

# FEDERAL RESERVE BANK OF SAN FRANCISCO

101 MARKET STREET, SAN FRANCISCO, CALIFORNIA

December 20, 2004

## **BANKING SUPERVISION AND REGULATION: BANK HOLDING COMPANY RATING SYSTEM**

To State Member Banks, Bank  
Holding Companies, U.S. Branches  
and Agencies of Foreign Banks,  
and Others Concerned,  
in the Twelfth Federal Reserve District

### **Bank Holding Company Rating System (SR 04-18)**

To more closely align the supervisory rating system for bank holding companies (BHCs), including financial holding companies, with the Federal Reserve's current supervisory practices, on December 1, 2004, the Board of Governors approved for System-wide implementation the attached revised BHC rating system. The revised rating system becomes effective January 1, 2005 and is to be used for all inspections commencing after that date. For inspections opened in 2004 and closed in 2005, Reserve Banks may assign either the BOPEC rating or the revised rating.

### **Background**

The increased complexity of the U.S. banking industry has necessitated a shift over time in the focus of the Federal Reserve's supervisory practices for BHCs away from historical analyses of financial condition toward more forward-looking assessments of risk management and financial factors. While the Federal Reserve has a well-established emphasis on risk management in its supervisory processes for BHCs of all sizes, which it re-enforced through the introduction of a risk management rating for all BHCs in the mid-1990s, the primary components of the BHC supervisory rating system known as BOPEC (Bank subsidiaries, Other subsidiaries, Parent, Earnings, Capital) do not directly reflect this emphasis. To align more closely the ratings with the supervisory processes, the Federal Reserve has developed a revised BHC rating system that emphasizes risk management; introduces a more comprehensive and adaptable framework for analyzing and rating financial factors; and provides a framework for assessing and rating the potential impact of the parent holding company and its nondepository subsidiaries on the subsidiary depository institution(s).

Because the revised rating system is consistent with current supervisory practices, the revisions generally should not have an effect on the conduct of inspections, nor add to the supervisory burden of supervised institutions. Rather, the revised rating system will better communicate the supervisory findings of examination staff to both supervised institutions and System staff. In addition, the Federal Reserve will continue to rely to the greatest possible extent on the work of the primary bank and other functional nonbank regulators. The new rating system is not intended to signal any shift in this practice.

### **Revisions to the Rating System**

Each BHC is assigned a composite rating (C) based on an evaluation and rating of its managerial and financial condition and an assessment of future potential risk to its subsidiary depository institution(s). The main components of the rating system represent: Risk Management (R); Financial Condition (F); and Potential Impact (I) of the parent company and nondepository subsidiaries (collectively nondepository entities) on the subsidiary depository institution(s). While all BHCs are

required to act as sources of strength to their subsidiary depository institutions, pursuant to the Board's rules and policies, the Impact rating focuses on downside risk—that is, on the likelihood of significant negative impact on the subsidiary depository institutions. A fourth component rating, Depository Institution (D), will generally mirror the primary regulator's assessment of the subsidiary depository institution(s), as has been the case for the Bank (B) rating under the BOPEC rating system. Thus, the primary component and composite ratings are displayed:

### **R F I / C (D)**

In order to provide a consistent framework for assessing risk management, the R component is supported by four subcomponents that reflect the effectiveness of the banking organization's risk management and controls. The subcomponents are: Board and Senior Management Oversight; Policies, Procedures, and Limits; Risk Monitoring and Management Information Systems; and Internal Controls. The F component is similarly supported by four subcomponents reflecting an assessment of the quality of the banking organization's Capital; Asset Quality; Earnings; and Liquidity. A simplified version of the rating system that requires only the assignment of the risk management component rating and composite rating will be applied to noncomplex BHCs with assets below \$1 billion.

Composite, component, and subcomponent ratings are assigned based on a 1 to 5 numeric scale. A 1 indicates the highest rating, strongest performance and practices, and least degree of supervisory concern; a 5 indicates the lowest rating, weakest performance, and highest degree of supervisory concern.

The Federal Reserve recognizes the interrelationship between the risk management and financial performance components of the revised rating system, an interrelationship that is inherent in all supervisory rating systems. Accordingly, examiners are expected to consider that a risk management factor may have a bearing on the assessment of a financial subcomponent or component rating and vice versa. In general, however, the risk management component and subcomponents should be viewed as the more forward-looking aspect of the rating system, and the financial condition component and subcomponents should be viewed as the current aspect of the rating system. For example, a BHC's ability to monitor and manage market risk (or sensitivity to market risk) should be evaluated together with the organization's ability to monitor and manage all risks under the R component of the rating system. However, poor market risk management may also be reflected in the F component if it impacts earnings or capital.

### **Implementation**

The revised BHC rating system will be implemented on January 1, 2005. Although the timing of implementation is relatively close to the December 1 release of the final rating system, the revised rating system was developed and reviewed over several years with participation from a wide range of Federal Reserve System supervision and examination staff, so the new system has a high degree of familiarity. Because the revised BHC rating system incorporates factors that examiners have been routinely considered for many years in evaluating a BHC's condition, the revised rating system should not have a significant effect on the conduct of inspections or impose additional regulatory burden on supervised institutions. Supervision and examination staff at all twelve Federal Reserve Banks and the Board of Governors have received and will continue to receive training in the revised rating system.

Over the course of the first inspection cycle under the revised rating system, as Federal Reserve Banks implement and gain experience with the revised rating system, Federal Reserve Bank senior management should be prepared to discuss implementation issues and difficult rating scenarios (including any rating situation involving a downgrade of a BHC) with Board staff and, as appropriate, with the relevant Strategic Plan Steering Committee management groups. Board staff and designated contacts at each Federal Reserve Bank will serve as a resource on the revised rating system and will collect feedback on its implementation.

All of the BHC numeric ratings, including the composite, component, and subcomponent ratings, should be presented in the report of inspection, in accordance with the Federal Reserve's current supervisory practices. The management of each BHC under inspection should be made aware of the fact that this rating is furnished solely for its confidential use and under no circumstances should the BHC or any of its directors, officers, or employees disclose or make public any of the ratings. Of course, as a result of the introduction of risk management and other components and subcomponents, the ratings of some BHCs may increase or decrease due to the change in the rating system. Examiners should help BHC management understand the revised rating system and the basis for all assigned ratings. Moreover, during the first inspection cycle under the revised rating system, examiners should be prepared to discuss with senior BHC management the new ratings and how they compare with the BOPEC ratings for that institution. The appeals process for material supervisory determinations remains unchanged.

Certain SR letters refer to a BHC's BOPEC composite or component rating in determining its status for certain supervisory policies, e.g., inspection frequency. For purposes of those policies, the composite rating of the revised rating system may be substituted for the BOPEC composite rating referenced in the SR letters, the capital subcomponent may be substituted for the BOPEC capital component, and the depository institution component may be substituted for the BOPEC bank component.

In addition, "well managed" BHCs enjoy a variety of privileges under the Board's Regulations K, W, and Y. These regulations generally define a well-managed BHC as a BHC with a satisfactory composite rating and a satisfactory management rating. See 12 CFR 211.2(z) and 225.2(s). For purposes of these regulatory definitions of a "well managed" BHC, Board staff views the R component rating under the revised rating system to be the management rating of a BHC.<sup>1</sup>

This SR letter supersedes SR letter 79-530, "Bank Holding Company Rating System" and partially supersedes SR letter 95-51, "Rating the Adequacy of Risk Management Processes and Internal Controls at State Member Banks and Bank Holding Companies," and SR letter 02-1, "Revisions to Bank Holding Company Supervision Procedures for Organizations with Total Consolidated Assets of \$5 Billion or Less."<sup>2</sup>

### **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>.

For additional information about the revised Bank Holding Company rating system, please contact our Banking Supervision and Regulation Department at (415) 974-2821.

## FEDERAL RESERVE BANK OF SAN FRANCISCO

### ***Attachment: Bank Holding Company Rating System***

Supersedes: SR letter 79-530

Partially supersedes: SR letters 95-51, 02-1

Cross-references: SR letters 99-17, 99-15, 98-29, 97-27, 97-21, 96-26, 96-14, 95-30, 95-19, 95-13, 95-12

#### Notes:

1 Board staff would continue to view a BHC's M rating under the BOPEC/F-M rating system to be the management rating of the BHC until such time as the BHC has been rated under the revised rating system.

2 The risk management rating described in SR 95-51 is rescinded for all BHCs, and the abbreviated rating system described in SR 02-01 is rescinded for small shell BHCs.