BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

OFFICE OF INSPECTOR GENERAL

May 23, 2012

Mr. Michael Gibson
Director
Division of Banking Supervision and Regulation
Board of Governors of the Federal Reserve System
Washington, D.C. 20551

Dear Mr. Gibson:

The Office of Inspector General of the Board of Governors of the Federal Reserve System (Board) is pleased to present the result of our Audit of the Board's Progress in Developing Enhanced Prudential Standards. Section 165 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) requires the Board to establish enhanced prudential standards for bank holding companies (BHCs) with total consolidated assets equal to or greater than $50 billion (referred to in this report as large BHCs), and nonbank financial companies that are determined by the Financial Stability Oversight Council (FSOC) to pose a risk to financial stability.[1] Given the extent and importance of these new responsibilities for the Board, we conducted our audit to analyze the Board's approach and activities for its supervision of large BHCs in preparing to meet the related requirements of Dodd-Frank.

Specifically, our audit objective was to assess the Board's Division of Banking Supervision and Regulation's (BS&R's) approach and activities to comply with Dodd-Frank requirements related to developing enhanced prudential standards for large BHCs, including prudential standards that would apply to any nonbank financial company determined by FSOC to be systemically important. The scope of our work focused on BS&R's progress toward enhancing prudential standards for large BHCs that are currently supervised by one of three BS&R sections: the Large Institution Supervision Coordinating Committee (LISCC), the Large Banking Organizations (LBO), and the International Banking Organizations (IBO).

To accomplish our objective, we identified and examined policies, procedures, and guidance to gain a better understanding of BS&R's approach and activities for supervising large BHCs. We interviewed BS&R staff with responsibility for supervising BHCs, as well as staff in the Board's newly established Office of Financial Stability, Policy and Research (OFS). We also obtained information from BS&R's information systems and databases, but our audit did not include a review of the individual controls for these information systems.

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1 Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 165, 124 Stat. 1376, 1423-32 (2010) (codified at 12 U.S.C. § 5365). Section 165 of Dodd-Frank requires that the Board's enhanced prudential standards include (1) risk-based capital requirements and leverage limits, (2) liquidity requirements, (3) overall risk management requirements, (4) resolution plan and credit exposure report requirements, and (5) concentration limits. In addition, Dodd-Frank authorizes, but does not require, the Board to establish requirements related to contingent capital, enhanced public disclosures, short-term debt limits, and such other prudential standards as the Board, either on its own or at the recommendation of the FSOC, determines appropriate.

We selected two financial institutions from the LISCC portfolio and compared BS&R's supervisory activities before and after the financial crisis to assess BS&R's progress on developing enhanced prudential standards. The two institutions were Bank of New York Mellon, supervised by the Federal Reserve Bank of New York, and Wells Fargo & Company, supervised by the Federal Reserve Bank of San Francisco. We selected these institutions because they had BHC inspection activity in 2011, as well as in 2007, prior to the recent financial crisis. We reviewed inspection working papers and interviewed management and other supervision staff for the institutions to gain an understanding of the changes in their supervisory approach in preparing to meet Dodd-Frank requirements.

Overall, we found that BS&R had taken a proactive approach to enhancing its supervision of large BHCs, including initiating actions prior to the passage of Dodd-Frank. BS&R has reorganized its sections to accommodate a new framework for supervision of large BHCs and has taken actions to meet the related requirements of Dodd-Frank. As BS&R continues to enhance its supervisory approach, we are providing two suggestions for management's consideration that we believe would further strengthen BS&R's efforts to supervise large BHCs and meet related Dodd-Frank requirements. First, we suggest that the LISCC define and document roles and responsibilities for its subgroups and for coordination with other Board offices, to ensure a clear understanding of each office's purposes and functions. Second, we suggest that BS&R finalize the process for distributing and maintaining a complete list of large BHCs that are subject to enhanced prudential standards, including BHCs that may fluctuate above or below the $50 billion threshold in asset size, to effectively and timely supervise BHCs under Dodd-Frank requirements. This management letter provides background on BS&R's activities to establish enhanced prudential standards for large BHCs, the results of our audit work, and suggestions for management's consideration.

We conducted our fieldwork from January 2011 to July 2011. We performed our work in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our results and conclusions, based on our objective. We believe that the evidence obtained provides a reasonable basis for our results, based on our audit objective.

Background

The Bank Holding Company Act of 1956 established the Federal Reserve as the primary supervisor and regulator for BHCs. In July 2010, Dodd-Frank established new supervisory responsibilities by designating the Board, acting on its own or pursuant to recommendations by the FSOC,[2] to establish more stringent prudential standards for large BHCs, including certain nonbank financial companies that present financial stability risks. In addition, Dodd-Frank specified that the application of the standards should be tailored to include differentiating among

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2 The FSOC consists of 10 voting members and 5 nonvoting members and brings together the expertise of federal financial regulators, state regulators, and an insurance expert appointed by the President. The voting members are the Secretary of the Treasury, who serves as the Chairperson of the Council; the Chairman of the Board; the Comptroller of the Currency; the Director of the Bureau of Consumer Financial Protection; the Chairman of the Securities and Exchange Commission; the Chairperson of the Federal Deposit Insurance Corporation; the Chairperson of the Commodity Futures Trading Commission; the Director of the Federal Housing Finance Agency; the Chairman of the National Credit Union Administration Board; and an independent member with insurance expertise who is appointed by the President and confirmed by the Senate for a six-year term. The nonvoting members are the Director of the Office of Financial Research; the Director of the Federal Insurance Office; a state insurance commissioner designated by the state insurance commissioners; a state banking supervisor designated by the state banking supervisors; and a state securities commissioner designated by the state securities commissioners.

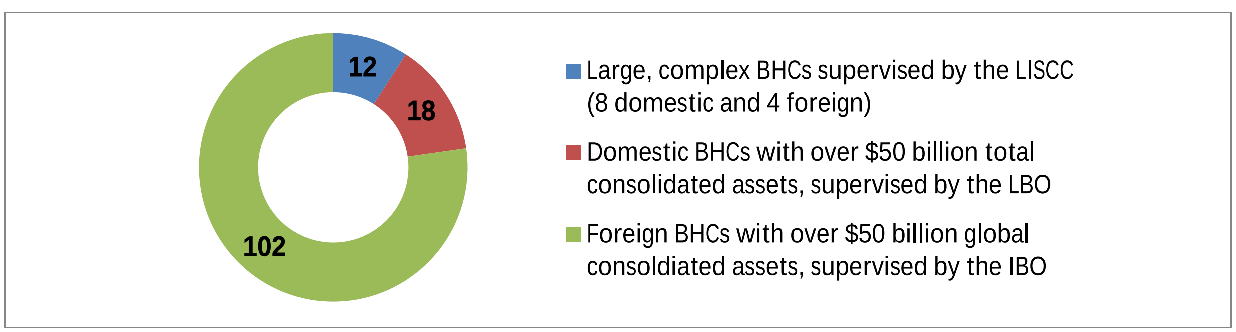
companies on an individual basis or by category, taking into consideration their capital structure, riskiness, complexity, financial activities (including the financial activities of their subsidiaries), size, and any other risk-related factors that the Board deems appropriate. The Board may also, pursuant to a recommendation by the FSOC in accordance with section 115 of Dodd-Frank, establish an asset threshold above $50 billion for the application of any established standard.

During our review, we identified that the Federal Reserve supervised 4,770 domestic BHCs and 179 foreign-owned BHCs operating in the United States as of March 31, 2011. Of these domestic BHCs, 26 had $50 billion or more in total consolidated assets. Their combined total consolidated asset value was approximately $13 trillion, with the top four totaling approximately $8 trillion. In addition, 106 foreign-owned BHCs had $50 billion or more in total global consolidated assets. Their combined total global consolidated asset value amounted to approximately $60 trillion, including both U.S. and foreign assets.

In addition to establishing enhanced prudential standards for large BHCs, the Board is required to develop enhanced prudential standards for certain nonbank financial companies determined by the FSOC to be systemically important. Dodd-Frank requires the Board to issue regulations that establish the requirements for determining whether a nonbank company is "predominantly engaged in financial activities" and to define the term "significant nonbank financial company." Accordingly, the Board issued a notice of proposed rulemaking in February 2011, with a follow-up notice of proposed rulemaking in December 2011.

The Board's BS&R division has responsibility for supervising BHCs and establishing enhanced prudential standards for large BHCs as required by Dodd-Frank. However, we found that BS&R began to modify its framework for large BHC supervision prior to the passage of Dodd-Frank. BS&R's Large Financial Institutions (LFI) section, which sought to promote greater consistency in the supervisory approach for institutions that had substantial activities in multiple, significant markets, became the LISCC. After the passage of Dodd-Frank, the LISCC continued to develop its structure and define its roles and responsibilities. In addition, we found that BS&R has also made changes to the LBO and the IBO sections, which also supervise large BHCs. As identified in chart 1 below, at the time of our audit, these sections supervised 132 large BHCs; however, the number of BHCs can fluctuate depending on each institution's total asset value.

Chart 1: Number of Large BHCs per BS&R Supervision Section



Large Institution Supervision Coordinating Committee

LISCC was developed to provide strategic and policy direction for supervisory activities across the Federal Reserve System, improve the consistency and quality of supervision, incorporate systemic risk considerations, and monitor the execution of the resulting supervisory program. However, unlike its predecessor, the LFI section, which consisted principally of Reserve Bank and Board BS&R personnel, the LISCC has a multidisciplinary composition, bringing together views and analysis from Reserve Banks, LISCC subcommittees, and various Board divisions.

LISCC takes a macro perspective by considering information gleaned from its Quantitative Surveillance group, which is charged to identify systemic and firm-specific risks through macroeconomic scenarios and loss forecasts, financial market vulnerabilities, and measures of interconnectedness among firms. The Quantitative Surveillance group provides information on system-wide financial risks and vulnerabilities for use in macroeconomic forecasts. The Quantitative Surveillance group also participates in specific supervisory efforts, such as horizontal assessments across large financial institutions and stress testing for capital adequacy assessments.

LISCC also has an Operating Committee. The Operating Committee is directly involved in the supervisory process for large banking organizations and is supported by various subgroups, to include the Risk Secretariat, the Capital Performance Secretariat, the Data Team, Products and Processes, the Tactical Action Group, and Vetting. At the time of our audit, the Operating Committee was still determining the responsibilities of some of these subgroups with respect to meeting requirements of Dodd-Frank.

Large Banking Organizations Section

The LBO section is responsible for risk-focused supervision of the activities of large banking organizations. As such, the section oversees the respective examination and supervisory functions of the district Reserve Banks. The LBO section analyzes and evaluates state member banks and BHCs through the review of examination and inspection reports, regulatory financial filings, and other externally and internally prepared analyses. The LBO section coordinates with Reserve Bank and Board staff to resolve supervisory issues or problems, including the development of formal enforcement actions and informal corrective measures.

The LBO section develops supervisory strategies, recommends supervisory responses in emergency situations, coordinates with other bank regulatory agencies, and develops policies and procedures. The LBO section monitors market developments with respect to products and services affecting the large U.S. banking organizations’ portfolios, evaluates structural changes in balance sheet/income stream composition both individually and portfolio-wide, identifies potential developments that could undermine the stability of banking or financial markets, and supplements Reserve Bank staff upon request.

International Banking Organizations Section

The IBO section, in conjunction with other sections of the Federal Reserve’s supervision function at both the Board and the Federal Reserve Banks, is responsible for providing timely and insightful analysis of foreign country economic, banking sector, and supervisory conditions that influence the supervisory strategy for the operations of foreign banks in the United States. In addition, the section serves as the focal point for communication and coordination with foreign bank supervisors related to examination practices and protocols, information about the U.S. banking market, and Federal Reserve views on supervisory issues and banking sector trends of global interest. The IBO section also provides ongoing support to the foreign supervision program by developing policy enhancements, setting quality management benchmarks, and providing input to examiner training.

Findings, Conclusions, and Suggestions

Overall, we found that BS&R had taken a proactive approach to enhancing its supervision of large BHCs, including initiating actions prior to the passage of Dodd-Frank. BS&R has reorganized its sections that supervise large BHCs to establish strategic and policy direction for supervisory activities for the most significant BHCs and has taken actions to enhance the supervision of large BHCs to meet the related requirements of Dodd-Frank. As BS&R continues to enhance its approach for supervising large BHCs, we are providing two suggestions for management's consideration that we believe would further strengthen BS&R's efforts to supervise large BHCs and meet related Dodd-Frank requirements.

1. **We suggest that LISCC define and document roles and responsibilities for its subgroups and for coordination with other Board offices, to ensure a clear understanding of each office's purposes and functions.**

We identified that although the roles and responsibilities of BS&R's LISCC Operating Committee and Quantitative Surveillance group are documented, roles and responsibilities for some of the Operating Committee's new subgroups, namely the Capital Performance Secretariat, the Tactical Action Group, and Vetting, are not documented.

We also identified that both Quantitative Surveillance and OFS were responsible for providing a similar quantitative macro perspective on large BHCs, but since these offices have been recently established, there was not a clear understanding and documentation on how the offices will work together. Quantitative Surveillance and OFS are chaired by the same Board official, and their agendas are similar with some overlapping activities. OFS is responsible for coordinating and supporting the Board's work on financial stability. In conjunction with other Board divisions, OFS identifies and analyzes potential threats to financial stability; monitors financial markets, institutions, and structures; and assesses and recommends policy alternatives to address these threats. Also, OFS fosters broader understanding of financial stability issues by undertaking longer-term research, primarily in banking, finance, and macroeconomics. Similar to OFS, Quantitative Surveillance members include individuals who work in other Board divisions (as well as from BS&R) and who conduct analysis on financial markets and large complex institutions to identify systemic and firm-specific risks through macroeconomic scenarios and loss forecasts.

We recognize that BS&R and LISCC are still evolving and working to meet their Dodd-Frank requirements. However, we suggest that defining and documenting the roles and responsibilities of these offices will not only minimize duplication of efforts but will also ensure that all staff have a clear understanding of their roles and responsibilities to ensure that Dodd-Frank requirements are implemented in an efficient and effective manner.

2. We suggest that BS&R finalize the process for distributing and maintaining a complete list of large BHCs that are subject to enhanced prudential standards, including BHCs that may fluctuate above or below the $50 billion threshold in asset size, to effectively and timely supervise BHCs under Dodd-Frank requirements.

We found that although BS&R has developed a list of large BHCs, details regarding the list's distribution had not been finalized as of the end of our fieldwork. As previously mentioned, Dodd-Frank requires that enhanced prudential standards be developed and applied to BHCs with $50 billion or more in total consolidated assets. BS&R designated its Monitoring/Surveillance section to periodically generate a list of domestic BHCs with $50 billion or more in total consolidated assets and foreign BHCs with $50 billion or more in total global consolidated assets. In July 2011, Monitoring/Surveillance generated a draft list of large BHCs that included 132 domestic and foreign BHCs. However, we found that because the distribution process had not been finalized, the LISCC, the LBO, and the IBO did not have knowledge of the list. Further, we found that the IBO had developed its own draft list of foreign large BHCs.

The Monitoring/Surveillance section's list is planned to be the basis upon which classification as a large BHC will be reviewed on a quarterly basis. Classification applies to any BHC that has $50 billion or more in total consolidated assets and any foreign bank or company that is or is treated as a BHC and that has $50 billion or more in total consolidated assets, that meets the Board's defined criteria.[3] A large BHC remains under enhanced supervision standards unless and until it has less than $45 billion in total consolidated assets, as determined based on the most recent annual or, as applicable, the average of the four most recent quarterly reports made to the Board.

Finalizing the process for distributing and maintaining a complete list of large BHCs will assist BS&R in timely and effectively applying enhanced prudential standards and supervisory procedures, including cases where a BHC's total consolidated assets rise to $50 billion or more but then fall below $45 billion at a later date. Fluctuations in asset size may cause BHCs to move above or below the $50 billion threshold specified by Dodd-Frank. As of September 30, 2011, five U.S. BHCs had total consolidated assets in the $40-$60 billion range.

We provided a draft of our report to you for review; however, since we are not making formal recommendations, a written response to this report was not required. However, BS&R senior management indicated that actions are being taken to fully implement our suggestions.

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3 The classification applies to any BHC that has $50 billion or more in total consolidated assets, as determined based on the average of the company's four most recent Consolidated Financial Statements for BHCs as reported quarterly to the Board. The classification also applies to any foreign bank or company that is, or is treated as, a BHC and that has $50 billion or more in total consolidated assets, as determined based on the average of the foreign bank's or company's four most recent quarterly, or in some cases annual, Capital and Asset Reports for Foreign Banking Organizations.

We appreciate the support and assistance of BS&R staff throughout this engagement. This management letter will be included on our publicly available website and in our semiannual report to Congress. The principal contributors to this report were Ms. Anna Saez, Senior Auditor and Project Lead; Ms. Margaret An, Auditor; and Mr. Peter Sheridan, Project Manager.

Please contact Mr. Sheridan at 202-973-5009 or me at 202-973-5003 if you wish to discuss this letter or any related issues.

Sincerely,

Andrew Patchan Jr.

Andrew Patchan, Jr.
Associate Inspector General for Audits and Attestations

cc: Ms. Maryann Hunter
Mr. William Spaniel
Mr. Timothy Clark