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## Enhancing Transparency in the Applications Process

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SR letter 14-2/CA letter 14-1, titled "Enhancing Transparency in the Federal Reserve's Applications Process," seeks to provide a greater understanding of the applications process and, in particular, the issues that can prevent the Federal Reserve System from taking favorable action on a proposal. When these issues are not resolved and System staff determines favorable action on the proposal cannot be recommended, System staff has typically provided the applicant the option to withdraw the application or notice before the System takes final action. The reasons for withdrawal are not public so other potential filers would not be able to identify, and thereby avoid issues that might lead to denial of a proposal. Going forward, to enhance the transparency of the applications process, the System will publish a semi-annual report consisting of statistical information on applications and notices processed. This report will include the primary reasons for withdrawals. However, it will not identify specific applicants.

Issues that have resulted in the withdrawal of applications and notices from consideration include less-than-satisfactory ratings or enforcement actions at the applicant organization; financial factors that indicate an applicant organization is not in sound financial condition on a current or pro forma basis; and managerial factors that raise concerns about the competence, experience, and integrity of the officers, directors, and principal shareholders of the applicant organization, including ineffective consumer compliance programs. Issues with respect to Bank Secrecy Act compliance, proposed changes to an organization's business plan, adverse public comments and concerns regarding competitive factors have also been obstacles to favorable action and also resulted in the withdrawal of applications and notices.

Expansionary applications and notices filed by organizations with less-than-satisfactory ratings or enforcement actions face significant barriers to approval and have generally been discouraged. The Letter states that under very limited circumstances, the System may consider proposals from 3-rated organizations. In addition to convincingly demonstrating that the proposal would not distract management from addressing or further exacerbate existing problems, such applicants must demonstrate the proposal would strengthen the organization. Our experience shows that such applicants have generally been unable to successfully make these demonstrations. Less-than-satisfactory component ratings can also be significant impediments to favorable action on an application. In particular, less-than-satisfactory ratings

for the risk management or financial condition component at the holding company or less-than-satisfactory ratings for the management or capital component at the subsidiary bank have proven to be obstacles to favorable action.

Expansionary applications or notices by organizations in satisfactory financial condition can potentially raise issues when the target organization is in less-than-satisfactory financial condition. If the applicant organization's due diligence has identified significant financial, managerial or compliance weaknesses in the target organization, the application or notice should discuss the steps that the applicant will take to correct these weaknesses. The applicant should be able to demonstrate that it has the managerial and financial resources necessary to minimize any potential negative effects of the transaction.

The Letter notes that acquisitions should not be funded by short-term debt (i.e., less than three years). An applicant must be able to demonstrate that it can service debt without relying on sustained high levels of dividends or other income from its subsidiary depository institutions. An applicant should also be able to service acquisition debt without relying on dividends or other income from a target that is in less-than-satisfactory condition. System staff also will consider the impact of financial obligations related to other instruments (e.g., trust preferred securities) and, in certain circumstances, personal debt incurred by applicant's principals.

Finally, capital levels or structures that do not adequately support the organization, are not commensurate with its risk profile, and, in the case of bank holding companies that are subject to the Board's capital adequacy guidelines, have a capital composition in which voting common equity is not the predominant element, raise significant issues. At a minimum, such holding companies and their subsidiary banks must be at least well capitalized on a pro forma basis.

The Letter emphasizes that financial institutions and individuals are expected to have resolved any outstanding substantive supervisory issues before filing with the System. The Reserve Bank encourages filers with proposals that present new or unusual issues to use the pre-filing process outlined 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 facilitate the identification of potential problems before a final application or notice is submitted.

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