

RFI RATING SYSTEM AUDIO CONFERENCE

Prepared Remarks

February 24, 2005, 2:00pm

Introduction

Speaker: Teresa Curran

Welcome to “Call the Fed”, the San Francisco Fed’s first audio conference on banking topics. I’m Teresa Curran, Group Vice President and Deputy for Banking Supervision and Regulation. The topic today is the new Bank Holding Company rating system, an important supervisory development that will affect how we rate holding companies.

Today’s conference call is part of our effort to reach out to bankers to help give you the information and skills that you need to successfully operate in today’s banking environment. Given the rapid pace of change, we feel it is more important than ever for the Federal Reserve to have open and timely communication with the banking community.

We are exploring additional ways to share our expertise and perspectives on banking issues. Educational forums—including calls like this—are a critical part of that effort. We want to engage in a robust dialogue with the banking community on emerging issues and risks, and work with bankers and other regulators to develop strong supervisory programs. We also are seeking feedback from you on how we can create more effective educational forums on emerging issues.

The San Francisco Fed has a number of resources that are available to you. At the end of this call, I will give more information about some of them. **But now, I would like to get right to the program.**

Today we are here to talk with you about the new Bank Holding Company rating system that has replaced the old BOPEC rating scheme as of January of this year. Ken Szyndel, Manager of the Surveillance and Analysis unit, will lead off and then turn the discussion over to Dave Reiser, Director in the Regional and Community Banking Group, and then Ken will wrap up. Then we will have time for your questions and answers. Ken...

Speaker: Ken Szyndel

Slide #1

Welcome everyone. Dave and I are very happy to have this opportunity to explain the new BHC rating system to you this afternoon. We will be referring to the slide presentation that was made available to everyone with the invitation to this meeting.

Our goal in this presentation is to provide you an overview of the RFI rating system and hopefully relieve you of any anxieties that you may have with the transition to the new rating system. We hope to accomplish this by showing you that:

- RFI is an enhancement of the BOPEC rating rather than a completely new rating scheme
- Therefore, much of BOPEC has been retained in the RFI system
- As a result, much of the difference in the two rating systems is more of terminology and a greater emphasis on certain factors rather than a wholesale change in what we evaluate
- The move to RFI should not have an effect on the conduct of inspections nor add to the supervisory burden of institutions
- Inspection frequencies are not changed
- The time spent on inspections and size of inspection teams should not change
- Areas reviewed during inspections will remain the same; however, the emphasis on certain rating aspects has been strengthened
- Finally, as is our current practice, the federal reserve will continue to rely on the work of the primary bank and other functional nonbank regulators when rating RFI components

With this as a foundation let's proceed with the presentation. We have allotted time at the end of our discussion for questions so we asked that you hold your queries until that time.

Slide#2

Please direct your attention to slide number 2 which covers the agenda for today's meeting. I will start the presentation by describing the factors that led the Federal Reserve to change its BOPEC rating system and provide you with some information about the number of BHCs in the district and the ratings they will receive. Dave will then cover the middle two points and go into detail on each of the components and subcomponents of RFI and will continue his discussion by demonstrating how the old BOPEC rating maps into the new RFI rating system.

I will then close the presentation by briefly talking about what we are doing to increase the knowledge and understanding of the application of the RFI rating system and discuss certain implementation aspects of the transition to the RFI rating.

Slide #3

Please move to slide #3. The Federal Reserve has been working on a proposal to change the BHC rating system for a number of years, with the most recent effort starting about a year and a half ago. The RFI rating system was developed by a working group that consisted of representatives from the board supervision operations for large and small companies sections, the board policy section, and reserve bank supervision for both large and small BHC populations. Finally, the new rating system was vetted through senior management at all reserve banks.

The main goal of the change was to bring the rating system in line with the Federal Reserve's current supervisory practices. This is accomplished by emphasizing risk management and allowing more flexibility in our assessment of financial factors. The new system also addresses our view of the potential impact of nondepository entities on subsidiary depository institutions.

As you may be aware, the BOPEC/f-m rating was developed in 1979 and consisted of:

B-Banks

O-Other nonbank subsidiaries

P- Parent company

E-Consolidated earnings

C- Consolidated capital

As well as a financial composite and managerial composite rating

Now it may not be obvious from these components but the old BOPEC rating was based on an assessment of the historical financial condition and managerial strength of each legal entity within the organization.

The BOPEC rating served its purpose very well until some wholesale changes were introduced into the banking industry which made the industry more complex. To address these changes we shifted the focus of our supervisory practices for bank holding companies of all sizes from a point-in-time historical analysis of financial condition toward more forward looking assessments of risk management practices and financial factors.

A major push in this direction was the introduction of a rating for bank holding company risk management which was added to the BOPEC in 1995. However, at that time it was not a central focus of the rating system as we were not exactly sure how to balance this concept into our overall assessment of an institution. Therefore, risk management was used only as a side rating.

Over the years since 1995 our knowledge of the focus on risk management increased and the focus on forward looking assessments of financial factors in our supervisory practices became more pronounced as regulators and bankers realized that the ability to recognize and control risks was critical to the ongoing viability and financial health of an institution.

Additionally, over this period of time we also saw an expansion of banking powers and a corresponding increase in the number of FHCs including the growth in the depth and volume of activities being conducted by the parent and/or nonbank subsidiaries. We also saw the development of a number of nontraditional BHCs where the subsidiary bank was only a small portion of the institution. As activities outside the banking subsidiaries became more dominant we saw the need to explicitly assess the impact that these activities could have on the financial condition of banks, thereby creating the “I” component as a separate rating.

Also as these industry changes became more numerous we discovered that it became harder and harder to squeeze our evolving supervisory practices into the BOPEC framework. So in order to address this growing gap, we developed a revised bank holding company rating system in order to address the factors I just discussed.

The new RFI rating system also helps to address an inefficiency of the BOPEC rating process as it applies to our largest and most complex companies because BOPEC lacked a strong enough emphasis on risk management. As a result, the BOPEC framework proved to be an inadequate platform to communicate our supervisory concerns regarding risk issues with the management of our institutions.

Finally, the heavy focus on legal entities in the BOPEC rating made it increasingly difficult to apply it to companies that manage their operations across business and product lines.

Because the RFI rating system was specifically created to address the existing gap between supervisory focus and the focus of the BOPEC rating, the new RFI rating is not intended to introduce additional burden to the supervisory program for any institution.

Slide#4

This brings us to slide #4 and concludes our review of the factors that led to the change in how we rate holding companies and we are now ready to discuss the actual elements of the RFI rating system and see which types of BHCs may be most affected by the new rating.

Slide#5

As we move to slide #5 you can see a substantial number of BHCs in this district fall under the small BHC program which consists of noncomplex institutions with assets of \$1 billion or less.

As a reminder, complexity is determined by the size and structure of the holding company, the extent of intercompany transactions, the nature and scale of nonbank activities, the consolidation of risk management processes at the holding company, and whether the holding company has material debt outstanding to the public.

Small noncomplex companies have been receiving a simplified BOPEC rating, consisting of only a management and composite rating, for the past several years.

In this district we have 277 BHCs of which 216 are monitored under the small BHC program. Nationwide almost 90% of BHCs fall under the small BHC program.

Slide #6

Continuing to slide #6 we see that the RFI rating represents no change for small noncomplex BHCs from the perspective of the federal reserve or the bank's primary regulator.

These companies will continue to receive an abbreviated rating as they did under the BOPEC rating system which was primarily based on the results of the subsidiary bank examination. This does not change under the current policy, as the r rating will reflect the management rating from the subsidiary depository institution's camels rating, and the c will reflect the composite camels rating.

With regard to small BHCs, the federal reserve bank of San Francisco continues to receive bank reports from the various state agencies, the FDIC, and the OCC. We then review these reports for potential issues affecting the parent company and in conjunction with our off-site monitoring process will assign the r and the c rating for the BHC and convey these ratings to the bank holding company via a transmittal letter. In practically all cases this entire review process is accomplished off-site; however, in very rare instances there are times when we do go on-site to obtain information needed to complete the inspection.

Dave will now address each of these factors and components in further detail.

Speaker: David Reiser

Slide #7

I will start with slide 7 and discuss in more detail the rating system for companies that are complex or over \$1 billion in total assets. These are companies where we previously assigned full BOPEC ratings.

As Ken previously mentioned, most Bank Holding Companies in the 12th District fall under the small bank supervision program. However, we do have 61 companies whose size exceeds \$1 billion in assets or who have been designated as having complex operations. For these larger and more complex companies we will be assigning the full RFI ratings.

The new rating system, which incorporates the goal of elevating risk management, consists of an overall "R" for Risk Management, "F" for Financial Condition, "I" for Impact and "C" for the Composite rating. The rating also contains a "D" rating, which replaces the B in the BOPEC rating system.

As we discuss each of the rating components and subcomponents in greater detail you will see that, in addition to retaining the B rating, the new system contains all the elements of the BOPEC rating, but adds additional areas of focus and shifts the emphasis somewhat.

Slide #8

Slide 8 highlights the key elements of the “R” rating, which serves as an overall evaluation of the competency of management and the board of directors, and their ability to manage risk. This includes management’s responsiveness and ability to address emerging problems, as well as their knowledge of laws and regulations. It is a forward looking assessment and an important component of the supervisory approach embodied in the Basel II capital accord.

The “R” rating also underscores the importance of an organization’s control environment and takes into consideration the financial complexity and strength of the organization, and the risk inherent in its activities.

As noted on the slide, the “R” component has four subcomponents, each of which will be assigned a rating of 1 – 5. Each subcomponent will be evaluated in the context of the inherent risks and complexity of the organization. The weighting afforded to a particular subcomponent when assigning the rating for “R” will depend on its relative importance and severity of any issues identified.

I will briefly touch on some of the factors that we will review to assess each of these R subcomponent ratings.

For Board and management oversight, we will assess the effectiveness, competence and capabilities of each group, including their ability to understand risks undertaken, hire competent staff, and respond to any changes in the institution’s risk profile or operating environment.

For the assessment of policies, procedures and limits, we will focus on the appropriateness of the stated policies, procedures and limits given the inherent risk and stated goals and objectives of the organization. This review will also include an assessment of the adequacy of accounting and disclosure policies.

In rating Risk Monitoring and MIS, we will consider areas such as the assumptions, data and procedures used to measure risk, the adequacy of reports to management and the Board, and the effectiveness and consistency of tools employed in relation to complexity and risks undertaken.

For the internal control subcomponent, we will evaluate the effectiveness of the internal control program and audit procedures and scope to ensure that they are consistent with the size and complexity of the organization. We will also assess the accuracy of financial reporting and disclosure, and the strength of the audit team.

Slide #9

Slide 9 highlights the “F” component which evaluates the consolidated organization’s financial condition and focuses on the BHC’s ability to support the level of risk associated

with its activities. It encompasses a review of the financial issues at the parent company and all subsidiaries.

The four subcomponents can be evaluated along individual business lines, product lines or legal entities. For all but the very large and complex BHCs in the 12th District, we expect to assess the consolidated CAEL on a legal entity basis. While the subcomponents are focused on the current condition of the organization, examiners will also consider the adequacy of practices, such as credit underwriting and IRR management, and the extent to which those practices may be an indicator that one (or more) of the CAEL areas is likely to deteriorate.

Similar to the “R” analysis, the weighting afforded to a particular “F” subcomponent will depend on its relative importance and severity of issues identified.

I would also like to note that one of the CAMELS components, specifically the S, is not captured in the new “F” component rating. Since Sensitivity to market risk is considered to be an aspect of risk management, it is analyzed under the “R” rating, similar to the organization’s sensitivity to other types of risks.

Next I will touch on some of the specific factors that we will review in the CAEL subcomponents assessments.

We will evaluate Capital similar to our assessment in the prior BOPEC system. The Capital rating will reflect the quality of the organization’s consolidated capital position in relation to its risk profile. In addition, will review and assess the adequacy of regulatory and economic capital, as appropriate, while also considering the distribution of capital, transferability, and the ability of capital to absorb unanticipated losses. We also assess capital support in relation to the level and composition of parent and subsidiary debt.

Asset quality is now formally rated where in the past it was not. This rating reflects the consolidated organization’s assets and will include areas such as on and off balance sheet exposures, the level and trend of criticized and nonperforming assets, and the level of concentration risk in the organization.

The factors and areas reviewed for the Earnings subcomponent rating will also be similar to our approach in the BOPEC system. Key areas of focus will be the level, trend, and sources of earnings, as well as earnings’ stability and its ability to augment capital.

The Consolidated Liquidity rating reflects the organization’s ability to attract and maintain the sources of funds necessary to support its operations and meet its obligations. In assessing liquidity, we will review any funding weaknesses at any material legal entity that could affect the overall funding profile of the consolidated organization or subsidiary depository institutions.

Slide #10

Next I want to discuss the “I” rating component which is on Slide 10. While this is a new rating, the Fed had previously captured the impact that the parent and other nonbanking subsidiaries had on the depository institutions under the O and P components of BOPEC.

In rating the “I” or Impact area, examiners will consider both current and forward looking indicators relating to risk management practices and financial condition, and will borrow heavily from the analysis conducted for the “R” and the “F” components.

In assessing the risk management practices and how they impact insured depositories, examiners will consider how the BHC and nonbank subsidiaries manage risk. Some the risks and areas we will review include:

- Strategic considerations such as plans for growth in existing businesses and expansion into new businesses, products or services;
- Operational considerations such as the spillover effect of operational losses or a poor control environment in the nondepositories onto the depository entities;
- Legal and reputational considerations such as the spillover effect of complaints and litigation;
- And concentration issues such as nondepository concentrations in business lines, geographic areas, industries, or the customer base

Examiners will also consider a number of financial factors in assigning the “I” rating, such as:

- How capital is distributed among the various legal entities;
- Intra-group exposures, such as servicing agreements, credit concentrations; and derivative and payment exposures; and
- Parent company cash flow and leverage

Slide #11

Moving to Slide 11 you will see that the “I” component is rated on the traditional five point scale. However, the descriptions differ and focus on the likelihood of a negative impact. This is consistent with the Fed’s historical view that BHCs are expected to serve as a source of financial and managerial strength to their insured depository institutions.

As noted, the ratings range from low to high likelihood of significant negative impact. In other words, examiners will focus on weaknesses at the BHC and nonbank subsidiaries that could directly impact the affiliated insured depositories.

Slide #12

Slide 12 highlights the “C” composite rating. This rating encompasses both a forward looking and static assessment of the consolidated organization, as well as an assessment of the relationship between the depository and nonbank entities.

The Composite rating incorporates the R, F, and I component ratings and the weight of each depends on the circumstances of each individual company.

The Composite is also rated on the five point scale previously discussed.

As noted, the “D” stands for depository institutions. While the Bank or B rating was previously a large part of BOPEC, under the new system it is not included in the Composite rating and is retained only as a reference rating. This is because the risk management and financial condition of the subsidiary depository institutions are now assessed as part of the “R” and “F” component ratings.

The “D” component is also rated on a five point scale and will generally reflect the Composite CAMELS rating assigned by the primary regulator. The “D” rating may differ and reflect the Federal Reserve’s evaluation, but this likely to occur infrequently.

Slides #13 and #14

Next I would like to briefly summarize and compare the old BOPEC and new rating system and this is captured in Slide 14.

First, as noted before, the new system includes all elements of the prior BOPEC rating system. But it also shifts the emphasis by more explicitly focusing on Risk Management. It is also more forward looking.

Aspects of the system that are the same include the Bank rating which is now equivalent to the D or depository institution rating.

The consolidated earnings and capital ratings, the E and C in the BOPEC system, are now captured as subcomponents under the F or financial condition component.

As Ken noted, for small Bank Holding Companies the rating process and factors rated are the same, but the terminology is different.

Slide #15

Slide 15 highlights the key differences between the two rating systems.

First, we have added new components to capture consolidated risk management (the R rating) and the consolidated financial condition (the F rating).

The R rating is now much broader than the prior Management rating and focuses more on a forward looking assessment. The rating also more closely aligns with the Fed's prior Risk Management rating which was a separate rating assigned in conjunction with the BOPEC system.

For the F rating we have explicitly incorporated both asset quality and liquidity – in BOPEC these financial factors were not formally assessed.

As previously stated, a significant change is the addition of a rating for Impact or the "I" rating. This rating is intended to give a clear indication of the degree of risk posed by nondepository institutions to the federal safety net.

The last significant difference is that the composite rating incorporates both financial and risk management factors. Under the BOPEC system, we rated these separately.

Ken will now discuss the Implementation process for the new rating system.

Slide #16

Thanks Dave. We are now at slide #16. At this point I will discuss how you can continue to keep informed on the RFI rating as it is implemented during the remainder of 2005. Currently, we have begun issuing the simplified RFI rating for noncomplex companies and will do the same for the large and/or complex companies at their next inspection.

Slide #17

Please direct your attention to Slide #17. The BHC website referred to here is an online reference tool geared to bankers and other parties interested in information on the recent rating system change and includes many of the items covered in this presentation such as:

- Why the rating system changed
- Details about the new rating system
- What's the same and what's different about the new rating system

Two areas of the site that I think you will find most helpful are the sections for:

- Frequently asked questions about the rating system
- And "ask" the expert feature where you can submit any questions that you might have concerning RFI.

You should also know that all BHCs and state member banks in this district have been assigned to a central point of contact and this person should be viewed as a resource on the new rating system. Please feel free to contact them with any specific questions regarding RFI as it may apply to your institution.

Slide #18

Please move to slide #18. Implementation of the new rating system for small BHCs is expected to be very straightforward. As previously mentioned with regard to small BHCs we will continue to review bank reports for potential BHC issues, rely on our monitoring system, exception reporting, and financial screens to identify parent activities that could be harmful to their subsidiary banks and send out transmittal letters providing the R and C rating. The bank exam will continue to drive the ratings for these types of companies.

The scenario is similar for mid-sized, non-complex companies where again we will also continue to rely on the work of primary regulators to assign the r and f ratings. The “I” rating will be assessed independently.

Once again the work of functional and primary bank regulators is also an integral part of our assessment of complex companies and non-traditional holding companies and their findings will be used by us to derive the r and f ratings. However, we will conduct independent assessments for the I rating, for risk management conducted by the parent and non-functionally regulated bank subsidiaries, or for any risk management functions as they relate to a subsidiary depository institution.

Slide #19

We are now at slide #19. We expect the new rating system to present some challenges in applying any of the component ratings in RFI. To minimize this, the Federal Reserve has issued rating guidelines for each component and subcomponent of RFI to ensure consistency in the application of the rating system. We have also held many training sessions with field staff to explain the technical aspects of the RFI rating system.

Additionally, each reserve bank has identified a specific contact person to track the implementation of the RFI rating system and provide feedback on any issues encountered in implementing the new rating system to staff at the board of governors.

Slide #20

This brings us to the last slide of the presentation.

Obviously, the easiest holding company for us to evaluate are those where the subsidiary bank is a member of the federal reserve system as we then control the entire review process and determine the depth and breadth of areas subject to review.

Admittedly, implementing the RFI rating becomes more challenging for BHCs that have non-state member banks or where certain aspects of their activities or operations are governed by other functional regulators.

In situations where there are information or analysis gaps because of the structure of the BHC, that make it difficult to complete an RFI assessment, we will attempt to eliminate the gap and obtain the necessary information:

- First studying the scope of an examination or review, considering information within any reports generated from an examination or review, and reviewing work papers associated with these examinations or reviews.
- Secondly we will hold discussions with the primary or functional regulator concerning our need for certain information.
- Finally, we will conduct coordinated reviews with other regulators as appropriate to obtain the information needed to complete the RFI assessment.

Our experience in piloting the RFI rating has indicated that in most cases we will be able to obtain the information needed to assign the RFI rating without having to conduct coordinated reviews.

Question and Answer Session

Wrap-up of Fed Audio Conference Call

Speaker: Teresa Curran

Thank you, Ken and Dave, for your presentation. To our callers, we thank you for your participation and hope you have found this information to be useful. If you would like to learn more about this topic, you will find additional information posted on our website.

Speaking of our website, I mentioned earlier that I wanted to tell you a little bit about some of the resources we have that are available to you, and I want to spend a couple of minutes on that.

We have enhanced our public Web site and made it more user-friendly. If you haven't seen it lately, I highly recommend that you go to www.frbsf.org and check it out. Again, that's www.frbsf.org.

Under Banking Information, you will find helpful publications, such as *On the Radar Screen*. If you haven't already done so, I encourage you to subscribe to receive email notification of our publications. It's easy and you can choose which publications and letters you want to receive. You might be interested in *On the Radar Screen*, or the *12th District Banking Profile*, or perhaps the *Community Investments Newsletters*.

At our website, you will also find a wealth of resources for bank directors and managers, such as on-line training for bank directors. At the San Francisco Fed, we recognize that the directors' role is more demanding than ever before. I think you will find this on-line director training to be helpful for your directors. It complements other educational and training efforts. And it is convenient, since you can choose the time and place that best suits you and your laptop. There are modules on bank director responsibilities, financial statements, loans and similar topics, along with case studies. You can find the link to the on-line training web site under Banking Information/Banking Resources at www.frbsf.org .

Our website also provides links to Federal Reserve System sites, such as "Ask the Expert" (which Ken Szyndel mentioned) that gives you the opportunity to ask questions.

Your feedback is important to us. Tell us which resources on the website are useful to you. Tell us what trends are important to the banking community. Tell us about the issues that concern you the most.

And since this conference call is a new approach for us, we are interested in your feedback on today's call. Please send your ideas, comments, and questions to us at

SF.BSR.FedAudioConference@sf.frb.org

Again, that is [SF.BSR. FedAudioConference \(all one word\) @sf.frb.org](mailto:SF.BSR.FedAudioConference@sf.frb.org). Let us know if you have topics you would like addressed in the future. And please check the "Quick Pick" at our web site to access the Events page for information on future events and conference calls.

Again, thank you all for your participation. We are adjourned.