



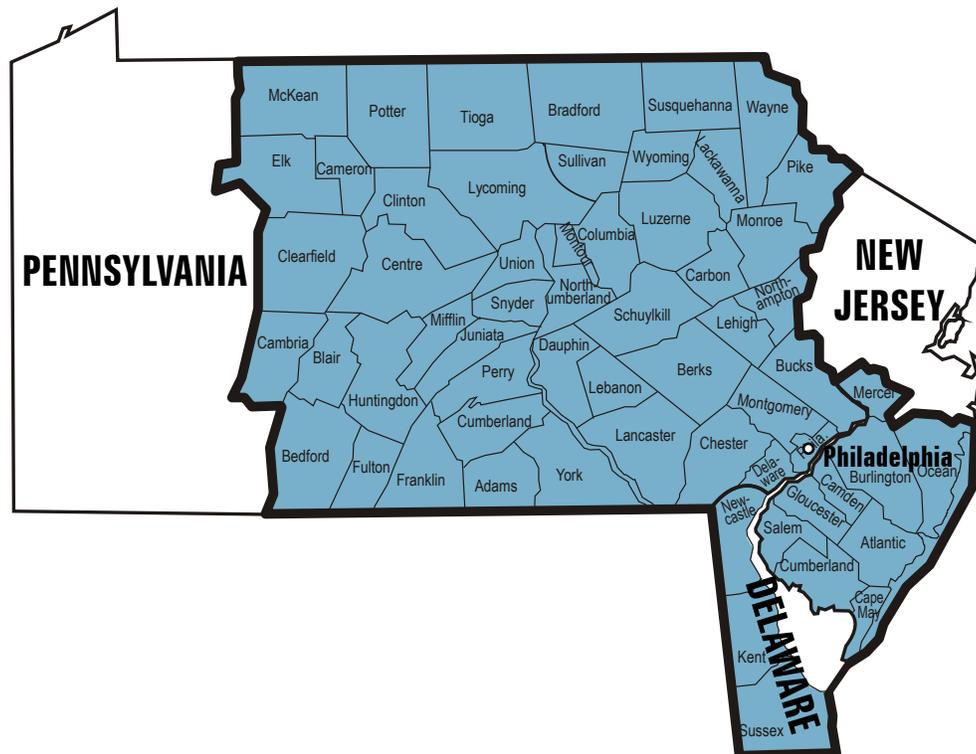
SUPERVISION, REGULATION, AND CREDIT ENFORCEMENT UNIT PURPOSE AND PRACTICES



FEDERAL RESERVE BANK OF PHILADELPHIA
SUPERVISION, REGULATION, AND CREDIT
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THIRD FEDERAL RESERVE DISTRICT



The comments expressed in this document are those of the Enforcement Unit Staff and do not represent the opinions of the Federal Reserve Bank of Philadelphia or the Federal Reserve System.



The critical role that can be played by the supervisor in problem cases, both through public enforcement actions and through other less visible means, cannot be overstated.

*-William J. McDonough, President of the Federal Reserve Bank of New York (retired July 31, 2003),
Meeting of the International Bankers, September 10, 1997*

Although this statement was spoken several years ago, the premise remains valid. Today's banking organizations operate in a dynamic environment marked by increased competition, ongoing innovation, a high degree of regulation, intense public scrutiny, and rapid changes in economic conditions and financial markets. Consequently, banks are continually challenged to balance the risks and returns of their operations with the regulators' precept that they operate in a safe and sound manner and in compliance with all laws and regulations. These risks, if not effectively managed, can negatively affect the financial condition of a banking organization, and if the problems become systemic, they can undermine the public's confidence in the industry and threaten the stability of the financial markets.

To fulfill its supervisory mission in such an environment, the Supervision, Regulation and Credit (SRC) department of the Federal Reserve Bank of Philadelphia (Reserve Bank) employs a proactive, risk-based supervisory process, a significant component of which is the enforcement process, led by staff members of the Enforcement Unit.

Understanding the Enforcement Unit's critical role in the supervisory process requires a basic knowledge of the framework in which Enforcement operates, the mission of the unit, the examination process, the types of enforcement tools available, and the factors which contribute to enforcement actions.

SUPERVISORY AUTHORITY

The Federal Reserve System's supervisory and enforcement authority is embedded in the Federal Reserve Act and is codified in 12 U.S.C. 1818. This authority has been enhanced and expanded through various subsequent acts, including the Financial Institution Supervisory Act of 1966 (FISA); the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA); the Crime Control Act of 1990; the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA); the Gramm-Leach-Bliley Act of 1999 (GLBA); and the Financial Services Regulatory Relief Act of 2006. Congress passed these acts either in response to conditions that threatened the safety and soundness of the banking industry or to changes in the structure of the industry.

The Federal Reserve System conducts supervisory and enforcement activities through its Division of Banking Supervision and Regulation (BS&R), Division of Consumer and Community Affairs (C&CA), and General Counsel. Certain supervisory and enforcement powers are delegated to the 12 regional Federal Reserve Banks, including the Federal Reserve Bank of Philadelphia. The Federal Reserve System is the primary supervisor of the following entities:

- State-chartered banks that are members of the Federal Reserve System (state member banks, or SMBs)
- Bank holding companies
- Financial holding companies
- Nonbank subsidiaries of bank holding companies
- Edge and agreement corporations
- Branches and agencies of foreign banking organizations operating in the United States and their parent banks
- Institution-affiliated parties (IAPs), which include any officer, director, employee, controlling shareholder, or agent of a financial institution. The IAP designation also applies to any shareholder, consultant, joint venture partner, or any other person who participates in the conduct of the affairs of the financial institution and independent contractors, including attorneys, appraisers, and accountants.

SRC MISSION

The mission of SRC is to promote financial stability; to foster a safe and sound, competitive banking system; to provide collaborative oversight of institutional and industry activities; and to provide consistent, fair, and timely supervision through knowledge building, integrated processes, and value-added, risk-focused supervisory practices. This mission covers the safety and soundness and the consumer compliance aspects of bank supervision, as well as the discount window, payment system risk, and reserve administration aspects of the Credit and Risk Management function. SRC's objectives mirror those established by the Federal Reserve System for the supervision and regulation, consumer and community affairs, and credit and risk management functions.

To carry out its mission and to minimize systemic risks, SRC embraces practices that support effective responses to changes in financial markets, changes in banking and financial conditions, and shifts in monetary and public policy. SRC works in conjunction with other federal and state authorities to ensure that financial institutions safely manage their operations and provide fair and equitable services to consumers.

ENFORCEMENT

The Enforcement Unit collaborates with the other units of SRC—particularly Community and Regional Supervision, Consumer Compliance and CRA, Applications, Surveillance, and Credit and Risk Management—to support the mission of the department and to translate its objectives into measurable actions. Specifically, the Enforcement Unit is charged with instituting and monitoring preventive and corrective supervisory actions in response to identified unsafe and unsound banking practices by institutions and IAPs supervised by the Reserve Bank. Unsafe or unsound practices encompass any action or lack of action that is contrary to generally accepted standards or prudent operation, the possible consequences of which, if continued, could be abnormal risk or loss or damage to an institution, its shareholders, its depositors, or the insurance fund administered by the Federal Deposit Insurance Corporation (FDIC).

Due to the complexity of enforcement-related issues, enforcement staff must demonstrate strong analytical, communication, and interpersonal skills.

To support SRC's mission of effective supervision, the Enforcement Unit utilizes a functional approach, which includes focused policies and procedures; consistent application of enforcement actions; and coordination among departmental units, BS&R and C&CA, the legal departments of the Reserve Bank and the Board of Governors of the Federal Reserve System (Board of Governors or Board), and other regulators.

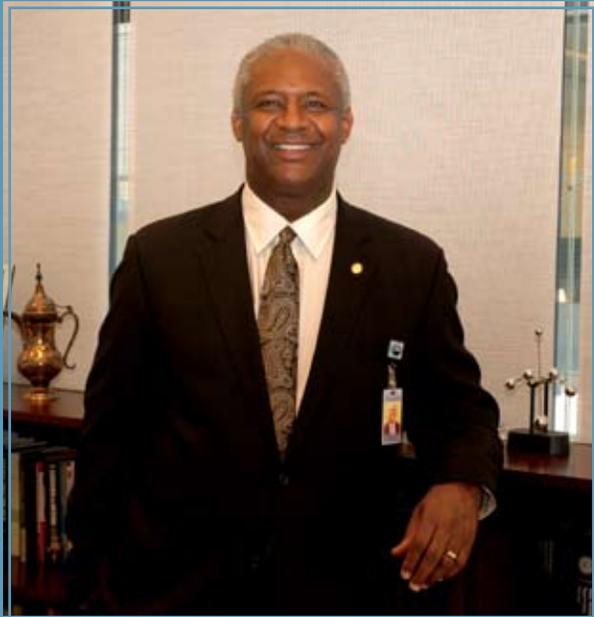
The Enforcement Unit consists of specialized staff members who are trained to execute its mission. Due to the complexity of enforcement-related issues, enforcement staff must demonstrate strong analytical, communication, and interpersonal skills. Typically, an enforcement analyst will hold a degree in a business field, have completed the training requirements to become a commissioned examiner, and have prior experience in bank supervision or in the financial services industry.

The key responsibilities of an enforcement analyst include analyzing examination reports and other documents and factors to determine the need for an enforcement action, preparing recommendations for and drafts of enforcement actions, and monitoring compliance with enforcement actions. Enforcement analysts also participate on bank examinations, when necessary.

ESTABLISHMENT OF THE ENFORCEMENT UNIT

According to the FDIC, 1,375 banks and 1,182 saving institutions failed from 1985 to 1995 due to a combination of insider abuse, poor credit quality, lax underwriting standards, and unfavorable economic conditions.¹ During this crisis, Congress passed legislation that

¹ FDIC, Historical Statistics on Banking — Bank and Thrift Failure Report, available at www.fdic.gov/bank/individual/failed/index.html, accessed July 16, 2007.



Michael E. Collins, former Senior Vice President of SRC and founder of SRC's Enforcement Unit in 1992.

mandated bank supervisors to take prompt and effective remedial action against organizations and individuals who violate laws, engage in unsafe and unsound banking practices, or breach their fiduciary duties related to financial institutions. To comply with this requirement, in June 1992, senior management of SRC formed the Enforcement Unit as a separate unit within the department to coordinate all of the enforcement actions and to ensure that all significant supervisory concerns are addressed in a thorough and efficient manner.

The advantages of this structure include an independent, objective review of supervisory

recommendations; a comprehensive, unfragmented approach to enforcement activities; improved flexibility with regard to changes in the regulatory environment; and a high level of expertise and organizational efficiency.

ADDITIONAL RESPONSIBILITIES

In addition to its primary responsibilities, the Enforcement Unit remains up-to-date on new enforcement issues and educates stakeholders about enforcement-related topics by participating in Federal Reserve System and industry work groups and training courses; providing training for the Community and Regional Supervision, Consumer Compliance, and Surveillance units within SRC; and conducting outreach initiatives to financial institutions and law enforcement. Specifically, the Enforcement Unit actively participates in the Federal Reserve System's Fraud Information Network (FIN), which facilitates the use of System fraud specialists to address potential issues of fraud within the System; serves as a communication resource on issues related to financial crimes; monitors fraudulent activity throughout the District; and develops examiner knowledge on financial fraud.

The Enforcement Unit also hosts the Bank Fraud Work Group, the purpose of which is to foster communication in the Third Federal Reserve District (Third District) amongst the regulators and between the regulators and members of the federal and state law enforcement communities. The work group also shares information on fraud, both internal and external, that may affect Third District institutions.

An enforcement analyst serves as a member of SRC's Bank Secrecy Act/Anti-Money Laundering (BSA/AML) Work Group. This work group is responsible for providing SRC staff with guidance on any regulatory updates pertaining to BSA/AML and the USA PATRIOT Act, and also acts as liaison between SRC staff and the Board of Governors' anti-money laundering and compliance experts.

GENERAL OVERVIEW OF ENFORCEMENT ACTIONS

Enforcement actions have been a key supervisory tool for over 40 years, and they complement traditional supervisory policies and practices, such as moral suasion. Typically, bank supervisors impose enforcement actions to remedy unsafe or unsound practices and violations of laws uncovered during on-site examinations or inspections. In addition, weaknesses identified through the analysis of off-site surveillance information, such as data reported in the institution's regulatory filings, information filed in suspicious activity reports (SARs), and information forwarded by the management of financial institutions, can also result in enforcement actions.

Different issues and circumstances can raise concern. Following are some of the most prevalent issues that trigger the need for an enforcement action:

- Violations of laws and regulations
- Ineffective policies, procedures, risk management practices, and internal controls
- Lack of appropriate managerial oversight and corporate governance
- Insider abuse
- Deteriorating financial condition, and particularly a decline in capital

Once such deficiencies have been identified, banking supervisors use enforcement actions to compel management and financial institutions to (i) restore the institution to a safe and sound condition; (ii) address weaknesses before they become pronounced; and/or (iii) comply with consumer and safety and soundness laws, regulations, and standards.

An enforcement action stipulates the provisions that the institution must adhere to in order to remediate deficiencies and weaknesses and to be considered in compliance with the action. The following table lists examples, but is not all inclusive, of typical provisions.

TYPICAL PROVISIONS	
Conduct management reviews	Divest of any impermissible activities
Maintain specific capital levels	Restrict the payment of dividends
Adopt and implement effective policies and procedures	Restrict the redemption of stock
Restrict growth	Restrict the issuance of debt
Prohibit acquisitions or mergers	Provide regular progress reports to the regulator

In most cases, enforcement actions provide management and boards of directors of financial institutions an opportunity to implement important changes that can restore and enhance the institution's overall performance, franchise value, and reputation in the long run. However, some

enforcement actions may contain elements that serve as a deterrent for banks engaging in high-risk activities without commensurate controls (e.g., subprime lending and dealing with money services businesses) or activities that supervisors have deemed to be abusive (e.g., predatory lending, self-dealing, and violations of law).

EXAMINATION/INSPECTION PROCESS

To better understand how the need for an enforcement action evolves and how an appropriate enforcement action is determined, it is helpful to understand the examination/inspection process.

Commercial Examinations

During the examination of a commercial bank, Reserve Bank examiners evaluate state member banks using the CAMELS rating system, which is an acronym for the six components of a bank's financial condition: **C**apital, **A**sset quality, **M**anagement, **E**arnings, **L**iquidity, and **S**ensitivity to market risk. In addition to the CAMELS rating, examiners also assign an overall composite rating and a risk management rating. As illustrated in Figure 1, examiners rate each component and the composite on a scale of one to five, with one being the best rating and five being the worst.

When assigning CAMELS ratings, examiners consider not only financial ratios and trends but also the effectiveness and appropriateness of internal controls, policies and procedures, and managerial oversight.

To determine the risk profile of a bank, examiners analyze and quantify the following factors with respect to credit risk, market risk, liquidity risk, operational risk, legal risk, and reputational risk.

FIGURE 1—CAMELS Components	
Commercial Exam Components	Rating Scale
<ul style="list-style-type: none"> • Capital • Asset Quality • Management • Earnings • Liquidity • Sensitivity to Market Risk • Composite • Risk Management 	<ul style="list-style-type: none"> • 1-Strong • 2-Satisfactory • 3-Needs Improvement • 4-Deficient • 5-Critically Deficient

- **Inherent Risk** — the nature, complexity, and volume of the activities giving rise to the risk in question; it is rated as low, moderate, or high.
- **Adequacy of Risk Management** — the strength of risk management processes and controls for each risk; it is expressed as strong, acceptable, or weak.
- **Composite Risk** — the level of inherent risk measured against the strength of risk management for each risk; it is rated as low, moderate, or high.
- **Direction of Risk** — the likely change to the risk profile over the next 12 months; it is expressed as increasing, stable, or decreasing.

In addition to commercial examinations, Reserve Bank examination staff also conducts trust and information systems examinations. Each of those examinations culminates in a separate rating, as illustrated in Figure 2.

FIGURE 2—Specialty Examination Ratings	
<p>Trust Examination Components</p> <ul style="list-style-type: none"> • Management • Operations, Internal Controls, and Audit • Earnings • Compliance • Asset Management • Composite <p>Rating Scale</p> <ul style="list-style-type: none"> • 1-Strong • 2-Satisfactory • 3-Fair • 4-Marginal • 5-Unsatisfactory 	<p>Information Technology Examination Components</p> <ul style="list-style-type: none"> • Audit • Management • Development and Acquisition • Support and Delivery • Composite <p>Rating Scale</p> <ul style="list-style-type: none"> • 1-Strong • 2-Satisfactory • 3-Fair • 4-Marginal • 5-Unsatisfactory

Consumer Compliance/ Community Reinvestment Act Examinations

Examiners assigned to the Consumer Compliance Unit of SRC examine state member banks to evaluate compliance with consumer protection, civil rights, and fair lending laws and regulations as they pertain to financial institutions (Figure 3 on page 8). In addition, through Community Reinvestment Act examinations, examiners determine how well a state member bank is meeting the credit needs of its entire community, including low- and moderate-income neighborhoods. Each statute and regulation specifies the various government agencies responsible for enforcement, and the penalties, liabilities, and administrative sanctions that can be imposed for noncompliance. For example, if the Reserve Bank determines that a state member bank has engaged in a pattern or practice of discouraging or denying credit applications from members of a protected class, in violation of the Equal Credit Opportunity Act (ECOA), which is implemented by Regulation B, it will refer the matter to the Board of Governors. If the Board concurs with the Reserve Bank’s determination, the Board has the authority to impose an enforcement action to obtain compliance. If the Board determines that the bank has engaged in a pattern or practice of credit discrimination, the Board is required under ECOA to refer the

FIGURE 3 — Consumer Regulations and Implementing Legislation

Reg. B - Equal Credit Opportunity Act	Reg. AA - Unfair or Deceptive Acts or Practices
Reg. C - Home Mortgage Disclosure Act	Reg. BB - Community Reinvestment Act (CRA)
Reg. D - Reserve Requirements of Depository Institutions	Reg. CC - Availability of Funds/Collection of Checks
Reg. H - National Flood Insurance Act	Reg. DD - Truth in Savings Act
Reg. E - Electronic Funds Transfer	Fair Housing Act
Reg. M - Consumer Leasing Disclosure	Fair Credit Reporting Act
Reg. P - Privacy of Consumer Financial Information	Fair Debt Collection Practices Act
Reg. X - Real Estate Settlement Procedures Act (RESPA)	Right to Financial Privacy Act
Reg. Z - Truth in Lending	

case to the Department of Justice. The Department of Justice can bring a civil action, including actual and punitive damages and injunctive relief, against the bank or return the case to the referring agency if an administrative action is more appropriate.

The examiners also assess the level of consumer compliance risk of the bank and incorporate this into the bank’s overall rating. The rating system for compliance and CRA examinations is presented in Figure 4 on page 9.

Bank Holding Company Inspections

The inspection process of a bank holding company (BHC) is similar to the examination process of a commercial bank. However, as shown in Figure 5 on page 9, examiners evaluate the bank holding company using the RFI/C (D) rating system, which stands for the components of the holding company’s ratings: **R**isk management, **F**inancial condition, **I**mpact of parent company and nondepository entities on subsidiary depository institutions, **C**omposite, and **D**epository institution. The risk management (R) component is supported by four subcomponents: board and senior management competence; policies, procedures, and limits; risk monitoring and management information systems; and internal controls. The financial condition (F) component is also supported by four subcomponents, each represented on a consolidated basis: capital, asset quality, earnings, and liquidity. The rating for the depository institutions (D) usually reflects the CAMELS composite rating of the subsidiary bank(s). For multi-bank holding companies, the (D) rating is a weighted average, based on asset size and relevant importance of the individual subsidiary banks.



FIGURE 4—Consumer Compliance and CRA Examination Ratings	
<p>Consumer Compliance</p> <ul style="list-style-type: none"> • Board and Senior Management Oversight • Policies, Procedures, and Limits • Risk Monitoring and Management Information Systems • Internal Controls <p>Rating Scale</p> <ul style="list-style-type: none"> • 1-Strong • 2-Generally Strong • 3-Less than Satisfactory • 4-Requires Close Supervisory Attention • 5-Substantial Noncompliance 	<p>Community Reinvestment Act</p> <ul style="list-style-type: none"> • Lending Test • Investment Test • Service Test <p>Rating Scale</p> <ul style="list-style-type: none"> • O-Outstanding • S-Satisfactory • I-Needs to Improve • N-Substantial Noncompliance

FIGURE 5—RFI/C (D) Components	
<p>Bank Holding Inspection Components</p> <ul style="list-style-type: none"> • Risk Management • Financial Condition • Impact of Parent and Nonbank Entities on Subsidiary Depository Institutions • Composite • Depository Institution 	<p>Rating Scale</p> <ul style="list-style-type: none"> • 1-Strong • 2-Satisfactory • 3-Fair • 4-Marginal • 5-Unsatisfactory

After completing the examination or inspection, the examiners draft the report of examination or inspection, which summarizes the findings and ratings and also stipulates the required and expected actions and other matters requiring board and management attention. The draft report is submitted to SRC management along with the recommendation for an enforcement action, if applicable.

TYPES OF ENFORCEMENT ACTIONS

Once a serious concern has been identified through the supervisory process or other means, the Federal Reserve can utilize various enforcement actions to compel management of the financial institution to resolve the issues. These actions range from informal to more severe formal actions and can be used for both safety and soundness and consumer compliance concerns.

The level of severity of the action is determined on a case-by-case basis and generally depends on the following factors:

- The nature, duration, and pervasiveness of the problems
- The immediacy of the concern
- The resources and actions necessary to resolve the problems
- The cooperation and ability of management and the board of directors

Generally, the severity of enforcement actions tracks downgrades in an institution's component or composite ratings, with more severe problems requiring stronger action. In addition, monetary penalties generally are tied to increasing levels of noncompliance, although some statutes mandate specific levels of monetary penalties.

When entering into an enforcement action with a state member bank, the enforcement unit will coordinate and work closely with the relevant state bank supervisor.

The Federal Reserve drafts each enforcement action so it addresses the issues specific to the institution and, in most cases, has discretion over the content and severity of the enforcement action. The provisions of an enforcement action can be intensified if management is not responsive, if new concerns arise, or if conditions deteriorate.

When entering into an enforcement action with a state member bank, the enforcement unit will coordinate and work closely with the relevant state bank supervisor. Often, the Reserve Bank and the state banking department enter into a joint enforcement action with the institution. On other occasions, depending on state law, the state banking department may enter into a separate but identical enforcement action.

Informal and formal actions, in increasing order of severity, and their descriptions are outlined below. The descriptions provide general guidance on when a particular type of action may be considered. However, the final determination of the appropriate level action is, again, made only after considering all of the facts and circumstances of the case.

INFORMAL ENFORCEMENT ACTIONS

Each Reserve Bank has delegated authority to administer informal actions, which are designed to obtain corrective action by identifying problem areas and establishing responsibility for ensuring that the problems are addressed effectively. Informal actions are considered voluntary agreements. In other words, when the Reserve Bank deems that an informal action is necessary, the enforcement officer of the Reserve Bank requests in writing that senior management or the board of directors of the institution voluntarily implement the prescribed actions.

The Reserve Bank can employ informal actions for any institution requiring corrective action. These actions may be appropriate for institutions with the following characteristics:

- A bank with a composite rating of 3 or better
- A bank with relatively minor violations and/or an improving trend
- A bank deemed “needs improvement,” “marginal,” or “less than satisfactory” in a single component or limited number of areas
- A bank that is likely to consent and comply with the informal action
- A bank holding company whose primary issues are at the subsidiary bank and are being addressed by the primary regulator

Informal actions are not enforceable in court, and the violation of an informal action cannot serve as a basis for assessing a Civil Money Penalty or initiating a removal and prohibition action (see *Formal Enforcement Actions* below). The Federal Reserve does not make informal actions publicly available. However, the Sarbanes-Oxley Act of 2002 and SEC regulations require publicly-held institutions to disclose any information that is considered material for securities law purposes and, when asked, enforcement staff advise publicly-held institutions to consult with counsel.

1. *Supervisory Letter*

A Supervisory Letter is the least severe form of informal enforcement action. In the Supervisory Letter, the Federal Reserve informs the principal of the institution in writing of the matters that require attention and requests compliance with the included provisions. The principal, usually the president or CEO, may agree to the provisions of the Supervisory Letter without involving the institution’s



board of directors. Typical BHC provisions place restrictions on the payment of dividends, the issuance of debt, or the redemption of stock without prior regulatory approval.

The Reserve Bank typically will consider using a Supervisory Letter under the following conditions:

- Small, deteriorating banks with a few minor problems but no significant violations
- Shell BHCs rated 3 or better that have no significant violations and that have a lead subsidiary bank that is not considered a major problem or where the enforcement action at the subsidiary bank adequately addresses the issues at the bank
- When no significant violations of law or unsafe or unsound practices exist
- When principals are expected to cooperate and comply readily

2. Board Resolution

A Board Resolution is a moderate-level informal enforcement action. The action is not a contract between the institution and the Federal Reserve. Rather, the board of directors of the institution voluntarily passes a resolution, which contains provisions recommended by the Federal Reserve, to ensure that problems are adequately resolved. In a typical Board Resolution, the Reserve Bank may request the directorate to develop plans, procedures, or policies to facilitate corrective action, and it may require that the institution take or refrain from taking certain actions within a stated period of time.

A Board Resolution generally is appropriate under the following conditions:

- Banks that have a composite rating of 2 or a strong 3 when management appears to be taking the necessary actions to improve the condition of the bank
- BHCs that have a composite rating of 3 or 4 that have no significant violations of law and that have a lead subsidiary bank with a composite rating of 4 or better
- When management of the institution has addressed any prior criticisms and there are no repeat violations or material criticisms
- When Reserve Bank staff are confident that management will agree with the provisions and address the identified weaknesses

3. Memorandum of Understanding

The most severe form of informal enforcement action is the Memorandum of Understanding (MOU). An MOU is a written, signed contract between the directorate of an institution and the Reserve Bank that details supervisory expectations and the institution's plan and commitment to remedy the identified problems.

The Reserve Bank generally would initiate an MOU under the following circumstances:

- An SMB with a composite rating of 3, which exhibits significant management or policy deficiencies, and which may also have violations of law that are not abusive
- An SMB or a BHC with a composite rating of 2 or 3 that is in substantial noncompliance with commitments
- A BHC with a composite rating of 4, which is heavily leveraged and may also have violations of law that are not abusive
- An institution whose management has failed to address prior criticisms, resulting in repeat violations or material criticisms
- When Reserve Bank staff are confident that the directorate of the institution is willing to sign the MOU and will comply with the provisions

In the event that concerns raised in the MOU are not adequately addressed and resolved, or that any term of the MOU is violated, the Reserve Bank may pursue one of the more formal enforcement actions.

FORMAL ENFORCEMENT ACTIONS

Only the Board of Governors has the authority to approve and issue formal enforcement actions. This authority is delegated to the Board's General Counsel with the concurrence of the

Director of BS&R or C&CA, as appropriate. Reserve Banks make the recommendations for these actions and monitor compliance with the actions. The Board uses formal enforcement actions to:

- Prevent and, where possible, stop financial institutions and IAPs from engaging in unsafe or unsound practices or violations of applicable laws, rules, and regulations
- Ensure that appropriate corrective action programs are developed and used by problem financial institutions
- Deter unsafe or unsound banking practices and violations of law
- Minimize losses to financial institutions and the federal deposit insurance funds
- Ensure that commitments made to the Federal Reserve and all Federal Reserve policy statements are complied with to the fullest extent possible by financial institutions and individuals
- For IAPs, ensure that those who engage in abusive insider practices or misconduct or violations of law are permanently barred from the banking industry, fined, or both, for their malfeasance



By definition, banking institutions with composite ratings of 4 or 5 usually have problems so severe that formal action is warranted. However, the Federal Reserve may recommend a formal action given any of the following factors:

- Management does not respond appropriately to informal actions or is seriously deficient
- The risks to the institution are significant
- There are continued violations of law or regulations or a violation of the Bank Secrecy Act
- There are violations of conditions imposed in writing by the Board of Governors in connection with granting an application or any written agreement
- There are unsafe and abusive practices, including instances of insider abuse or misconduct, or significant violations of laws, rules, or regulations by IAPs
- There are unsatisfactory policies or procedures or inadequate internal controls

Formal enforcement actions are legally enforceable and, under the provisions of FIRREA and the Crime Control Act of 1990, must be publicly disclosed by the federal banking agencies.²

²There is one exception to the public notice requirement. The Board of Governors does not disclose publicly 4(m) Agreements as to do so could implicitly disclose an institution's management rating.

In addition to issuing a press release upon issuing a formal action, the Board maintains a database of formal enforcement actions on its public web site. For publicly held companies, formal enforcement actions also usually trigger securities-related disclosure requirements.

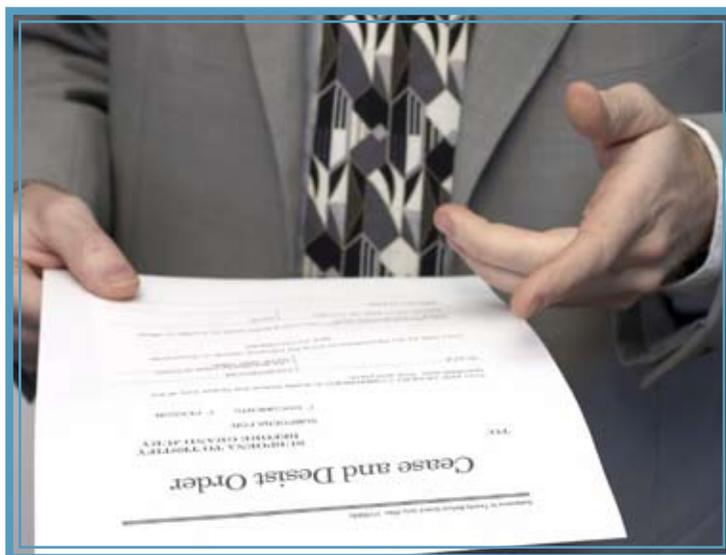
Subjects of a formal action can voluntarily agree to the action and follow the proscriptions contained in the action—or they can contest it. If the formal action is contested, the Board may issue a notice of charges, which starts a formal process that begins with a public administrative hearing.

1. Written Agreement

An institution or an IAP may enter into a Written Agreement, which is the least severe form of formal enforcement action, with either the Board or a Reserve Bank under delegated authority. A Written Agreement is typically imposed when an institution has been accorded a 4 or 5 rating, or a 3 rating with severe problems noted. The provisions of this type of action can relate to any of the problems at the institution or any issues involving the IAP.

2. Cease and Desist Order

Through a Cease and Desist Order, the Board requires a person or an entity to halt certain practices, to take affirmative action to correct violations or practices, and to follow any proscriptions contained in the order. In addition, the Board is required to initiate a Cease and Desist Order when an institution fails to establish and maintain a reasonably designed BSA Compliance Program or when it fails to correct previously reported problems with the BSA Compliance Program.



3. Temporary Cease and Desist Order

The Board can issue a Temporary Cease and Desist Order if immediate harm to the bank or its depositors will likely take place in the absence of such an order. The order remains effective pending completion of regular cease and desist proceedings.

4. Prompt Corrective Action Directive (PCAD)

Section 131 of FDICIA created a statutory framework that applies a system of supervisory actions indexed to the capital level of a bank or thrift. The purpose of this statutory provision is to resolve the problems of insured depository institutions at the least possible long-term cost to the deposit insurance fund.

The prompt corrective action provisions classify insured depository institutions into five categories based on their capital levels. The capital categories include well capitalized, adequately



PROMPT CORRECTIVE ACTION (PCA) CATEGORIES	
Capital Categories	Corresponding Capital Ratios
Well Capitalized	Total Risk Based Capital Ratio $\geq 10\%$ and Tier 1 Risk Based Capital Ratio $\geq 6\%$ and Leverage Ratio $\geq 5\%$ and not subject to Capital Directive
Adequately Capitalized	Total Risk Based Capital Ratio $\geq 8\%$ and Tier 1 Risk Based Capital Ratio $\geq 4\%$ and Leverage Ratio $\geq 4\%$ or $\geq 3\%$ if most recent composite rating = 1
Undercapitalized	Total Risk Based Capital Ratio $< 8\%$ or Tier 1 Risk Based Capital Ratio $< 4\%$ or Leverage Ratio $< 4\%$ or $< 3\%$ if most recent composite rating = 1
Significantly Undercapitalized	Total Risk Based Capital Ratio $< 6\%$ or Tier 1 Risk Based Capital Ratio $< 3\%$ or Leverage Ratio $< 3\%$
Critically Undercapitalized	Ratio of Tangible Equity to Total Assets $\leq 2\%$

capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized. As a bank falls into lower capital categories, the federal bank regulatory agencies are required to impose increasingly stringent restrictions on the institutions' activities.

Once the Reserve Bank becomes aware that a state member bank is less than well capitalized, it will notify bank management of its capital category and discuss limitations on its activities and any supervisory requirements. If a capital restoration plan is required, the plan should indicate how and when the required capital levels will be met. Any PCAD issued is enforceable to the same extent as a Cease and Desist Order.

5. 4(m) Agreement

The name of this action corresponds to section 4(m) of the Bank Holding Company Act, which requires that the Board take corrective action against any financial holding company (FHC) that has a depository institution subsidiary that fails to remain well capitalized or well managed.

To initiate the action, the Board, in consultation with the Reserve Bank, will send a written notice to the FHC outlining the areas of noncompliance and requiring the FHC to submit an acceptable corrective action plan within 20 days and enter into the 4(m) Agreement within 45 days. As part of the agreement, the Board will impose limitations on the activities of the FHC and its affiliates, including prohibiting any additional activities not otherwise permissible for a bank holding company without prior written approval. In the event that the deficiencies are not corrected within 180 days, the Board will require that the FHC either terminate any activity that is not permissible for a bank holding company or divest control of the deficient depository institution subsidiary.

Failure to comply with a 4(m) Agreement can have the serious consequences, including the assessment of civil money penalties against the FHC and its IAPs.

Although 4(m) Agreements are considered formal actions, the Board does not issue press releases or post them to the enforcement action database on its public web site.

6. Termination of Membership

Termination of membership is the most drastic solution that the Federal Reserve can take to address banking concerns. If at any time it appears that a member bank has failed to comply with applicable laws and regulations or has ceased its banking functions, the Board can require the bank to surrender its Federal Reserve Bank stock and forfeit all rights and privileges of membership. For example, the termination of FDIC insurance is grounds for termination of membership. The Board may restore membership upon proof of compliance.

7. Suspension, Removal, Prohibition

The Board is authorized to suspend and remove current or former IAPs for certain violations and activities and to permanently prohibit their future involvement with any insured depository institution, bank holding company, and nonbank subsidiary.

These actions may be taken under the following circumstances:

- A violation of law, rule, regulation, or formal enforcement action
- Conduct which results in financial loss or damage to the institution
- Prejudice to depositors' interest for personal financial gain
- Conduct evidencing personal dishonesty, willful or continuing disregard for safety and soundness, or breach of fiduciary duty
- Conviction of a state or federal crime or crime of personal dishonesty
- Presence which poses a threat to depositors or public confidence
- Intentional violations of the Bank Secrecy Act

8. Civil Money Penalty (CMP)

Some violations of law or regulation require mandatory CMPs, such as a pattern and practice of violating the National Flood Insurance Act. In addition, the Board can assess CMPs against any institution or IAP for:

- Any violation of law or regulation
- Any violation of a formal enforcement action
- Any violation of a condition imposed in writing by the Board in connection with the granting of an application or other request
- The filing of late, false, or misleading regulatory reports
- A pattern of misconduct which causes or is likely to cause losses to the bank or financial or other gain for the subject

ENFORCEMENT ACTION PROCESS: FROM RECOMMENDATION TO TERMINATION

The sections above explain the purpose of enforcement actions, the factors that can give rise to them, how these factors are uncovered, and descriptions of the various types of enforcement actions. So what happens once it has been determined that an enforcement action is appropriate?

When an enforcement action is recommended based on the findings of an examination or inspection, the examiner-in-charge will host a vetting session with representatives from senior management and from the Enforcement, Community and Regional Supervision, Consumer Compliance, Surveillance, and/or Application units, as appropriate. The purpose of the session is to share knowledge and gain additional input and perspective. The examiner-in-charge will then finalize the report of examination, which includes a separate recommendation for the enforcement action.

The enforcement officer will review and edit the draft and submit the final draft to the Reserve Bank's legal department for review.

The enforcement analyst will then review the report of examination to determine whether the recommended enforcement action is fully supported by the findings included in the report. If the enforcement action is fully supported, the analyst will begin to draft the action. If not, further discussions will be held to clarify any inconsistencies.

In the case of an informal enforcement action, the enforcement analyst will work with the examiner-in-charge to draft the action, including provisions and reporting requirements. The enforcement analyst will also coordinate with the state banking department when appropriate. The enforcement officer will review and edit the draft and submit the final draft to the Reserve Bank's legal department for review. A Supervisory Letter or a Board Resolution can be mailed to senior management and the board of directors or presented during a board of directors meeting, while a Memorandum of Understanding will always be presented for signature during a board meeting.

When a formal action is recommended, the enforcement analyst—with input from the enforcement officer, the examiner-in-charge, senior management, and the Reserve Bank legal department—will submit the recommendation for and a draft of the proposed formal action to the Board. Board staff will review the documents, discuss any changes with the Reserve Bank, and will finalize the final action. The Board delegates execution of certain formal actions to the Reserve Banks, but retains authority to enter into other formal actions through the Board's

The Enforcement Unit of the Reserve Bank is responsible for monitoring and assessing the subject's compliance with the action.

Office of the Secretary. The enforcement officer of the Reserve Bank may present the formal action to the directorate during a board meeting. Once executed, the Office of the Secretary will post the formal action, with the exception of a 4(m) Agreement, to the Board's public web site.

Although the Board will issue the formal action, the Enforcement Unit of the Reserve Bank is responsible for monitoring and assessing the subject's compliance with the action. An enforcement action usually requires the institution to provide regular reporting on its progress in correcting the identified deficiencies. The enforcement analyst will analyze these status reports, along with other documents, such as examination reports and regulatory reports, to measure the level of compliance with the enforcement action.

When the institution is in full compliance, the enforcement analyst will consider the examiners' recommendation to terminate the action. The following factors are considered when determining whether to recommend that an enforcement action be terminated:

- Improved financial condition
- Improvements in policies, procedures, internal controls, and managerial oversight as determined by the results of an examination or inspection
- Full compliance with all of the provisions included in the enforcement action
- Payment of civil money penalties.

Throughout the monitoring period, the enforcement analyst will work closely with the appropriate examination area.

COORDINATED EFFORTS

Given that a banking organization may be supervised by more than one regulatory agency, enforcement actions may be issued independently, jointly, or in coordination with other agencies.

For example, in the case of a publicly held bank holding company that has a state member bank subsidiary and a national bank subsidiary, the Federal Reserve would act as the umbrella

supervisor of the organization, inspect the parent company, and share supervisory responsibility over the state member bank subsidiary with the state banking department. The Office of the Comptroller of the Currency would be responsible for supervising the national bank subsidiary. In addition to the relevant federal and state laws, the organization may also be subject to Securities and Exchange Commission (SEC) regulations and the Financial Crimes Enforcement Network (FinCEN) reporting and recordkeeping requirements.

The following two prominent cases exemplify how the various regulatory agencies effectively collaborate.

J.P. Morgan Chase & Co.

On July 28, 2003, the Federal Reserve Board and the New York State Banking Department jointly announced the execution of a Written Agreement among J.P. Morgan Chase & Co., New York, New York; the Federal Reserve Bank of New York; and the New York State Banking Department. The Written Agreement followed a special review of transactions involving J.P. Morgan Chase & Co. and its subsidiaries and Enron Corporation, Houston, Texas. As characterized in a separate U.S. Securities and Exchange Commission (SEC) action against J.P. Morgan Chase & Co., J.P. Morgan had helped Enron mislead its investors by characterizing what were essentially loan proceeds as cash from operating activities. The Written Agreement required J.P. Morgan Chase & Co.—on its own behalf and on behalf of its subsidiaries—to continue to take measures to strengthen risk management practices, particularly those associated with complex financial transactions. This action was coordinated with actions taken by the New York County District Attorney and the SEC. The SEC also instituted and settled enforcement proceedings against J.P. Morgan Chase & Co. for its role in Enron’s manipulation of its financial statements.

AmSouth Bank

On October 12, 2004, the Financial Crimes Enforcement Network (FinCEN) and the Board of Governors of the Federal Reserve System announced that they jointly assessed a \$10 million Civil Money Penalty against AmSouth Bank of Birmingham, Alabama for its violations of the Bank Secrecy Act.

FinCEN and the Federal Reserve Board based their civil money penalty assessment on the failure of the banking organization to establish an adequate anti-money laundering program and the failure to file accurate, complete, and timely suspicious activity reports (SARs). The agencies found systemic defects in AmSouth’s program with respect to internal controls, employee training, and independent reviews that resulted in failures to identify, analyze, and report suspicious activities occurring at the bank.

The Federal Reserve Board and FinCEN provided assistance to and cooperated with the Office of the U.S. Attorney for the Southern District of Mississippi and the Internal Revenue Service, Criminal Investigation, during the course of the investigation. This culminated in a Deferred Prosecution Agreement with AmSouth in connection with charges that the bank violated the Bank Secrecy Act relating to the filing of inaccurate, incomplete, or late SARs.

In addition, the Federal Reserve Board and the Alabama Superintendent of Banks concurrently issued a Cease and Desist Order requiring AmSouth Bank and its parent bank holding company, AmSouth Bancorporation, to take certain corrective actions. The order required improvements in the banking organization's Bank Secrecy Act compliance and suspicious activity monitoring and reporting programs, a review of prior transactions to ensure that all SARs had been filed, as required, and enhancements to internal controls and management oversight.

LEARNING FROM THE PAST AND MEETING FUTURE CHALLENGES

A strong correlation between economic and industry performance and the number of enforcement actions initiated exists. In 1992 alone the Federal Reserve issued 135 formal actions and 336 informal actions due to the impact of the economic recession of 1991 and the banking crisis of the late 1980s. During the economic expansion starting in 2000 and continuing through July 2007, banking organizations posted record earnings, and only 30 banks failed, including four state member banks. The number of enforcement actions issued by the Federal Reserve also dropped significantly from its 1992 peak. However, it would not be accurate to conclude that enforcement actions are only relevant during periods of poor financial performance or economic slowdowns.

With the passage of FIRREA in 1989 and FDICIA in 1991, bank supervisors adopted a more proactive supervisory philosophy, shifting away from relying predominantly on ratings and using enforcement actions primarily as punitive measures to be taken after an institution has become troubled. The current approach focuses more on risk management practices, compliance, managerial oversight and competence, corporate governance, and the accountability of insiders and third party providers. This approach allows bank supervisors to proactively identify weaknesses in operations that could, if uncorrected, lead to future financial deterioration and to take early corrective action. Consequently, there has been an increase in the number of highly rated institutions that have come under enforcement actions.

The banking industry continues to evolve in scope and complexity. Banking organizations are entering new markets, introducing new products and services, and facing increased competition and heightened scrutiny from government and consumer groups. With each new endeavor, new challenges arise, and Enforcement must remain aware of and ready for any future issues. Through good times and bad, the Enforcement Unit will remain a key component of SRC's and the Federal Reserve System's mission to promote a safe, sound, and competitive banking system well into the future. 



FEDERAL RESERVE BANK OF PHILADELPHIA