

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

May 7, 2003

**BANKING SUPERVISION AND REGULATION:
INSTITUTIONS IN TROUBLED CONDITION**

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

Guidance Regarding Restrictions on Institutions in Troubled Condition (SR 03-6)

It has come to the attention of the staff of the Division of Banking Supervision and Regulation that some state member banks and bank holding companies that are in less than satisfactory condition may not be aware of certain statutory restrictions on severance payments made to their institution-affiliated parties, which are referred to as “golden parachute” payments, and requirements regarding the appointment of new directors or senior executive officers that may apply to such institutions.¹ The purpose of this SR letter is to ensure that banking organizations subject to the restrictions are fully aware of them and have monitoring programs in place to ensure compliance with the statutory requirements regarding certain payments and appointments.

Troubled Condition

For Federal Reserve supervisory purposes, the restrictions described in this SR letter apply only to state member banks and bank holding companies that are in “troubled condition.” Section 225.71 of Regulation Y defines a “troubled condition” for a state member bank or bank holding company as an institution that (i) has a composite rating of 4 or 5; (ii) is subject to a cease and desist order or formal written agreement that requires action to improve the institution’s financial condition, unless otherwise informed in writing by the Federal Reserve; or (iii) is informed in writing by the Federal Reserve that it is in a troubled condition.

Except in some limited circumstances, cease and desist orders or written agreements issued by the Federal Reserve are aimed at improving the financial condition of the banking organization subject to the action. Therefore, most state member banks and bank holding companies subject to a formal enforcement action need to comply with the restrictions placed on troubled institutions by the federal laws and regulations that are described below.²

Golden Parachute Payments

“Golden parachute” payment restrictions were enacted as part of the Crime Control Act of 1990.³ The law added section 18(k) to the Federal Deposit Insurance Act (12 U.S.C. 1828(k)) and authorized the FDIC to issue implementing regulations. The FDIC’s golden parachute regulations may apply to an insured depository institution or its holding company if the institution or company is in a “troubled condition” as defined in Regulation Y. The purposes of the law and regulations include safeguarding the assets of financial institutions and limiting rewards to institution-affiliated parties who may have contributed to the institution’s condition.

¹ The term “institution-affiliated party” includes any officer, director, employee, and controlling stockholder, as well as others who participate in the affairs of a financial institution. The term is defined in the law at 12 U.S.C. 1813(u).

² Board staff, in consultation with Reserve Bank staff, will determine when a banking organization subject to a cease and desist order or written agreement will be advised that is not considered to be in a “troubled condition” due to the limited purpose or scope of the enforcement action.

In general, the FDIC's regulations prohibit insured depository institutions and their holding companies from making "golden parachute" payments except in certain circumstances.⁴ Under the FDIC's regulations, a "golden parachute" payment means any payment in the nature of compensation (or agreement to make such a payment) for the benefit of any current or former institution-affiliated party of an insured depository institution or its holding company that meets three criteria. First, the payment or agreement must be contingent upon the termination of the institution-affiliated party's employment or association. Second, the payment or agreement is received on or after, or made in contemplation of, among other things, a determination that the institution or holding company is in a "troubled condition" under the regulations of the applicable banking agency. Third, the payment or agreement must be payable to an institution-affiliated party who is terminated when the institution or holding company meets certain specific conditions, including being subject to a determination that it is in a troubled condition.

The definition of a "golden parachute" payment also covers a payment made by a bank holding company that is not in a troubled condition to an institution-affiliated party of an insured depository institution subsidiary that is in a troubled condition, if the other criteria in the definition are met. This circumstance may arise when a bank holding company, as part of an agreement to acquire a troubled bank or savings association, proposes to make payments to the troubled institution's institution-affiliated parties that are conditioned on their termination of employment.⁵

A state member bank or bank holding company may make or enter into an agreement to make a golden parachute payment only: (i) if the Federal Reserve, with the written concurrence of the FDIC, determines that the payment or agreement is permissible; (ii) as part of an agreement to hire competent management in certain conditions, with the consent of the Federal Reserve and the FDIC as to the amount and terms of the proposed payment; or (iii) pursuant to an agreement to provide a reasonable severance not to exceed twelve months' salary in the event of an unassisted change in control of the depository institution, with the consent of the Federal Reserve. In determining permissibility of the payment, the Federal Reserve may consider a variety of factors, including the individual's degree of managerial responsibilities, length of service, the reasonableness of the payment, and any other factors or circumstances that would indicate that the proposed payment would be contrary to the purposes of the statute or regulations.

A state member bank or bank holding company requesting approval to make a golden parachute payment or enter into an agreement to make such a payment should submit its request simultaneously to the appropriate FDIC regional office and Reserve Bank. The request must detail the proposed payments and demonstrate that the state member bank or bank holding company does not possess and is not aware of any evidence that there is reasonable basis to believe, at the time that the payment is proposed to be made, that the institution-affiliated party receiving such a payment has committed any fraud, breach of fiduciary duty, insider abuse, or materially violated any applicable banking law or regulation that had or is likely to have a material adverse affect on the bank or company, that the individual is substantially responsible for the institution's insolvency or troubled condition, and has violated specified banking or criminal laws.

In the event that a state member bank or bank holding company makes or enters into an agreement to make a golden parachute payment without prior regulatory approval when required, appropriate follow-up supervisory action should be taken. This could include an enforcement action requiring the offending institution-affiliated party to reimburse the institution for the amount of the prohibited

³ SR letter 90-38, dated December 5, 1990, generally describes the provisions of the Crime Control Act of 1990.

⁴ The full scope of the FDIC's golden parachute regulations is set out in 12 C.F.R. Part 359.

⁵ The FDIC's regulations exclude from the definition of a golden parachute payment several types of payments, such as payments made pursuant to a qualified pension or retirement plan, a benefit plan or bona fide deferred compensation plan (which are further defined in the FDIC's regulations), or a severance plan that provides benefits to all eligible employees, does not exceed the base compensation paid over the preceding twelve months, and otherwise meets the regulatory definition of nondiscriminatory and other conditions in the FDIC's regulations.

payment. Applications involving state member banks or bank holding companies with golden parachute-related issues identified in the supervisory process should be carefully reviewed by appropriate Reserve Bank and Board applications and supervisory staff for compliance with the law and the FDIC's regulations.

Appointment of Directors and Senior Executive Officers

Under section 32 of the Federal Deposit Insurance Act (12 U.S.C. 1831i) and Subpart H of Regulation Y (12 C.F.R. 225.71 *et seq.*), any state member bank or bank holding company that is in a troubled condition or does not meet minimum capital standards must provide 30 days' written notice to the Board of Governors prior to appointing any new director or senior executive officer.⁶ This requirement also applies to any change in the responsibilities of any current senior executive officer who is proposing to assume a different senior officer position. Subpart H of Regulation Y details the procedures for filing and the content of the notice. The Board may disapprove a notice if it finds that the competence, experience, character, or integrity of the proposed individual indicates that such service would not be in the best interest of the institution's depositors or the public. A disapproved individual or the institution that filed the notice may appeal the Federal Reserve's notice of disapproval under the procedures detailed in Regulation Y. The individual may not serve as a director or senior executive officer while the appeal is pending.

In the event that a state member bank or bank holding company that is in a troubled condition appoints a director or senior officer without the required 30 days' prior written notice, appropriate follow-up supervisory action should be taken.

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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 notice (**SR 03-6**) are available from our Corporate Services Department. To request copies to be sent by mail, please call (415) 974-2060.

For additional information about this matter, please contact our Banking Supervision and Regulation Department at (415) 974-2911.

FEDERAL RESERVE BANK OF SAN FRANCISCO

Cross Reference: SR letter 90-38

⁶ The Board or Reserve Bank may permit an individual to serve as a director or senior executive officer before a notice is provided under extraordinary circumstances; however, this does not affect the Federal Reserve's authority to disapprove a notice within 30 days of its filing.