be at least well capitalized on a pro forma basis. The quality of the organization's capital also is considered. Further, capital structures for existing and proposed holding companies with consolidated assets greater than \$500 million should comply with the Board's revised capital framework.
- **Source of strength** – Holding companies are required to serve as "a source of strength" to their subsidiary IDIs.<sup>5</sup> Proposals involving holding companies that are unable to clearly demonstrate their ability to serve as a source of strength have faced significant barriers to approval. Holding companies with insufficient financial resources at the parent, limited access to capital, and/or high levels of debt, often lack the ability to provide adequate support to their subsidiary IDIs. In some instances, such holding companies expose their subsidiary IDIs to additional risks due to the reliance on significant dividend payments from the IDIs to meet the obligations of the parent.
- **Acquisition debt** – Expansionary proposals funded by debt are expected to meet the requirements of relevant regulatory policies and guidance, such as the Small Bank Holding Company Policy Statement.<sup>6</sup> Applicants and notificants are expected to clearly demonstrate the ability to service any debt incurred under the terms of the obligation without reliance on sustained high levels of dividends or other payments from their IDIs. In addition, acquisitions should not be funded by short-term debt; expansionary proposals funded by debt maturing in less than three years generally have been viewed unfavorably.

## **Other Managerial Factors**

The competence, experience, and integrity of the officers, directors, and principal shareholders of an applicant, its subsidiaries, and the related IDIs and holding companies are essential factors in the Federal Reserve's evaluation of applications and notices. As part of the application review process, the Federal Reserve conducts extensive reviews of the background,

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<sup>5</sup> 12 USC 1831o-1.

<sup>6</sup> 12 CFR part 225, appendix C.

financial history, and professional experience of the proposed principals of an organization. Principals, particularly directors and managers, whose backgrounds raise questions regarding their integrity, financial responsibility, or competence, or otherwise raise doubt about their ability to fulfill the responsibilities of their respective roles within the organization, have been viewed unfavorably. Common managerial issues identified that have made approval of applications and notices problematic include the following:

- Insufficient banking experience – Proposed directors and managers of an organization should have experience commensurate with the duties required for the position being sought, taking into consideration the size and complexity of the organization. For example, individuals with extensive large bank or investment banking experience may not necessarily have the appropriate experience to manage community or regional banks. Proposals that consider individuals with limited relevant banking or business experience for key management or decisionmaking positions have been discouraged. Further, proposals that would result in individuals who have been associated with failed IDIs or IDIs that are or were in troubled condition as a result of their actions or decisions being appointed in key management or decisionmaking positions or serving as principal shareholders, have faced significant barriers to approval.
- Financial responsibility – Proposed principals of an organization are expected to have the financial resources and integrity to meet their financial obligations. For example, proposed principals, particularly directors and senior executive officers, either individually or through related business interests, who have a history of bankruptcy filings or defaults on obligations that have resulted in losses to IDIs or the Deposit Insurance Fund, or exhibit other behaviors that indicate a lack of financial responsibility, have been a barrier to approval. Further, individuals unable or unwilling to demonstrate the financial capacity to meet their personal obligations have not been viewed favorably.
- Other background information – The Federal Reserve contacts other federal, state, and local government agencies regarding the background of proposed principals as part of its review of applications and notices. Proposals involving principals who have been convicted of crimes have faced significant barriers to approval. Noncriminal acts committed by proposed principals that have resulted in adverse actions taken by a federal or state agency, such as the assessment of a civil money penalty or issuance of an enforcement action, also are considered and have made approval of applications and notices problematic.

## **Other Factors**

Other common issues identified during the application review process that have led to the withdrawal of applications and notices include the organization's compliance with the Bank Secrecy Act, the appropriateness of the organization's business plan, and the need for an exemption from Section 23A of the Federal Reserve Act and Regulation W. These issues, discussed below, can raise significant safety and soundness concerns at the organization and typically do not meet the statutory requirements for approval.

### *Compliance with the Bank Secrecy Act*

As discussed in SR letter 02-8, “Implementation of Section 327 of the USA Patriot Act in the Applications Process,” the Federal Reserve is required to consider an organization’s effectiveness in combatting money laundering activities in its evaluation of certain applications and notices. As part of the application review process, Federal Reserve staff considers the primary supervisor’s assessment of the organization’s compliance with the Bank Secrecy Act and its anti-money laundering program. Bank Secrecy Act compliance and anti-money laundering programs with significant program violations and/or deficiencies that have resulted in the issuance of a formal or informal enforcement action generally are considered to be less than satisfactory. Proposals from financial institutions with less than satisfactory Bank Secrecy Act and anti-money laundering compliance programs face substantial barriers to approval and generally have not received favorable consideration.

### *Business Plan*

In considering the future prospects of an organization, staff assesses the proposed business plan in conjunction with the organization’s current condition, economic environment, and other relevant factors. Proposed business plans that substantially increase the risk to an organization or raise safety and soundness concerns have been viewed unfavorably and have been a barrier to approval. Common issues with business plans include the following:

- Overly aggressive – Business plans that include overly aggressive strategies, such as rapid or excessive growth, significant out-of-territory lending, or reliance on less stable funding (for example, brokered deposits).
- Concentrations – Business plans that would result in a concentration of assets, liabilities, product offerings, customers, revenues, geography, or business activity without effective mitigants (for example, additional capital, liquidity, or other support).
- Managerial deficiencies – Business plans that contemplate entry into significant new lines of business in which the organization does not have demonstrated managerial experience or expertise, has not developed appropriate risk management policies, and lacks credible plans to acquire sufficient managerial expertise and risk management policies.
- Ineffective – Business plans that do not satisfactorily address known deficiencies at the organization.

### *Section 23A and Regulation W Exemption Requests*

Proposed transactions that contemplate an IDI receiving a Regulation W exemption require consultation with, and approval from, the primary supervisor of the IDI and the FDIC (if the FDIC is not the primary supervisor) for the Regulation W exemption. Regulation W exemption requests in connection with a merger or acquisition will be carefully reviewed to ensure that an exempt transaction is consistent with the safety and soundness requirements of the statute and the regulation. The Board expects the applicant to contact the appropriate supervisor

and the FDIC. In all instances, the FDIC must concur with an exemption request and the relevant agencies must find that the exemption is in the public interest and consistent with the purposes of section 23A, and the FDIC must find that the exemption does not present an unacceptable risk to the Deposit Insurance Fund.<sup>7</sup> The Board will not act on a proposal that involves a request for a Regulation W exemption without the approval of the appropriate supervisors (including the FDIC). In cases where the Board is the appropriate supervisor of the IDI, the Board considers the size and quality of the assets and liabilities proposed to be transferred, the likely effect on the operations of the IDI, whether the transaction provides diversification benefits to the IDI, the ability of the parent to protect the IDI against losses on transferred assets, and other relevant factors. The Board also will consult with the FDIC.

### **Additional Considerations**

The items discussed below have not resulted in a significant number of withdrawals, but they are required to be considered under the statutory factors for certain applications and notices. As part of the application review process, the Federal Reserve strongly considers substantive public comments and the effect a proposed transaction could have on competition and financial stability. Significant issues identified would have to be resolved before Federal Reserve staff would recommend approval of a proposal.

#### *Adverse Public Comments*

Substantiated public comments with allegations related to consumer compliance, including fair lending, or CRA performance, have presented barriers to approval of proposals. The Federal Reserve provides on its public website a list of pending applications and notices subject to public comment.<sup>8</sup>

#### *Competitive and Financial Stability Factors*

In certain cases, relevant banking laws require the Board to consider the effect of proposed transactions on competition and financial stability. The Board has developed criteria for competitive and financial stability factors that allow most cases to be delegated to a Reserve Bank for approval, if the application raises no other issues. Applications that do not meet the delegation criteria may be approved by the Board, if the facts presented by the proposed transaction suggest that competitive and financial stability considerations are consistent with approval. In instances where competitive or financial stability issues raise concerns, mitigating actions may be considered. Mitigating actions could include, for example, divestiture of some branches, assets, or businesses of either the target financial institution or the acquiring financial institution to address the competitive or financial stability issues raised by the proposal.

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<sup>7</sup> See 12 USC 371c(f)(2).

<sup>8</sup> <http://www.federalreserve.gov/apps/h2a/h2aindex.aspx>

## Supervisory Expectations

The issues discussed above are not intended to be exhaustive, but should be taken into consideration by all financial institutions and individuals when contemplating filing an application or notice with the Federal Reserve. As noted above, applicants and notificants are generally expected to resolve their outstanding substantive supervisory issues prior to filing an application or notice with the Federal Reserve. Applicants and notificants with proposals that present unique or novel issues are encouraged to use the Federal Reserve's pre-filing process described in SR letter 12-12/ CA letter 12-11, "Implementation of a New Process for Requesting Guidance from the Federal Reserve Regarding Bank and Nonbank Acquisitions and Other Proposals" to receive feedback on potential issues on a filing prior to submitting a formal filing. The semi-annual report on applications and notices will update the issues identified in applications and notices withdrawn.

Reserve Banks are asked to distribute this letter to the supervised organizations in their districts and to appropriate supervisory staff. Questions regarding this guidance may be directed to:

- **Division of Banking Supervision and Regulation:** Katie Cox, Manager, Domestic Banking Acquisitions and Activities, at (202) 452-2721; Betsy Howes-Bean, Manager, International Banking Acquisitions and Activities, at (202) 452-3096; Susan Motyka, Manager, Domestic Banking Acquisitions and Activities, at (202) 452-5280; or Jevon Gordon, Senior Supervisory Financial Analyst, Domestic Banking Acquisitions and Activities, at (202) 973-7384.
- **Division of Consumer and Community Affairs:** Melissa Vanouse, Manager, Applications, at (202) 452-3488; or Charles Fleet, Senior Supervisory Consumer Financial Services Analyst, Applications, at (202) 452-2776.
- **Legal Division:** Alison Thro, Assistant General Counsel, Banking Regulation and Policy Group, at (202) 452-3236.

In addition, questions may be sent via the Board's public website.<sup>9</sup>

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<sup>9</sup> <http://www.federalreserve.gov/apps/contactus/feedback.aspx>.



Cross-references to:

- [SR letter 13-7 / CA letter 13-4](#), “State Member Bank Branching Considerations”
- [SR letter 12-12 / CA letter 12-11](#), “Implementation of a New Process for Requesting Guidance from the Federal Reserve Regarding Bank and Nonbank Acquisitions and Other Proposals”
- [SR letter 02-8](#), “Implementation of Section 327 of the USA Patriot Act in the Applications Process”