

FEDERAL RESERVE BANK OF SAN FRANCISCO
101 MARKET STREET, SAN FRANCISCO, CALIFORNIA 94105

March 28, 2002

**BANKING SUPERVISION AND REGULATION:
ARTHUR ANDERSEN LLP AND
REGULATION H COMPLIANCE**

To State Member Banks,
Bank Holding Companies,
and Others Concerned,
in the Twelfth Federal Reserve District

Interagency Statement Regarding Arthur Andersen LLP (SR 02-7)

On March 19, 2002, the Federal Reserve, along with the other federal financial institutions supervisory agencies, issued the enclosed "Interagency Statement Regarding Arthur Andersen LLP." The agencies' release follows pronouncements made by the SEC on March 14 and 18 concerning Andersen. These pronouncements are referenced in the Interagency Statement.

Consistent with the SEC's public releases, the Interagency Statement generally advises the banking organizations that cease their audit relationship with Andersen that they can file reports required by various federal banking laws and regulations with unaudited financial statements so long as they file audited statements within the deadline prescribed by the SEC (currently 60 days).

For Federal Reserve-supervised institutions, the Interagency Statement directly affects bank holding companies that are not registered with the SEC but are still subject to an annual audit requirement due to their obligations to file FR Y-6s. It also affects state member banks with total assets of \$500 million or more who are subject to the annual audit, attestation, and other reporting requirements of section 36 of the Federal Deposit Insurance Act, and state member banks that have securities registered with the Board and are thus subject to section 208.36 of Regulation H of the Board of Governors.

Guidance Regarding Significant Changes in the General Character of a State Member Bank's Business and Compliance with Regulation H (SR 02-9)

Regulation H sets forth the requirements for state chartered banks' membership in the Federal Reserve System and imposes certain conditions of membership on applicant banks. Under the regulation, a member bank must "at all times conduct its business and exercise its powers with due regard to safety and soundness" and "may not, without the permission of the Board, cause or permit any change in the general character of its business or in the scope of the corporate powers it exercises at the time of admission to membership." Please refer to 12 CFR 208.3(d)(1) and (2).

The purpose of this letter is to remind both Federal Reserve Bank examiners and state member banks of the requirement in Regulation H that state member banks must receive the prior approval of the Board before making any significant change in business plans. In view of the trend toward more diverse, complex and, at times, riskier activities of some banks, the prior approval requirements of Regulation H have become more important.

Changes in a Bank's Business

Changes in the general character of a bank's business would include, for example, becoming a primarily Internet-focused or Internet-only operation, or concentrating solely on subprime lending or leasing activities. These activities can present novel risks for banking organizations, depending on how they are conducted and managed, and may also present risks to the deposit insurance fund. In many cases, these activities involve aggressive growth plans and may give rise to significant financial, managerial, and other supervisory issues.

In applications for membership in the Federal Reserve System, careful consideration is given to a bank's proposed business plan in order to ensure, at a minimum, that appropriate financial and managerial standards are met. Likewise, the other federal banking agencies consider a bank's business plan when they review applications for federal deposit insurance, in the case of the FDIC, or a national bank or federal thrift charter, in the case of the OCC and OTS. The OCC, FDIC, and OTS have been conditioning their approvals of applications to require that, during the first three years of operations, the bank or thrift provide prior notice or obtain prior approval of any proposed significant deviations or changes from its original operating plan. Rather than using similar commitments, the Federal Reserve has relied on the provisions of Regulation H cited above in order to address situations where a state member bank proposes to materially change its core business plan.

Federal Reserve supervisors will be monitoring changes in the general character of the business of state member banks as part of the normal supervisory process to ensure compliance with the requirements of Regulation H and with safe and sound banking practices. This review should be conducted on at least an annual basis by the Federal Reserve Bank. A significant change in a bank's business plan without the Board's prior approval would be considered a violation of Regulation H and would be addressed through follow-up supervisory action.

Additional Information

All circulars and documents are available on the Internet through the Federal Reserve Bank of San Francisco's Internet site, at <http://www.frbsf.org/banking/letters>. Paper copies of the Board's notice (SR 02-7 and SR 02-9) are available from our Corporate Services Department. To request copies to be sent by mail, please call (415) 974-2060.

For additional information about **SR 02-7** only, please contact our Banking Supervision and Regulation Department at (415) 974-2936.

For additional information about **SR 02-9**, please contact our Banking Supervision and Regulation Department at (415) 974-3007.

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Enclosure