
WHAT'S NEW IN THIS REVISED SECTION

Effective January 2015, footnote 5 of this section was revised to delete a reference to SR-99-15, which was superseded by SR-12-17/CA-12-14, "Consolidated Supervision Framework for Large Financial Institutions."

On December 1, 2004, the Board of Governors approved for System-wide implementation a revised bank holding company (BHC) rating system to more closely align the supervisory rating system for BHCs, including financial holding companies, with the Federal Reserve's current supervisory practices.¹ The revised rating system became effective January 1, 2005, and is to be used for all inspections commencing after that date.

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 (I) 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). Thus, the primary component and composite ratings are displayed:

RFI/C(D)

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 MIS; 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. (See SR-04-18 and its attachment.)

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 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.

1. The Federal Reserve System's previous BHC rating system was the BOPEC rating system. The components of the name represented the Bank, Other nonbank subsidiaries, Parent company, Earnings, and Capital.

4070.0.1 THE BANK HOLDING COMPANY RFI/C(D) RATING SYSTEM

The bank holding company (BHC) rating system provides an assessment of certain risk-management and financial-condition factors that are common to all BHCs, as well as an assessment of the potential impact of the parent BHC and its nondepository subsidiaries (collectively nondepository entities) on the BHC's subsidiary depository institutions. Under this system, the Federal Reserve endeavors to ensure that all BHCs, including financial holding companies (FHCs), are evaluated in a comprehensive and uniform manner, and that supervisory attention is appropriately focused on the BHCs that exhibit financial and operational weaknesses or adverse trends. The rating system serves as a useful vehicle for identifying problem or deteriorating BHCs, as well as for categorizing BHCs with deficiencies in particular areas. Further, the rating system assists the Federal Reserve in following safety-and-soundness trends and in assessing the aggregate strength and soundness of the financial industry.

Each BHC² is assigned a composite rating "C" based on an overall 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 nondepository entities on the subsidiary depository institutions. While the Federal Reserve expects all BHCs to act as a source of strength to their subsidiary depository institutions, the Impact (I) rating focuses on downside risk—that is, on the likelihood of significant negative impact by the nondepository entities on the subsidiary depository institution(s). A fourth rating, Depository institution(s) (D), will generally mirror the primary regulator's assessment of the subsidiary depository institution(s). Thus, the primary component and composite ratings are displayed:

RFI/C(D)

To provide a consistent framework for assessing risk management, the R component is sup-

ported 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 MIS; and internal controls. The F component is also supported by four subcomponents reflecting an assessment of the quality of the consolidated banking organization's capital, asset quality, earnings, and liquidity.

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

The following three sections contain detailed descriptions of the composite, component, and subcomponent ratings; implementation guidance by BHC type; and definitions of the ratings.

4070.0.2 DESCRIPTION OF THE RATING-SYSTEM ELEMENTS

4070.0.2.1 The Composite (C) Rating

"C" is the overall composite assessment of the BHC as reflected by consolidated risk management, consolidated financial strength, and the potential impact of the nondepository entities on the subsidiary depository institutions. The composite 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 nondepository entities. Consistent with current Federal Reserve practice, the C rating is not derived as a simple numeric average of the R, F, and I components; rather, it reflects examiner judgment with respect to the relative importance of each component to the safe and sound operation of the BHC.

4070.0.2.2 The Risk-Management (R) Component

"R" represents an evaluation of the ability of the BHC's board of directors and senior management, as appropriate for their respective positions, to identify, measure, monitor, and control risk. The R rating underscores the importance of the control environment, taking into consideration the complexity of the organization and the risk inherent in its activities.

2. A simplified version of the rating system that includes only the R and C components will be applied to noncomplex bank holding companies with assets at or below \$1 billion.

The R rating is supported by four subcomponents that are each assigned a separate rating. The four subcomponents are as follows: (1) board and senior management oversight; (2) policies, procedures, and limits; (3) risk monitoring and MIS; and (4) internal controls. The subcomponents are evaluated in the context of the risks undertaken by and inherent in a banking organization and the overall level of complexity of the firm's operations. They provide the Federal Reserve System with a consistent framework for evaluating risk management and the control environment. Moreover, the subcomponents provide a clear structure and basis for discussion of the R rating with BHC management, reflect the principles of SR-95-51, are familiar to examiners, and parallel the existing risk-assessment process. SR-95-51 contains a detailed description of the four risk-management subcomponents.

4070.0.2.2.1 Risk-Management Subcomponents

4070.0.2.2.1.1 Board and Senior Management Oversight

This subcomponent evaluates the adequacy and effectiveness of board and senior management's understanding and management of risk inherent in the BHC's activities, as well as the general capabilities of management. It also includes consideration of management's ability to identify, understand, and control the risks undertaken by the institution, to hire competent staff, and to respond to changes in the institution's risk profile or innovations in the banking sector.

4070.0.2.2.1.2 Policies, Procedures, and Limits

This subcomponent evaluates the adequacy of a BHC's policies, procedures, and limits given the risks inherent in the activities of the consolidated BHC and the organization's stated goals and objectives. This analysis will include consideration of the adequacy of the institution's accounting and risk-disclosure policies and procedures.

4070.0.2.2.1.3 Risk Monitoring and Management Information Systems

This subcomponent assesses the adequacy of a BHC's risk measurement and monitoring, and the adequacy of its management reports and information systems. This analysis will include

a review of the assumptions, data, and procedures used to measure risk and the consistency of these tools with the level of complexity of the organization's activities.

4070.0.2.2.1.4 Internal Controls

This subcomponent evaluates the adequacy of a BHC's internal controls and internal audit procedures, including the accuracy of financial reporting and disclosure and the strength and influence of the internal audit team within the organization. This analysis will also include a review of the independence of control areas from management and the consistency of the scope coverage of the internal audit team with the complexity of the organization.

4070.0.2.3 The Financial-Condition (F) Component

"F" represents an evaluation of the consolidated organization's financial strength. The F rating focuses on the ability of the BHC's resources to support the level of risk associated with its activities. The F rating is supported by four subcomponents: capital (C), asset quality (A), earnings (E), and liquidity (L). The CAEL subcomponents can be evaluated along individual business lines, product lines, or on a legal-entity basis, depending on what is most appropriate given the structure of the organization. The assessment of the CAEL components should use benchmarks and metrics appropriate to the business activity being evaluated.

Consistent with current supervisory practices, examination staff should continue to review relevant market indicators, such as external debt ratings, credit spreads, debt and equity prices, and qualitative rating-agency assessments as a source of information complementary to examination findings.

4070.0.2.3.1 Financial-Condition Subcomponents (CAEL)

4070.0.2.3.1.1 Capital Adequacy

"C" reflects the adequacy of an organization's consolidated capital position, from a regulatory capital perspective and an economic capital per-

spective, as appropriate to the BHC.³ The evaluation of capital adequacy should consider the risk inherent in an organization's activities and the ability of capital to absorb unanticipated losses, to provide a base for growth, and to support the level and composition of the parent company and subsidiaries' debt.

4070.0.2.3.1.2 Asset Quality

"A" reflects the quality of an organization's consolidated assets. The evaluation should include, as appropriate, both on-balance-sheet and off-balance-sheet exposures and the level of criticized and nonperforming assets. Forward-looking indicators of asset quality, such as the adequacy of underwriting standards, the level of concentration risk, the adequacy of credit-administration policies and procedures, and the adequacy of MIS for credit risk, may also form the Federal Reserve's view of asset quality.

4070.0.2.3.1.3 Earnings

"E" reflects the quality of consolidated earnings. The evaluation considers the level, trend, and sources of earnings, as well as the ability of earnings to augment capital as necessary to provide ongoing support for a BHC's activities.

4070.0.2.3.1.4 Liquidity

"L" reflects the consolidated organization's ability to attract and maintain the sources of funds necessary to support its operations and meet its obligations. The funding conditions for each of the material legal entities in the holding company structure should be evaluated to determine if any weaknesses exist that could affect the funding profile of the consolidated organization.

4070.0.2.4 The Impact (I) Component

Like the other components and subcomponents, the I component is rated on a five-point numerical scale. However, the descriptive definitions of the numerical ratings for I are different than

those of the other components and subcomponents. The I ratings are defined as follows:

- 1 — low likelihood of significant negative impact
- 2 — limited likelihood of significant negative impact
- 3 — moderate likelihood of significant negative impact
- 4 — considerable likelihood of significant negative impact
- 5 — high likelihood of significant negative impact

The I component is an assessment of the potential impact of the nondepository entities on the subsidiary depository institution(s). The I assessment will evaluate both the risk-management practices and financial condition of the nondepository entities—an analysis that will borrow heavily from the analysis conducted for the R and F components. Consistent with current practices, nondepository entities will be evaluated using benchmarks and analysis appropriate for those businesses. In addition, for functionally regulated nondepository subsidiaries, examination staff will continue to rely, to the extent possible, on the work of those functional regulators to assess the risk management practices and financial condition of those entities. In rating the I component, examination staff is required to evaluate the degree to which current or potential issues within the nondepository entities present a threat to the safety and soundness of the subsidiary depository institution(s). In this regard, the I component will give a clearer indication of the degree of risk posed by the nondepository entities to the federal safety net than does the current rating system.

The I component focuses on the aggregate impact of the nondepository entities on the subsidiary depository institution(s). In this regard, the I rating does not include individual subcomponent ratings for the parent company and nondepository subsidiaries. An I rating is assigned always for each BHC; however, as is currently the case, nonmaterial nondepository subsidiaries⁴ may be excluded from the I analysis at the examiner's discretion. Any risk-management and financial issues at the nondepository entities that potentially impact the safety and soundness of the subsidiary depository institution(s) should be identified in the written comments under the I rating. This approach is consistent with the Federal Reserve's objective not to extend bank-like supervision to nondepository entities.

3. The regulatory minimum capital ratios for BHCs are 8 percent for total risk-based capital, 4 percent for tier 1 risk-based capital, 3 percent for tier 1 leverage for BHCs rated strong, and 4 percent for tier 1 leverage for all other BHCs. See 12 C.F.R. 225, appendices A and D.

4. As a general rule, nondepository subsidiaries should be included in the I analysis whenever their assets exceed 5 percent of the BHC's consolidated capital or \$10 million, whichever is lower.

The analysis of the parent company for the purpose of assigning an I rating should emphasize weaknesses that could directly impact the risk-management or financial condition of the subsidiary depository institution(s). Similarly, the analysis of the nondepository subsidiaries for the purpose of assigning an I rating should emphasize weaknesses that could negatively impact the parent company's relationship with its subsidiary depository institution(s) and weaknesses that could have a direct impact on the risk-management practices or financial condition of the subsidiary depository institution(s). The analysis under the I component should consider existing as well as potential issues and risks that may impact the subsidiary depository institution(s) now or in the future. Particular attention should be paid to the following risk-management and financial factors in assigning the I rating:

4070.0.2.4.1 Risk-Management Factors

- *Strategic considerations.* The potential risks posed to the subsidiary depository institution(s) by the nondepository entities' strategic plans for growth in existing activities and expansion into new products and services.
- *Operational considerations.* The spillover impact on the subsidiary depository institution(s) from actual losses, a poor control environment, or an operational loss history in the nondepository entities.
- *Legal and reputational considerations.* The spillover effect on the subsidiary depository institution(s) of complaints and litigation that name one or more of the nondepository entities as defendants, or involve violations of laws or regulations, especially pertaining to intercompany transactions where the subsidiary depository institution(s) is involved.
- *Concentration considerations.* The potential risks posed to the subsidiary depository institution(s) by concentrations within the nondepository entities in business lines, geographic areas, industries, customers, or other factors.

4070.0.2.4.2 Financial Factors

- *Capital distribution.* The distribution and transferability of capital across the legal entities.
- *Intra-group exposures.* The extent to which intra-group exposures, including servicing agreements, have the potential to undermine the condition of subsidiary depository institution(s).

- *Parent company cash flow and leverage.* The extent to which the parent company is dependent on dividend payments, from both the nondepository subsidiaries and the subsidiary depository institution(s), to service debt and cover fixed charges. Also, the effect that these upstreamed cash flows have had, or can be expected to have, on the financial condition of the BHC's nondepository subsidiaries and subsidiary depository institution(s).

4070.0.2.5 The Depository Institutions (D) Component

The (D) component will reflect generally the composite CAMELS rating assigned by the subsidiary depository institution's primary supervisor. In a multibank BHC, the (D) rating will reflect a weighted average of the CAMELS composite ratings of the individual subsidiary depository institutions, weighted by both asset size and the relative importance of each depository institution within the holding company structure. In this regard, the CAMELS composite rating for a subsidiary depository institution that dominates the corporate culture may figure more prominently in the assignment of the (D) rating than would be dictated by asset size, particularly when problems exist within that depository institution.

The (D) component conveys important supervisory information, reflecting the primary supervisor's assessment of the legal entity. The (D) component stands outside of the composite rating, although significant risk-management and financial-condition considerations at the depository institution level are incorporated in the consolidated R and F ratings, which are then factored into the C rating.

Consistent with current practice, if, in the process of analyzing the financial condition and risk-management programs of the consolidated organization, a major difference of opinion regarding the safety and soundness of the subsidiary depository institution(s) emerges between the Federal Reserve and the depository institution's primary regulator, then the (D) rating should reflect the Federal Reserve's evaluation.

To highlight the presence of one or more problem depository institution(s) in a multibank BHC whose depository institution component, based on weighted averages, might not otherwise reveal their presence (i.e., depository institution ratings of 1, 2, or 3), a problem modifier, P, would be attached to the depository institu-

tion rating (e.g., 1P, 2P, or 3P). Thus, 2P would indicate that, while on balance the depository subsidiaries are rated Satisfactory, there exists a problem depository institution (composite 4 or 5) among the subsidiary depository institutions. The problem identifier is unnecessary when the depository institution component is rated 4 or 5.

4070.0.3 IMPLEMENTATION OF THE BHC RATING SYSTEM BY BHC TYPE

The Federal Reserve's BHC rating system aligns the rating system with current Federal Reserve supervisory practices. The rating system requires analysis and support for BHCs of all sizes.⁵ As such, the level of analysis and support will vary based upon whether a BHC has been determined to be "complex" or "noncomplex."⁶ In addition, the resources dedicated to the inspection of each BHC will continue to be determined by the risk posed by the subsidiary depository institution(s) to the federal safety net⁷ and the risk posed by the BHC to the subsidiary depository institution(s).

4070.0.3.1 Noncomplex BHCs with Assets of \$1 Billion or Less (Shell Holding Companies)

Rating: R and C

Consistent with SR-13-21, examination staff will assign only an R and a C rating for all

companies in the shell BHC program (noncomplex BHCs with assets under \$1 billion). The R rating is the M rating from the subsidiary depository institution's CAMELS rating. To provide consistent rating terminology across BHCs of all sizes, the terminology is changed to R from the former M. The C rating is the subsidiary depository institution's composite CAMELS rating.

4070.0.3.2 Noncomplex BHCs with Assets Greater Than \$1 Billion

4070.0.3.2.1 One-Bank Holding Companies

Rating: RFI/C(D)

For all noncomplex one-bank holding companies with assets of greater than \$1 billion, examination staff will assign all component and sub-component ratings; however, examination staff should continue to rely heavily on information and analysis contained in the primary regulator's report of examination for the subsidiary depository institution to assign the R and F ratings. If examination staff have reviewed the primary regulator's examination report and are comfortable with the analysis and conclusions contained in that report, then the BHC ratings should be supported with concise language that indicates that the conclusions are based on the analysis of the primary regulator. No additional analysis will be required.

In cases where the analysis and conclusions of the primary regulator are insufficient to assign the ratings, the primary regulator should be contacted to ascertain whether additional analysis and support may be available. Further, if discussions with the primary regulator do not provide sufficient information to assign the ratings, discussions with BHC management may be warranted to obtain adequate information to assign the ratings. In most cases, additional information or support obtained through these steps will be sufficient to permit the assignment of the R and F ratings. To the extent that additional analysis is deemed necessary, the level of analysis and resources spent on this assessment should be in line with the level of risk the subsidiary depository institution poses to the federal safety net. In addition, any activities that involve information gathering with respect to the subsidiary depository institution should be coordinated with and, if possible, conducted by, the primary regulator of that institution.

Examination staff are required to make an independent assessment in order to assign the

5. As described in this manual, SR-95-51, SR-97-24, and SR-12-17/CA-12-14.

6. The determination of whether a holding company is "complex" versus "noncomplex" is made at least annually on a case-by-case basis taking into account and weighing a number of considerations, such as the size and structure of the holding company; the extent of intercompany transactions between depository institution subsidiaries and the holding company or nondepository subsidiaries of the holding company; the nature and scale of any nondepository activities, including whether the activities are subject to review by another regulator and the extent to which the holding company is conducting Gramm-Leach-Bliley-authorized activities (e.g., insurance, securities, merchant banking); whether risk-management processes for the holding company are consolidated; and whether the holding company has material debt outstanding to the public. Size is a less important determinant of complexity than many of the factors noted above, but generally companies of significant size (e.g., assets of \$10 billion on balance sheet or managed) would be considered complex, irrespective of the other considerations.

7. The federal safety net includes the federal deposit insurance fund, the payments system, and the Federal Reserve's discount window.

I rating, which provides an evaluation of the impact of the BHC on the subsidiary depository institution. Analysis for the I rating in noncomplex one-bank holding companies should place particular emphasis on issues related to parent company cash flow and compliance with sections 23A and 23B of the Federal Reserve Act and the Board's Regulation W.

4070.0.3.2.2 *Multibank Holding Companies*

Rating: RFI/C(D)

For all noncomplex BHCs with assets of greater than \$1 billion and more than one subsidiary depository institution, examination staff will assign all component and subcomponent ratings of the new system. Examiners should rely, to the extent possible, on the work conducted by the primary regulators of the subsidiary depository institutions to assign the R and F ratings. However, any risk-management or other important functions conducted by the nondepository entities of the BHC, or conducted across legal-entity lines, should be subject to review by Federal Reserve examination staff. These reviews should be conducted in coordination with the primary regulator(s). The assessment for the I rating requires an independent assessment by Federal Reserve examination staff.

4070.0.3.3 *Complex BHCs*

Rating: RFI/C(D)

For complex BHCs, examination staff will assign all component and subcomponent ratings of the new rating system. The ratings analysis should be based on the primary and functional regulators' assessment of the subsidiary entities, as well as on the examiners' assessment of the consolidated organization as determined through off-site review and the BHC inspection process, as appropriate. The resources needed for the inspection and the level of support needed for developing a full rating will depend on the complexity of the organization, including structure and activities (see footnote 5), and should be commensurate with the level of risk posed by the subsidiary depository institution(s) to the federal safety net and the level of risk posed by the BHC to the subsidiary depository institution(s).

4070.0.3.4 *Nontraditional BHCs*

Rating: RFI/C(D)

Examination staff are required to assign the full

rating system for nontraditional BHCs. Nontraditional BHCs include BHCs in which most or all nondepository entities are regulated by a functional regulator and in which the subsidiary depository institution(s) are small in relation to the nondepository entities. The rating system is not intended to introduce significant additional work in the rating process for these organizations. As discussed above, the level of analysis conducted and resources needed to inspect the BHC and to assign the consolidated R and F ratings should be commensurate with the level of risk posed by the subsidiary depository institution(s) to the federal safety net and the level of risk posed by the BHC to the subsidiary depository institution(s). The report of examination by, and other information obtained from, the functional and primary bank regulators should provide the basis for the consolidated R and F ratings. On-site work, to the extent it involves areas that are the primary responsibility of the functional or primary bank regulator, should be coordinated with and, if possible, conducted by, those regulators. Examination staff should concentrate their independent analysis for the R and F ratings around activities and risk management conducted by the parent company and nonfunctionally regulated nondepository subsidiaries, as well as around activities and risk-management functions that are related to the subsidiary depository institution(s), for example, audit functions for the depository institution(s) and compliance with sections 23A and 23B and the Board's Regulation W.

Examination staff are required to make an independent assessment of the impact of the nondepository entities on the subsidiary depository institution(s) in order to assign the I rating.

4070.0.4 **RATING DEFINITIONS FOR THE RFI/C(D) RATING SYSTEM**

All component and subcomponent ratings are rated on a five-point numeric scale. With the exception of the I component, ratings will be assigned in ascending order of supervisory concern as follows:

- 1 — Strong
- 2 — Satisfactory
- 3 — Fair
- 4 — Marginal
- 5 — Unsatisfactory

A description of the I component ratings is in the I section (see section 4070.0.4.4).

As is current Federal Reserve practice, the component ratings are not derived as a simple numeric average of the subcomponent ratings; rather, weight afforded to each subcomponent in the overall component rating will depend on the severity of the condition of that subcomponent and the relative importance of that subcomponent to the consolidated organization. Similarly, some components may be given more weight than others in determining the composite rating, depending on the situation of the BHC. Assignment of a composite rating may incorporate any factor that bears significantly on the overall condition and soundness of the BHC, although generally the composite rating bears a close relationship to the component ratings assigned.

4070.0.4.1 Composite Rating

Rating 1 (Strong). BHCs in this group are sound in almost every respect; any negative findings are basically of a minor nature and can be handled in a routine manner. Risk-management practices and financial condition provide resistance to external economic and financial disturbances. Cash flow is more than adequate to service debt and other fixed obligations, and the nondepository entities pose little risk to the subsidiary depository institution(s).

Rating 2 (Satisfactory). BHCs in this group are fundamentally sound but may have modest weaknesses in risk-management practices or financial condition. The weaknesses could develop into conditions of greater concern but are believed correctable in the normal course of business. As such, the supervisory response is limited. Cash flow is adequate to service obligations, and the nondepository entities are unlikely to have a significant negative impact on the subsidiary depository institution(s).

Rating 3 (Fair). BHCs in this group exhibit a combination of weaknesses in risk-management practices and financial condition that range from fair to moderately severe. These companies are less resistant to the onset of adverse business conditions and would likely deteriorate if concerted action is not effective in correcting the areas of weakness. Consequently, these companies are vulnerable and require more-than-normal supervisory attention and financial sur-

veillance. However, the risk-management and financial capacity of the company, including the potential negative impact of the nondepository entities on the subsidiary depository institution(s), pose only a remote threat to its continued viability.

Rating 4 (Marginal). BHCs in this group have significant risk-management and financial weaknesses, which may pose a heightened risk of significant negative impact on the subsidiary depository institution(s). The holding company's cash-flow needs may be being met only by upstreaming imprudent dividends and/or fees from its subsidiaries. Unless prompt action is taken to correct these conditions, the organization's future viability could be impaired. These companies require close supervisory attention and substantially increased financial surveillance.

Rating 5 (Unsatisfactory). The magnitude and character of the risk-management and financial weaknesses of BHCs in this category, and concerns about the nondepository entities negatively impacting the subsidiary depository institution(s), could lead to insolvency without urgent aid from shareholders or other sources. The imminent inability to prevent liquidity and/or capital depletion places the BHC's continued viability in serious doubt. These companies require immediate corrective action and constant supervisory attention.

4070.0.4.2 Risk-Management Component

Rating 1 (Strong). A rating of 1 indicates that management effectively identifies and controls all major types of risk posed by the BHC's activities. Management is fully prepared to address risks emanating from new products and changing market conditions. The board and management are forward-looking and active participants in managing risk. Management ensures that appropriate policies and limits exist and are understood, reviewed, and approved by the board. Policies and limits are supported by risk-monitoring procedures, reports, and MIS that provide management and the board with the information and analysis that is necessary to make timely and appropriate decisions in response to changing conditions. Risk-management practices and the organization's infrastructure are flexible and highly responsive to changing industry practices and current regulatory guidance. Staff has sufficient experience, expertise, and depth to manage the risks assumed by the institution.

Internal controls and audit procedures are sufficiently comprehensive and appropriate to the size and activities of the institution. There are few noted exceptions to the institution's established policies and procedures, and none is material. Management effectively and accurately monitors the condition of the institution consistent with the standards of safety and soundness, and in accordance with internal and supervisory policies and practices. Risk-management processes are fully effective in identifying, monitoring, and controlling the risks to the institution.

Rating 2 (Satisfactory). A rating of 2 indicates that the institution's management of risk is largely effective, but lacking in some modest degree. Management demonstrates a responsiveness and ability to cope successfully with existing and foreseeable risks that may arise in carrying out the institution's business plan. Although the institution may have some minor risk-management weaknesses, these problems have been recognized and are in the process of being resolved. Overall, board and senior management oversight, policies and limits, risk-monitoring procedures, reports, and MIS are considered satisfactory and effective in maintaining a safe and sound institution. Risks are controlled in a manner that does not require more-than-normal supervisory attention.

The BHC's risk-management practices and infrastructure are satisfactory and generally are adjusted appropriately in response to changing industry practices and current regulatory guidance. Staff experience, expertise, and depth are generally appropriate to manage the risks assumed by the institution.

Internal controls may display modest weaknesses or deficiencies, but they are correctable in the normal course of business. The examiner may have recommendations for improvement, but the weaknesses noted should not have a significant effect on the safety and soundness of the institution.

Rating 3 (Fair). A rating of 3 signifies that risk-management practices are lacking in some important ways and, therefore, are a cause for more-than-normal supervisory attention. One or more of the four elements of sound risk management⁸ (active board and senior management oversight; adequate policies, procedures, and

limits; adequate risk-management monitoring and MIS; comprehensive internal controls) are considered less than acceptable, and has precluded the institution from fully addressing one or more significant risks to its operations. Certain risk-management practices are in need of improvement to ensure that management and the board are able to identify, monitor, and control all significant risks to the institution. Also, the risk-management structure may need to be improved in areas of significant business activity, or staff expertise may not be commensurate with the scope and complexity of business activities. In addition, management's response to changing industry practices and regulatory guidance may need to improve.

The internal control system may be lacking in some important aspects, particularly as indicated by continued control exceptions or by a failure to adhere to written policies and procedures. The risk-management weaknesses could have adverse effects on the safety and soundness of the institution if corrective action is not taken by management.

Rating 4 (Marginal). A rating of 4 represents deficient risk-management practices that fail to identify, monitor, and control significant risk exposures in many material respects. Generally, such a situation reflects a lack of adequate guidance and supervision by management and the board. One or more of the four elements of sound risk management are deficient and requires immediate and concerted corrective action by the board and management.

The institution may have serious identified weaknesses, such as an inadequate separation of duties, that require substantial improvement in internal control or accounting procedures, or improved adherence to supervisory standards or requirements. The risk-management deficiencies warrant a high degree of supervisory attention because, unless properly addressed, they could seriously affect the safety and soundness of the institution.

Rating 5 (Unsatisfactory). A rating of 5 indicates a critical absence of effective risk-management practices with respect to the identification, monitoring, or control over significant risk exposures. One or more of the four elements of sound risk management are considered wholly deficient, and management and the board have not demonstrated the capability to address these deficiencies.

8. See the Federal Reserve System handbook *Framework for Risk-Focused Supervision of Large Complex Institutions*, August 1997, and SR-95-51, "Rating the Adequacy of Risk Management Processes and Internal Controls at State Member Banks and Bank Holding Companies."

Internal controls are critically weak and, as such, could seriously jeopardize the continued viability of the institution. If not already evident, there is an immediate concern as to the reliability of accounting records and regulatory reports and the potential for losses if corrective measures are not taken immediately. Deficiencies in the institution's risk-management procedures and internal controls require immediate and close supervisory attention.

4070.0.4.2.1 Risk-Management Subcomponents

4070.0.4.2.1.1 Board and Senior Management Oversight

Rating 1 (Strong). An assessment of Strong signifies that the board and senior management are forward-looking, fully understand the types of risk inherent in the BHC's activities, and actively participate in managing those risks. The board has approved overall business strategies and significant policies, and ensures that senior management is fully capable of managing the activities that the BHC conducts. Consistent with the standards of safety and soundness, oversight of risk-management practices is strong and the organization's overall business strategy is effective.

Senior management ensures that risk-management practices are rapidly adjusted in accordance with enhancements to industry practices and regulatory guidance, and exposure limits are adjusted as necessary to reflect the institution's changing risk profile. Policies, limits, and tracking reports are appropriate, understood, and regularly reviewed.

Management provides effective supervision of the day-to-day activities of all officers and employees, including the supervision of the senior officers and the heads of business lines. It hires staff that possess experience and expertise consistent with the scope and complexity of the organization's business activities. There is a sufficient depth of staff to ensure sound operations. Management ensures compliance with laws and regulations and that employees have the integrity, ethical values, and competence consistent with a prudent management philosophy and operating style.

Management responds appropriately to changes in the marketplace. It identifies all risks associated with new activities or products before they

are launched and ensures that the appropriate infrastructure and internal controls are established.

Rating 2 (Satisfactory). An assessment of Satisfactory indicates that board and senior management have an adequate understanding of the organization's risk profile and provide largely effective oversight of risk-management practices. In this regard, the board has approved all major business strategies and significant policies and ensures that senior management is capable of managing the activities that the BHC conducts. Oversight of risk-management practices is satisfactory, and the organization's overall business strategy is generally sound.

Senior management generally adjusts risk-management practices appropriately in accordance with enhancements to industry practices and regulatory guidance, and adjusts exposure limits as necessary to reflect the institution's changing risk profile, although these practices may be lacking in some modest degree. Policies, limits, and tracking reports are generally appropriate, understood, and regularly reviewed, and the new-product approval process adequately identifies the associated risks and necessary controls.

Senior management's day-to-day supervision of management and staff at all levels is generally effective. The level of staffing, and its experience, expertise, and depth, is sufficient to operate the business lines in a safe and sound manner. Minor weaknesses may exist in the staffing, infrastructure, and risk-management processes for individual business lines or products, but these weaknesses have been identified by management, are correctable in the normal course of business, and are in the process of being addressed. Weaknesses noted should not have a significant effect on the safety and soundness of the institution.

Rating 3 (Fair). An assessment of Fair signifies that board and senior management oversight is lacking in some important way and, therefore, is a cause for more-than-normal supervisory attention. The weaknesses may involve a broad range of activities or be material to a major business line or activity. Weaknesses in one or more aspect of board and senior management oversight have precluded the institution from fully addressing one or more significant risks to the institution. The deficiencies may include a lack of knowledge with respect to the organization's risk profile, insufficient oversight of risk-management practices, ineffective policies or limits, inadequate or under-utilized management reporting, an inability to respond to indus-

try enhancements and changes in regulatory guidance, or a failure to execute appropriate business strategies. Staffing may not be adequate or staff may not possess the experience and expertise needed for the scope and complexity of the organization's business activities. The day-to-day supervision of officer and staff activities, including the management of senior officers or heads of business lines, may be lacking. Certain risk-management practices are in need of improvement to ensure that management and the board are able to identify, monitor, and control all significant risks to the institution. Weaknesses noted could have adverse effects on the safety and soundness of the institution if corrective action is not taken by management.

Rating 4 (Marginal). An assessment of Marginal represents deficient oversight practices that reflect a lack of adequate guidance and supervision by management and the board. A number of significant risks to the institution have not been adequately addressed, and the board and senior management function warrants a high degree of supervisory attention. Multiple board and senior management weaknesses are in need of immediate improvement. They may include a significant lack of knowledge with respect to the organization's risk profile, largely insufficient oversight of risk-management practices, ineffective policies or limits, inadequate or considerably under-utilized management reporting, an inability to respond to industry enhancements and changes in regulatory guidance, or a failure to execute appropriate business strategies. Staffing may not be adequate or possess the experience and expertise needed for the scope and complexity of the organization's business activities, and the day-to-day supervision of officer and staff activities, including the management of senior officers or heads of business lines, may be considerably lacking. These conditions warrant a high degree of supervisory attention because, unless properly addressed, they could seriously affect the safety and soundness of the institution.

Rating 5 (Unsatisfactory). An assessment of Unsatisfactory indicates a critical absence of effective board and senior management oversight practices. Problems may include a severe lack of knowledge with respect to the organization's risk profile, insufficient oversight of risk-management practices, wholly ineffective policies or limits, critically inadequate or under-utilized management reporting, a complete inability to respond to industry enhancements and changes in regulatory guidance, or failure to

execute appropriate business strategies. Staffing may be inadequate, inexperienced, and/or inadequately supervised. The deficiencies require immediate and close supervisory attention, as management and the board have not demonstrated the capability to address them. Weaknesses could seriously jeopardize the continued viability of the institution.

4070.0.4.2.1.2 Policies, Procedures, and Limits

Rating 1 (Strong). An assessment of Strong indicates that the policies, procedures, and limits provide for effective identification, measurement, monitoring, and control of the risks posed by all significant activities, including lending, investing, trading, trust, and fiduciary activities. Policies, procedures, and limits are consistent with the institution's goals and objectives and its overall financial strength. The policies clearly delineate accountability and lines of authority across the institution's activities. The policies also provide for the review of new activities to ensure that the infrastructure necessary to identify, monitor, and control the associated risks is in place before the activities are initiated.

Rating 2 (Satisfactory). An assessment of Satisfactory indicates that the policies, procedures, and limits cover all major business areas, are thorough and substantially up-to-date, and provide a clear delineation of accountability and lines of authority across the institution's activities. Policies, procedures, and limits are generally consistent with the institution's goals and objectives and its overall financial strength. Also, the policies provide for adequate due diligence before engaging in new activities or products. Any deficiencies or gaps that have been identified are minor in nature and in the process of being addressed. Weaknesses should not have a significant effect on the safety and soundness of the institution.

Rating 3 (Fair). An assessment of Fair signifies that deficiencies exist in policies, procedures, and limits that require more-than-normal supervisory attention. The deficiencies may involve a broad range of activities or be material to a major business line or activity. The deficiencies may include policies, procedures, or limits (or the lack thereof) that do not adequately identify, measure, monitor, or control the risks posed by

significant activities; are not consistent with the experience of staff, the organization's strategic goals and objectives, or the financial strength of the institution; or do not clearly delineate accountability or lines of authority. Also, the policies may not provide for adequate due diligence before engaging in new activities or products. Weaknesses noted could have adverse effects on the safety and soundness of the institution unless corrective action is taken by management.

Rating 4 (Marginal). An assessment of Marginal indicates deficient policies, procedures, and limits that do not address a number of significant risks to the institution. Multiple practices are in need of immediate improvement, which may include policies, procedures, or limits (or the lack thereof) that ineffectively identify, measure, monitor, or control the risks posed by significant activities; are not commensurate with the experience of staff, the institution's strategic goals and objectives, or the financial strength of the institution; or do not delineate accountability or lines of authority. Moreover, policies may be considerably lacking with regard to providing for effective due diligence before engaging in new activities or products. These conditions warrant a high degree of supervisory attention because, unless properly addressed, they could seriously affect the safety and soundness of the institution.

Rating 5 (Unsatisfactory). An assessment of Unsatisfactory indicates a critical absence of effective policies, procedures, and limits. Policies, procedures, or limits (or the lack thereof) are largely or entirely ineffective with regard to identifying, measuring, monitoring, or controlling the risks posed by significant activities; are completely inconsistent with the experience of staff, the organization's strategic goals and objectives, or the financial strength of the institution; or do not delineate accountability or lines of authority. Also, policies may be completely lacking with regard to providing for effective due diligence before engaging in new activities or products. Critical weaknesses could seriously jeopardize the continued viability of the institution and require immediate and close supervisory attention.

4070.0.4.2.1.3 Risk Monitoring and Management Information Systems

Rating 1 (Strong). An assessment of Strong indicates that risk-monitoring practices and MIS reports address all material risks. The key assumptions, data sources, and procedures used in measuring and monitoring risk are appropriate, thoroughly documented, and frequently tested for reliability. Reports and other forms of communication are consistent with activities; are structured to monitor exposures and compliance with established limits, goals, or objectives; and compare actual versus expected performance when appropriate. Management and board reports are accurate and timely and contain sufficient information to identify adverse trends and to thoroughly evaluate the level of risk faced by the institution.

Rating 2 (Satisfactory). An assessment of Satisfactory indicates that risk-monitoring practices and MIS reports cover major risks and business areas, although they may be lacking in some modest degree. In general, the reports contain valid assumptions that are periodically tested for accuracy and reliability and are adequately documented and distributed to the appropriate decisionmakers. Reports and other forms of communication generally are consistent with activities; are structured to monitor exposures and compliance with established limits, goals, or objectives; and compare actual versus expected performance when appropriate. Management and board reports are generally accurate and timely, and broadly identify adverse trends and the level of risk faced by the institution. Any weaknesses or deficiencies that have been identified are in the process of being addressed.

Rating 3 (Fair). An assessment of Fair signifies that weaknesses exist in the institution's risk-monitoring practices or MIS reports that require more-than-normal supervisory attention. The weaknesses may involve a broad range of activities or be material to a major business line or activity. They may contribute to ineffective risk identification or monitoring through inappropriate assumptions, incorrect data, poor documentation, or the lack of timely testing. In addition, MIS reports may not be distributed to the appropriate decisionmakers, adequately monitor significant risks, or properly identify adverse trends and the level of risk faced by the institution. Weaknesses noted could have adverse effects on the safety and soundness of the institution if corrective action is not taken by management.

Rating 4 (Marginal). An assessment of Marginal represents deficient risk-monitoring practices or MIS reports that, unless properly addressed, could seriously affect the safety and soundness of the institution. A number of significant risks to the institution are not adequately monitored or reported. Ineffective risk identification may result from notably inappropriate assumptions, incorrect data, poor documentation, or the lack of timely testing. In addition, MIS reports may not be distributed to the appropriate decisionmakers, may inadequately monitor significant risks, or fail to identify adverse trends and the level of risk faced by the institution. The risk-monitoring and MIS deficiencies warrant a high degree of supervisory attention because, unless properly addressed, they could seriously affect the safety and soundness of the institution.

Rating 5 (Unsatisfactory). An assessment of Unsatisfactory indicates a critical absence of risk monitoring and MIS. They are wholly deficient due to inappropriate assumptions, incorrect data, poor documentation, or the lack of timely testing. Moreover, MIS reports may not be distributed to the appropriate decisionmakers, fail to monitor significant risks, or fail to identify adverse trends and the level of risk faced by the institution. These critical weaknesses require immediate and close supervisory attention, as they could seriously jeopardize the continued viability of the institution.

4070.0.4.2.1.4 Internal Controls

Rating 1 (Strong). An assessment of Strong indicates that the system of internal controls is robust for the type and level of risks posed by the nature and scope of the organization's activities. The organizational structure establishes clear lines of authority and responsibility for monitoring adherence to policies, procedures, and limits, and, wherever applicable, exceptions are noted and promptly investigated. Reporting lines provide clear independence of the control areas from the business lines and separation of duties throughout the organization. Robust procedures exist for ensuring compliance with applicable laws and regulations, including consumer laws and regulations. Financial, operational, and regulatory reports are reliable, accurate, and timely. Internal audit or other control review practices provide for independence and objectivity. Internal controls and information systems are thoroughly tested and reviewed; the coverage, procedures, findings, and responses to audits

and review tests are well documented; identified material weaknesses are given thorough and timely high-level attention; and management's actions to address material weaknesses are objectively reviewed and verified. The board or its audit committee regularly reviews the effectiveness of internal audits and other control review activities.

Rating 2 (Satisfactory). An assessment of Satisfactory indicates that the system of internal controls adequately covers major risks and business areas, with some modest weaknesses. In general, the control functions are independent from the business lines, and there is appropriate separation of duties. The control system supports accuracy in recordkeeping practices and reporting systems, is adequately documented, and verifies compliance with laws and regulations, including consumer laws and regulations. Internal controls and information systems are adequately tested and reviewed, and the coverage, procedures, findings, and responses to audits and review tests are documented. Identified material weaknesses are given appropriate attention, and management's actions to address material weaknesses are objectively reviewed and verified. The board or its audit committee reviews the effectiveness of internal audits and other control review activities. Any weaknesses or deficiencies that have been identified are modest in nature and in the process of being addressed.

Rating 3 (Fair). An assessment of Fair signifies that weaknesses exist in the system of internal controls that require more-than-normal supervisory attention. The weaknesses may involve a broad range of activities or be material to a major business line or activity. The weaknesses may include insufficient oversight of internal controls and audit by the board or its audit committee; unclear or conflicting lines of authority and responsibility; a lack of independence between control areas and business activities; or ineffective separation of duties. The internal control system may produce inadequate or untimely risk coverage and verification, including monitoring compliance with both safety-and-soundness and consumer laws and regulations; inaccurate records or financial, operational, or regulatory reporting; a lack of documentation for work performed; or a lack of timeliness in management review and correction of identified weaknesses. Weaknesses noted could have adverse effects on the safety and soundness of

the institution if corrective action is not taken by management.

Rating 4 (Marginal). An assessment of Marginal represents a deficient internal control system that does not adequately address a number of significant risks to the institution. The deficiencies may include neglect of internal controls and audit by the board or its audit committee, conflicting lines of authority and responsibility, a lack of independence between control areas and business activities, or no separation of duties in critical areas. The internal control system may produce inadequate, untimely, or nonexistent risk coverage and verification in certain areas, including monitoring compliance with both safety-and-soundness and consumer laws and regulations; inaccurate records or financial, operational, or regulatory reporting; a lack of documentation for work performed; or infrequent management review and correction of identified weaknesses. The internal control deficiencies warrant a high degree of supervisory attention because, unless properly addressed, they could seriously affect the safety and soundness of the institution.

Rating 5 (Unsatisfactory). An assessment of Unsatisfactory indicates a critical absence of an internal control system. There may be no oversight by the board or its audit committee, conflicting lines of authority and responsibility, no distinction between control areas and business activities, or no separation of duties. The internal control system may produce totally inadequate or untimely risk coverage and verification, including monitoring compliance with both safety-and-soundness and consumer laws and regulations; completely inaccurate records or regulatory reporting; a severe lack of documentation for work performed; or no management review and correction of identified weaknesses. Such deficiencies require immediate and close supervisory attention, as they could seriously jeopardize the continued viability of the institution.

4070.0.4.3 Financial-Condition Component

Rating 1 (Strong). A rating of 1 indicates that the consolidated BHC is financially sound in almost every respect; any negative findings are basically of a minor nature and can be handled

in a routine manner. The capital adequacy, asset quality, earnings, and liquidity of the consolidated BHC are more than adequate to protect the company from reasonably foreseeable external economic and financial disturbances. The company generates more-than-sufficient cash flow to service its debt and fixed obligations with no harm to subsidiaries of the organization.

Rating 2 (Satisfactory). A rating of 2 indicates that the consolidated BHC is fundamentally financially sound, but may have modest weaknesses correctable in the normal course of business. The capital adequacy, asset quality, earnings, and liquidity of the consolidated BHC are adequate to protect the company from external economic and financial disturbances. The company also generates sufficient cash flow to service its obligations; however, areas of weakness could develop into areas of greater concern. To the extent minor adjustments are handled in the normal course of business, the supervisory response is limited.

Rating 3 (Fair). A rating of 3 indicates that the consolidated BHC exhibits a combination of weaknesses ranging from fair to moderately severe. The company has less-than-adequate financial strength stemming from one or more of the following: modest capital deficiencies, substandard asset quality, weak earnings, or liquidity problems. As a result, the BHC and its subsidiaries are less resistant to adverse business conditions. The financial condition of the BHC will likely deteriorate if concerted action is not taken to correct areas of weakness. The company's cash flow is sufficient to meet immediate obligations, but may not remain adequate if action is not taken to correct weaknesses. Consequently, the BHC is vulnerable and requires more-than-normal supervision. Overall financial strength and capacity are still such as to pose only a remote threat to the viability of the company.

Rating 4 (Marginal). A rating of 4 indicates that the consolidated BHC has either inadequate capital, an immoderate volume of problem assets, very weak earnings, serious liquidity issues, or a combination of factors that are less than satisfactory. An additional weakness may be that the BHC's cash flow needs are met only by upstreaming imprudent dividends and/or fees from subsidiaries. Unless prompt action is taken to correct these conditions, they could impair future viability. BHCs in this category require close supervisory attention and increased financial surveillance.

Rating 5 (Unsatisfactory). A rating of 5 indicates that the volume and character of financial weaknesses of the BHC are so critical as to require urgent aid from shareholders or other resources to prevent insolvency. The imminent inability of such a company to service its fixed obligations and/or prevent capital depletion due to severe operating losses places its viability in serious doubt. Such companies require immediate corrective action and constant supervisory attention.

4070.0.4.3.1 *The Financial-Condition Subcomponents*

The financial-condition subcomponents can be evaluated along business lines, product lines, or legal-entity lines—depending on which type of review is most appropriate for the holding company structure.

4070.0.4.3.1.1 Capital Adequacy

Rating 1 (Strong). A rating of 1 indicates that the consolidated BHC maintains more-than-adequate capital to support the volume and risk characteristics of all parent and subsidiary business lines and products, provide a sufficient cushion to absorb unanticipated losses arising from the parent and subsidiary activities, and support the level and composition of parent and subsidiary borrowing. In addition, a company assigned a rating of 1 has more-than-sufficient capital to provide a base for the growth of risk assets and the entry into capital markets as the need arises for the parent company and subsidiaries.

Rating 2 (Satisfactory). A rating of 2 indicates that the consolidated BHC maintains adequate capital to support the volume and risk characteristics of all parent and subsidiary business lines and products, provide a sufficient cushion to absorb unanticipated losses arising from the parent and subsidiary activities, and support the level and composition of parent and subsidiary borrowing. In addition, a company assigned a rating of 2 has sufficient capital to provide a base for the growth of risk assets and the entry into capital markets as the need arises for the parent company and subsidiaries.

Rating 3 (Fair). A rating of 3 indicates that the consolidated BHC may not maintain sufficient capital to ensure support for the volume and risk characteristics of all parent and subsidiary busi-

ness lines and products, the unanticipated losses arising from the parent and subsidiary activities, or the level and composition of parent and subsidiary borrowing. In addition, a company assigned a rating of 3 may not maintain a sufficient capital position to provide a base for the growth of risk assets and the entry into capital markets as the need arises for the parent company and subsidiaries. The capital position of the consolidated BHC could quickly become inadequate in the event of asset deterioration or other negative factors and therefore requires more-than-normal supervisory attention.

Rating 4 (Marginal). A rating of 4 indicates that the capital level of the consolidated BHC is significantly below the amount needed to ensure support for the volume and risk characteristics of all parent and subsidiary business lines and products, the unanticipated losses arising from the parent and subsidiary activities, and the level and composition of parent and subsidiary borrowing. In addition, a company assigned a rating of 4 does not maintain a sufficient capital position to provide a base for the growth of risk assets and the entry into capital markets as the need arises for the parent company and subsidiaries. If left unchecked, the consolidated capital position of the company might evolve into weaknesses or conditions that could threaten the viability of the institution. The capital position of the consolidated BHC requires immediate supervisory attention.

Rating 5 (Unsatisfactory). A rating of 5 indicates that the level of capital of the consolidated BHC is critically deficient and in need of immediate corrective action. The consolidated capital position threatens the viability of the institution and requires constant supervisory attention.

4070.0.4.3.1.2 Asset Quality

Rating 1 (Strong). A rating of 1 indicates that the BHC maintains strong asset quality across all parts of the organization, with a very low level of criticized and nonperforming assets. Credit risk across the organization is commensurate with management's abilities and modest in relation to credit-risk management practices.

Rating 2 (Satisfactory). A rating of 2 indicates that the BHC maintains satisfactory asset qual-

ity across all parts of the organization, with a manageable level of criticized and nonperforming assets. Any identified weaknesses in asset quality are correctable in the normal course of business. Credit risk across the organization is commensurate with management's abilities and generally modest in relation to credit-risk management practices.

Rating 3 (Fair). A rating of 3 indicates that the asset quality across all or a material part of the consolidated BHC is less than satisfactory. The BHC may be facing a decrease in the overall quality of assets currently maintained on- and off-balance-sheet. The BHC may also be experiencing an increase in credit-risk exposure that has not been met with an appropriate improvement in risk-management practices. BHCs assigned a rating of 3 require more-than-normal supervisory attention.

Rating 4 (Marginal). A rating of 4 indicates that the BHC's asset quality is deficient. The level of problem assets and/or unmitigated credit risk subjects the holding company to potential losses that, if left unchecked, may threaten its viability. BHCs assigned a rating of 4 require immediate supervisory attention.

Rating 5 (Unsatisfactory). A rating of 5 indicates that the BHC's asset quality is critically deficient and presents an imminent threat to the institution's viability. BHCs assigned a rating of 5 require immediate remedial action and constant supervisory attention.

4070.0.4.3.1.3 Earnings

Rating 1 (Strong). A rating of 1 indicates that the quantity and quality of the BHC's consolidated earnings over time are more than sufficient to make full provision for the absorption of losses and/or accretion of capital when due consideration is given to asset quality and BHC growth. Generally, BHCs with a 1 rating have earnings well above peer-group averages.

Rating 2 (Satisfactory). A rating of 2 indicates that the quantity and quality of the BHC's consolidated earnings over time are generally adequate to make provision for the absorption of losses and/or accretion of capital when due consideration is given to asset quality and BHC growth. Generally, BHCs with a 2 earnings rat-

ing have earnings that are in line with or slightly above peer-group averages.

Rating 3 (Fair). A rating of 3 indicates that the BHC's consolidated earnings are not fully adequate to make provisions for the absorption of losses and the accretion of capital in relation to company growth. The consolidated earnings of companies rated 3 may be further clouded by static or inconsistent earnings trends, chronically insufficient earnings, or less-than-satisfactory asset quality. BHCs with a 3 rating for earnings generally have earnings below peer-group averages. Such BHCs require more-than-normal supervisory attention.

Rating 4 (Marginal). A rating of 4 indicates that the BHC's consolidated earnings, while generally positive, are clearly not sufficient to make full provision for losses and the necessary accretion of capital. BHCs with earnings rated 4 may be characterized by erratic fluctuations in net income, poor earnings (and the likelihood of the development of a further downward trend), intermittent losses, chronically depressed earnings, or a substantial drop from the previous year. The earnings of such companies are generally substantially below peer-group averages. Such BHCs require immediate supervisory attention.

Rating 5 (Unsatisfactory). A rating of 5 indicates that the BHC is experiencing losses or a level of earnings that is worse than that described for the 4 rating. Such losses, if not reversed, represent a distinct threat to the BHC's solvency through erosion of capital. Such BHCs require immediate and constant supervisory attention.

4070.0.4.3.1.4 Liquidity

Rating 1 (Strong). A rating of 1 indicates that the BHC maintains strong liquidity levels and well-developed funds-management practices. The parent company and subsidiaries have reliable access to sufficient sources of funds on favorable terms to meet present and anticipated liquidity needs.

Rating 2 (Satisfactory). A rating of 2 indicates that the BHC maintains satisfactory liquidity levels and funds-management practices. The parent company and subsidiaries have access to sufficient sources of funds on acceptable terms to meet present and anticipated liquidity needs. Modest weaknesses in funds-management practices may be evident, but those weaknesses are correctable in the normal course of business.

Rating 3 (Fair). A rating of 3 indicates that the BHC's liquidity levels or funds-management practices are in need of improvement. BHCs rated 3 may lack ready access to funds on reasonable terms or may evidence significant weaknesses in funds-management practices at the parent company or subsidiary levels. However, these deficiencies are considered correctable in the normal course of business. Such BHCs require more-than-normal supervisory attention.

Rating 4 (Marginal). A rating of 4 indicates that the BHC's liquidity levels or funds-management practices are deficient. Institutions rated 4 may not have or be able to obtain a sufficient volume of funds on reasonable terms to meet liquidity needs at the parent company or subsidiary levels and require immediate supervisory attention.

Rating 5 (Unsatisfactory). A rating of 5 indicates that the BHC's liquidity levels or funds-management practices are critically deficient and may threaten the continued viability of the institution. Institutions rated 5 require constant supervisory attention and immediate external financial assistance to meet maturing obligations or other liquidity needs.

4070.0.4.4 Impact Component

The I component rating reflects the aggregate potential impact of the nondepository entities on the subsidiary depository institution(s). It is rated on a five-point numerical scale. Ratings will be assigned in ascending order of supervisory concern as follows:

- 1 — low likelihood of significant negative impact
- 2 — limited likelihood of significant negative impact
- 3 — moderate likelihood of significant negative impact
- 4 — considerable likelihood of significant negative impact
- 5 — high likelihood of significant negative impact

Rating 1 (low likelihood of significant negative impact). A rating of 1 indicates that the nondepository entities of the BHC are highly unlikely to have a significant negative impact on the subsidiary depository institution(s) due to the sound financial condition of the nondepository entities, the strong risk-management practices within the nondepository entities, or the corporate structure of the BHC. The BHC maintains an appropriate capital allocation across the organization commensurate with associated risks.

Intra-group exposures, including servicing agreements, are very unlikely to undermine the financial condition of the subsidiary depository institution(s). Parent company cash flow is sufficient and not dependent on excessive dividend payments from subsidiaries. The potential risks posed to the subsidiary depository institution(s) by strategic plans, the control environment, risk concentrations, or legal or reputational issues within or facing the nondepository entities are minor in nature and can be addressed in the normal course of business.

Rating 2 (limited likelihood of significant negative impact). A rating of 2 indicates a limited likelihood that the nondepository entities of the BHC will have a significant negative impact on the subsidiary depository institution(s) due to the adequate financial condition of the nondepository entities, the satisfactory risk-management practices within the parent nondepository entities, or the corporate structure of the BHC. The BHC maintains adequate capital allocation across the organization commensurate with associated risks. Intra-group exposures, including servicing agreements, are unlikely to undermine the financial condition of the subsidiary depository institution(s). Parent company cash flow is satisfactory and generally does not require excessive dividend payments from subsidiaries. The potential risks posed to the subsidiary depository institution(s) by strategic plans, the control environment, risk concentrations, or legal or reputational issues within the nondepository entities are modest and can be addressed in the normal course of business.

Rating 3 (moderate likelihood of significant negative impact). A rating of 3 indicates a moderate likelihood that the aggregate impact of the nondepository entities of the BHC on the subsidiary depository institution(s) will have a significant negative impact on the subsidiary depository institution(s) due to weaknesses in the financial condition and/or risk-management practices of the nondepository entities. The BHC may have only marginally sufficient allocation of capital across the organization to support risks. Intra-group exposures, including servicing agreements, may have the potential to undermine the financial condition of the subsidiary depository institution(s). Parent company cash flow may at times require excessive dividend payments from subsidiaries. Strategic-growth plans, weaknesses in the control environment,

risk concentrations, or legal or reputational issues within the nondepository entities may pose significant risks to the subsidiary depository institution(s). A BHC assigned a 3 impact rating requires more-than-normal supervisory attention, as there could be adverse effects on the safety and soundness of the subsidiary depository institution(s) if corrective action is not taken by management.

Rating 4 (considerable likelihood of significant negative impact). A rating of 4 indicates that there is a considerable likelihood that the nondepository entities of the BHC will have a significant negative impact on the subsidiary depository institution(s) due to weaknesses in the financial condition and/or risk-management practices of the nondepository entities. A 4-rated BHC may have insufficient capital within the nondepository entities to support their risks and activities. Intra-group exposures, including servicing agreements, may also have the immediate potential to undermine the financial condition of the subsidiary depository institution(s). Parent company cash flow may be dependent on excessive dividend payments from subsidiaries. Strategic-growth plans, weaknesses in the control environment, risk concentrations, or legal or reputational issues within the nondepository entities may pose considerable risks to the subsidiary depository institution(s). A BHC assigned a 4 impact rating requires immediate remedial action and close supervisory attention because the nondepository entities could seriously affect the safety and soundness of the subsidiary depository institution(s).

Rating 5 (high likelihood of significant negative impact). A rating of 5 indicates a high likelihood that the aggregate impact of the nondepository entities of the BHC on the subsidiary depository institution(s) is or will become significantly negative due to substantial weaknesses in the financial condition and/or risk-

management practices of the nondepository entities. Strategic-growth plans, a deficient control environment, risk concentrations, or legal or reputational issues within the nondepository entities may pose critical risks to the subsidiary depository institution(s). The parent company also may be unable to meet its obligations without excessive support from the subsidiary depository institution(s). The BHC requires immediate and close supervisory attention, as the nondepository entities seriously jeopardize the continued viability of the subsidiary depository institution(s).

4070.0.4.5 (D) Depository Institutions Component

The (D) component identifies the overall condition of the subsidiary depository institution(s) of the BHC. For BHCs with only one subsidiary depository institution, the (D) component rating generally will mirror the CAMELS composite rating for that depository institution. To arrive at a (D) component rating for BHCs with multiple subsidiary depository institutions, the CAMELS composite ratings for each of the depository institutions should be weighted, giving consideration to asset size and the relative importance of each depository institution within the overall structure of the organization. In general, it is expected that the resulting (D) component rating will reflect the lead depository institution's CAMELS composite rating.

If, in the process of analyzing the financial condition and risk-management programs of the consolidated organization, a major difference of opinion regarding the safety and soundness of the subsidiary depository institution(s) emerges between the Federal Reserve and the depository institution's primary regulator, then the (D) rating should reflect the Federal Reserve's evaluation.

WHAT'S NEW IN THIS REVISED SECTION

Effective July 2016, this section is amended to acknowledge the issuance of SR-16-11, "Supervisory Guidance for Assessing Risk Management at Supervised Institutions with Total Consolidated Assets Less than \$50 Billion." With the issuance of SR-16-11, SR-95-51 is applicable to only state member banks and bank holding companies having \$50 billion or more in total assets.

The guidance within this section pertains to SR-95-51 and applies to the rating of risk management, processes, and internal controls of state member banks and bank holding companies that have \$50 billion or more in total assets.

The Federal Reserve places significant supervisory emphasis on the importance of sound risk-management processes and strong internal controls when evaluating the activities of banking organizations it supervises. Properly managing risks is always critical to the conduct of safe and sound banking activities, and it is even more important as new technologies, product innovation, and the size and speed of financial transactions change the nature of banking markets.

A bank holding company's failure to establish a management structure that adequately identifies, measures, monitors, and controls the risks involved in its various products and lines of business has long been considered unsafe and unsound conduct. Accordingly, while a bank holding company's financial performance is an important indicator of the adequacy of management, it is essential that examiners give significant weight to the quality of risk-management practices and internal controls when they evaluate the management and overall financial condition of banking organizations.

Consistent with the greater supervisory emphasis given to risk management in Federal Reserve examination and supervisory policy statements, System examiners are to assign a formal supervisory rating to the adequacy of a bank holding company's risk-management processes, including its internal controls. This step is a natural extension of current procedures that incorporate an assessment of risk management and internal controls during each on-site full-scope inspection. The specific rating of risk management and internal controls should be given significant weight when evaluating management under the bank holding company

RFI/C(D) rating system. Like the other components of this system, the risk-management rating should be based on a five-point numerical scale.

The rating of the risk-management process is designed to bring together and summarize much of the analysis of and many of the findings about a bank holding company's process for managing and controlling risks, which are an important part of the examiner's review of these individual areas. The formal rating is intended to highlight and incorporate both the quantitative and qualitative aspects of an examiner's review of an organization's overall process for identifying, measuring, monitoring, and controlling risk and to facilitate appropriate follow-up action.

The overall profitability, asset quality, and capital adequacy of a bank or bank holding company should continue to influence the examiner's assessment of management, but these indicators can to some extent be affected, either favorably or adversely, by factors outside management's control. For this reason, the specific evaluation of the risk-management process should be a primary factor when rating management, especially in the case of larger banking organizations whose activities and structures require more-formal and extensive procedures.

Examiners should apply the guidance in this section flexibly to appropriately reflect the banking organization's circumstances and the nature, scope, and complexity of its operations. Risk-management ratings should be assigned to all bank holding companies, regardless of their size.

In the appropriate open sections of the inspection report, examiners should discuss in a clear and straightforward manner the nature and severity of any problems or deficiencies found and the steps required to correct them, particularly if the risk-management rating is less than satisfactory. Serious lapses or deficiencies in internal controls, including inadequate separation of duties, can constitute an unsafe and unsound practice and possibly lead to significant losses or otherwise compromise the financial integrity of the organization. If appropriate, the bank holding company's directors and officers should be advised that the Federal Reserve will initiate supervisory actions if its failure to separate critical operational duties creates the potential for serious losses or if material deficiencies or situations that threaten the safe and

sound conduct of its activities are not adequately addressed in a timely manner. Such supervisory actions may include formal enforcement actions against the bank holding company, its responsible officers and directors, or both; supervisory actions would also require the immediate implementation of all necessary corrective measures. (See SR-95-51, as amended by SR-04-18 and SR-16-11.)

4070.1.1 ELEMENTS OF RISK MANAGEMENT

When rating the quality of risk management at bank holding companies as part of the evaluation of the overall quality of management, examiners should place primary consideration on findings relating to the following elements of a sound risk-management system:

1. active board and senior management oversight
2. adequate policies, procedures, and limits
3. adequate risk measurement, risk monitoring, and management information systems
4. comprehensive internal controls

Examiners should recognize that the considerations specified in SR-04-18 and SR-95-51 are intended only to assist in the evaluation of risk-management practices. *They are not a checklist of requirements for an individual organization.* Moreover, while all bank holding companies should be able to assess the major risks of the consolidated organization, examiners should expect parent companies that centrally manage the operations and functions of their subsidiary banks to have more-comprehensive, detailed, and developed risk-management systems than companies that delegate the management of risks to relatively autonomous banking subsidiaries.

4070.1.1.1 Active Board and Senior Management Oversight

In assessing the quality of oversight by boards of directors and senior management, examiners should consider whether the bank holding company follows policies and practices such as those described below:

1. The board and senior management have identified and have a clear understanding and

- working knowledge of the types of risks inherent in the bank holding company's activities, and they make appropriate efforts to remain informed about these risks as financial markets, risk-management practices, and the bank holding company's activities evolve.
2. The board has reviewed and approved appropriate policies to limit risks inherent in the bank holding company's lending, investing, trading, trust, fiduciary, and other significant activities or products.
3. The board and management are sufficiently familiar with and are using adequate record-keeping and reporting systems to measure and monitor the major sources of risk to the organization.
4. The board periodically (1) reviews and approves risk-exposure limits to conform with any changes in the bank holding company's strategies, (2) addresses new products, and (3) reacts to changes in market conditions.
5. Management ensures that its lines of business are managed and staffed by personnel whose knowledge, experience, and expertise are consistent with the nature and scope of the bank holding company's activities.
6. Management ensures that the depth of staff resources is sufficient to operate and soundly manage the bank holding company's activities and that its employees have the integrity, ethics, and competence that are consistent with a prudent management philosophy and operating style.
7. All levels of management adequately supervise the day-to-day activities of officers and employees, including management supervision of senior officers or heads of business lines.
8. Management is able to respond to risks that may arise from changes in the competitive environment or from innovations in markets in which the organization is active.
9. Before embarking on new activities or introducing new products, management identifies and reviews all risks associated with the activity or product and ensures that the infrastructure and internal controls necessary to manage the related risks are in place.

4070.1.1.2 Adequate Policies, Procedures, and Limits

A bank holding company's board of directors and senior management should tailor their risk-management policies and procedures to the types of risks that arise from the organization's

activities. The following guidelines should assist examiners in evaluating the adequacy of a bank holding company's policies, procedures, and limits:

1. The bank holding company's policies, procedures, and limits provide for adequate identification, measurement, monitoring, and control of the risks posed by its lending, investing, trading, trust, fiduciary, and other significant activities.
2. The policies, procedures, and limits are consistent with management's experience level, the organization's stated goals and objectives, and its overall financial strength.
3. Policies clearly delineate accountability and lines of authority across the organization's activities.
4. Policies provide for the review of new activities of the organization to ensure that the infrastructures necessary to identify, monitor, and control risks associated with an activity are in place before the activity is initiated.

4070.1.1.3 Adequate Risk Monitoring and Management Information Systems

Effective risk monitoring requires banking organizations to identify and measure all material risk exposures. Consequently, risk-monitoring activities must be supported by information systems that provide senior managers and directors with timely reports on the financial condition, operating performance, and risk exposure of the consolidated organization, as well as provide regular and sufficiently detailed reports for line managers engaged in the day-to-day management of the organization's activities.

In assessing the adequacy of a bank holding company's measurement and monitoring of risk and the adequacy of its management reports and information systems, examiners should consider whether the following conditions exist:

1. The bank holding company's risk-monitoring practices and reports address all of its material risks.
2. Key assumptions, data sources, and procedures used in measuring and monitoring risk are appropriate and adequately documented and tested for reliability on an ongoing basis.
3. Reports and other forms of communication are consistent with the bank holding company's activities; are structured to monitor exposures and compliance with established limits, goals, or objectives; and, as appropriate, compare actual versus expected performance.

4. Reports to management or the directors are accurate and timely and contain sufficient information for decision makers to identify any adverse trends and to adequately evaluate the level of risk the bank holding company faces.

4070.1.1.4 Adequate Internal Controls

A bank holding company's internal control structure is critical to its safe and sound functioning in general and to its risk-management system, in particular. Establishing and maintaining an effective system of controls, including the enforcement of official lines of authority and the appropriate separation of duties—such as trading, custodial, and back-office—is one of management's more important responsibilities.

Appropriate segregation of duties is a fundamental and essential element of a sound risk-management and internal control system. Failure to implement and maintain an adequate separation of duties can constitute an unsafe and unsound practice and possibly lead to serious losses or otherwise compromise the financial integrity of the bank holding company. Serious lapses or deficiencies in internal controls, including inadequate segregation of duties, may warrant supervisory action, including formal enforcement action.

When properly structured, a system of internal controls promotes effective operations and reliable financial and regulatory reporting; safeguards assets; and helps to ensure compliance with relevant laws, regulations, and bank holding company policies. Ideally, internal controls are tested by an independent internal auditor who reports directly to either the bank holding company's board of directors or a designated board committee, typically the audit committee. Personnel who perform these reviews should generally be independent of the function they are assigned to review. Given the importance of appropriate internal controls to banking organizations of all sizes and risk profiles, the results of audits or reviews, whether conducted by an internal auditor or other personnel, should be adequately documented, as should management's responses to them. In addition, communication channels should exist that allow negative or sensitive findings to be reported directly to the board of directors or the relevant board committee.

In evaluating the adequacy of a bank holding

company's internal controls and audit procedures, examiners should consider whether the following conditions are met:

1. The system of internal controls is appropriate to the type and level of risks posed by the nature and scope of the organization's activities.
2. The bank holding company's organizational structure establishes clear lines of authority and responsibility for monitoring adherence to policies, procedures, and limits.
3. Reporting lines ensure that control areas are sufficiently independent from the business lines, and the reporting lines adequately separate duties throughout the organization, such as those duties relating to trading, custodial, and back-office activities.
4. Official organizational structures reflect actual operating practices.
5. Financial, operational, and regulatory reports are reliable, accurate, and timely. When applicable, exceptions are noted and promptly investigated.
6. Adequate procedures exist for ensuring compliance with applicable laws and regulations.
7. Internal audit or other control review practices ensure independence and objectivity.
8. Internal controls and information systems are adequately tested and reviewed; the coverage, procedures, findings, and responses to audits and review tests are adequately documented; identified material weaknesses are given appropriate and timely high-level attention; and management's actions to address material weaknesses are objectively verified and reviewed.
9. The audit committee or the board of directors regularly reviews the effectiveness of internal audits and other control review activities.

4070.1.2 RATING DEFINITIONS

The rating for risk management is based on a scale of one through five, in ascending order of supervisory concern. Examiners should assign this rating to reflect their findings in all four of the elements of sound risk management described above. The risk-management rating should be reflected in the overall "Risk-Management" rating of the bank holding company and should be consistent with the following criteria:

Rating 1 (Strong). A rating of 1 indicates that management effectively identifies and controls all major types of risk posed by the BHC's activities. Management is fully prepared to address risks emanating from new products and changing market conditions. The board and management are forward looking and active participants in managing risk. Management ensures that appropriate policies and limits exist and are understood, reviewed, and approved by the board. Policies and limits are supported by risk-monitoring procedures, reports, and management information systems that provide management and the board with the information and analysis necessary to make timely and appropriate decisions in response to changing conditions. Risk-management practices and the organization's infrastructure are flexible and highly responsive to changing industry practices and current regulatory guidance. Staff has sufficient experience, expertise, and depth to manage the risks assumed by the institution.

Internal controls and audit procedures are sufficiently comprehensive and appropriate to the size and activities of the institution. There are few noted exceptions to the institution's established policies and procedures, and none is material. Management effectively and accurately monitors the condition of the institution consistent with the standards of safety and soundness and in accordance with internal and supervisory policies and practices. Risk-management processes are fully effective in identifying, monitoring, and controlling the risks to the institution.

Rating 2 (Satisfactory). A rating of 2 indicates that the institution's management of risk is largely effective but lacking in some modest degree. Management demonstrates a responsiveness and ability to cope successfully with existing and foreseeable risks that may arise in carrying out the institution's business plan. While the institution may have some minor risk-management weaknesses, these problems have been recognized and are in the process of being resolved. Overall, board and senior management oversight, policies and limits, risk-monitoring procedures, reports, and management information systems are considered satisfactory and effective in maintaining a safe and sound institution. Risks are controlled in a manner that does not require more-than-normal supervisory attention.

The BHC's risk-management practices and infrastructure are satisfactory and generally are adjusted appropriately in response to changing industry practices and current regulatory guidance. Staff experience, expertise, and depth are

generally appropriate to manage the risks assumed by the institution.

Internal controls may display modest weaknesses or deficiencies, but they are correctable in the normal course of business. The examiner may have recommendations for improvement, but the weaknesses noted should not have a significant effect on the safety and soundness of the institution.

Rating 3 (Fair). A rating of 3 signifies that risk-management practices are lacking in some important ways and, therefore, are a cause for more-than-normal supervisory attention. One or more of the four elements of sound risk management¹ (active board and senior management oversight; adequate policies, procedures, and limits; adequate risk-management monitoring and management information systems; comprehensive internal controls) are considered less than acceptable and have precluded the institution from fully addressing one or more significant risks to its operations. Certain risk-management practices are in need of improvement to ensure that management and the board are able to identify, monitor, and control all significant risks to the institution. Also, the risk-management structure may need to be improved in areas of significant business activity, or staff expertise may not be commensurate with the scope and complexity of business activities. In addition, management's response to changing industry practices and regulatory guidance may need to improve.

The internal control system may be lacking in some important aspects, particularly as indicated by continued control exceptions or by a failure to adhere to written policies and procedures. The risk-management weaknesses could have adverse effects on the safety and soundness of the institution if corrective action is not taken by management.

Rating 4 (Marginal). A rating of 4 represents deficient risk-management practices that fail to identify, monitor, and control significant risk exposures in many material respects. Generally, such a situation reflects a lack of adequate guidance and supervision by management and the

board. One or more of the four elements of sound risk management are deficient and require immediate and concerted corrective action by the board and management.

The institution may have serious identified weaknesses, such as an inadequate separation of duties, that require substantial improvement in internal control or accounting procedures or that require improved adherence to supervisory standards or requirements. The risk-management deficiencies warrant a high degree of supervisory attention because, unless properly addressed, they could seriously affect the safety and soundness of the institution.

Rating 5 (Unsatisfactory). A rating of 5 indicates a critical absence of effective risk-management practices with respect to the identification, monitoring, or control over significant risk exposures. One or more of the four elements of sound risk management are considered wholly deficient, and management and the board have not demonstrated the capability to address these deficiencies.

Internal controls are critically weak and, as such, could seriously jeopardize the continued viability of the institution. If not already evident, there is an immediate concern as to the reliability of accounting records and regulatory reports and the potential for losses if corrective measures are not immediately taken. Deficiencies in the institution's risk-management procedures and internal controls require immediate and close supervisory attention.

4070.1.3 REPORTING CONCLUSIONS

For bank holding companies, the separate numerical rating for the risk-management component and the rationale for the rating assigned should be included as the "Risk-Management Rating: (numerical rating)" and discussed on confidential page B, "Condition of Bank Holding Company," of the bank holding company inspection report. Comments, conclusions, and criticisms relating to a bank holding company's risk-management process should be brought to the attention of management and included on the "Policies and Supervision" page² of the bank holding company inspection report, as well as

1. See the Federal Reserve System handbook *Framework for Risk-Focused Supervision of Large Complex Institutions*, August 1997; SR-95-51, "Rating the Adequacy of Risk Management Processes and Internal Controls at State Member Banks and Bank Holding Companies" (as amended by SR-04-18, "Bank Holding Company Rating System" and SR-16-11, "Supervisory Guidance for Assessing Risk Management at Supervised Institutions with Total Consolidated Assets Less than \$50 Billion.>").

2. If a problem area is cited within the core section, the respective supporting report pages (the "Policies and Supervision" page) are to be included in the report to support the critical comments. See section 5010.1.3.

on core page 1, “Examiner’s Comments and Matters Requiring Special Board Attention,” if considered appropriate and particularly if the rating is less than satisfactory.

Inspection reports and transmittal letters to boards of directors of bank holding companies should specifically describe the types and nature of corrective actions that bank holding companies need to take to address noted risk-management and internal control deficiencies. When appropriate, bank holding companies should also be advised that the Federal Reserve will initiate supervisory actions if the failure to separate critical operational duties creates the potential for serious losses or if material deficiencies or situations that threaten the safe and sound conduct of a BHC’s activities are not adequately addressed in a timely manner. Such supervisory actions may include formal enforcement actions against the bank holding company (or a state member bank), its responsible officers and directors, or both; supervisory actions would also require the immediate implementation of all necessary corrective measures.

Supervisory ratings should be revised whenever there is strong evidence that the financial condition or risk profile of an institution has significantly changed.¹ In a risk-focused and continuous-supervision environment, supervisory ratings should be viewed as a continuum, rather than as a point-in-time assessment of an institution's financial condition.² It is important that supervisory ratings reflect a current assessment of an institution's financial condition and risk profile. The ratings can affect risk-based deposit insurance premiums; statutory and regulatory requirements, including applications and the prompt-corrective-action provisions of the Federal Deposit Insurance Act; supervisory reporting and inspection or examination requirements; and other factors. While supervisory ratings are most frequently revised as a result of on-site supervisory activities, other sources of information reviewed off-site may also indicate the need for a rating change.³ See SR-99-17.

1. SR-99-17 supersedes SR-92-31, which suspended the practice of revising CAMELS ratings for state member banks between examinations.

2. The procedures in SR-99-17 pertain to supervisory rating systems for bank holding companies (RFI/C(D)); state member banks (CAMELS); U.S. branches and agencies of foreign banking organizations (ROCA); and Edge and agreement corporations, overseas subsidiaries of U.S. banks, and U.S. nonbank subsidiaries of foreign banking organizations (CAMEO).

3. For example, a significant change in financial condition may be evident from some combination of the following: reports of examinations conducted by other agencies, meetings or other communications with management of the institution, published financial reports or press releases, status reports submitted by the institution as required by an enforcement action, and information generated by ongoing surveillance activities.

When a component of one of the supervisory rating systems is changed, the Reserve Bank must also reaffirm or revise the other component ratings and the composite rating, based on information available at that time. The factors contributing to a change in the rating of a selected component can affect one or more of the other components in the rating system, as well as the composite rating. Accordingly, if there is a compelling reason to change a selected component rating, all of the other components in the supervisory rating system must be either reaffirmed or revised. As applicable for bank holding companies and state member banks, the risk-management subcomponent rating must also be reaffirmed or revised when a CAMELS or RFI/C(D) rating is changed.⁴

Any change to a component or composite rating and the rationale for that change must be communicated in writing via a letter or report to the board of directors of the affected institution (or to the senior U.S. management official in the case of a U.S. branch, agency, office, or nonbank subsidiary of a foreign bank) and to the appropriate state and federal supervisory agencies.

4. Pursuant to the guidelines set forth in SR-04-18, the assignment of a risk-management (R) rating and a composite (C) rating is required for noncomplex shell bank holding companies.

WHAT'S NEW IN THIS REVISED SECTION

Effective July 2008, this section was revised to include the Federal Reserve's statement and clarification on its expectations regarding confidentiality provisions that are contained in agreements between a banking organization and its counterparties (for example, mutual funds, hedge funds, and other trading counterparties) or other third parties. See section 4070.5.3. (See also SR-07-19 and SR-97-17.)

4070.5.1 LIMITED DISCLOSURE OF CONFIDENTIAL COMPOSITE AND COMPONENT RATINGS IN INSPECTIONS AND EXAMINATIONS

The Federal Reserve's long-standing policy is to discuss fully and clearly in examination and inspection reports, and during meetings with senior management and boards of directors, supervisory issues, problems, or concerns relating to banking organizations that are under System supervision. Beginning on December 16, 1988, the Board authorized examiners to disclose to the senior officials and boards of directors of inspected bank holding companies the composite numeric rating assigned in an inspection, as part of the inspection report process. (See SR-88-37.) Generally, the Federal Reserve has also provided senior management and directors with the corresponding word descriptions (consisting of a single word or a few words) for the numeric component ratings assigned.

Beginning on January 1, 1997, in an effort to further strengthen communication with supervised banking organizations, the Federal Reserve has provided senior management and directors with the numeric and alphabetic component ratings assigned under various supervisory rating systems.¹ (See SR-96-26 and section 5010.4.) This disclosure includes the alphabetic compo-

1. The composite rating and the supporting component rating are disclosed for the following rating systems:

- CAMELS (state member banks)
- RFI/C(D) (bank holding companies, including financial holding companies)
- CAMEO (Edge and agreement corporations and overseas subsidiaries of U.S. banks)
- ROCA (U.S. branches and agencies of foreign banking organizations)
- Uniform Interagency Trust Rating System (UITRS)
- the interagency Uniform Rating System for Information Technology (URISIT)

nent ratings assigned to management under the bank holding company RFI/C(D) rating system. Building on existing practice, this step is intended to better focus management's attention on possible areas of weakness and the need for timely corrective actions.

The disclosure of the rating and its components should be made in the "Examiner's Comments and Matters Requiring Special Board Attention" page of inspection reports, in the summary reports prepared for boards of directors of inspected institutions, and in meetings with senior management and directors. In conjunction with disclosing the ratings and their components, examiners or supervisory officials should clearly explain what they mean. During the exit meeting, the examiner should discuss key overall inspection findings, including preliminary composite and component numeric ratings. Examiner-assigned ratings are subject to a review by Reserve Bank supervisory officials, and final ratings are to be included in the inspection report. In disclosing composite and component ratings, the examiner-in-charge should remind the board of directors and management that the ratings assigned are part of the findings of the inspection and are privileged and confidential under applicable law. If composite and component ratings need to be changed between inspections as a result of off-site analysis, the board of directors and management should be informed of the change. Ratings should not be disclosed to the bank holding company's directors and management until preliminary approval has been received from the appropriate senior Reserve Bank supervisory officials.

4070.5.2 INTERAGENCY ADVISORY ON THE CONFIDENTIALITY OF THE SUPERVISORY RATING AND OTHER NONPUBLIC SUPERVISORY INFORMATION

A February 28, 2005, interagency advisory reminds all banking organizations of the statutory prohibitions on the disclosure of supervisory ratings and other confidential supervisory information to third parties. The agencies² learned that some insurers had

2. The Board of Governors of the Federal Reserve System (FRB), the Office of the Comptroller of the Currency (OCC),

requested or required banks and other savings associations (financial institutions) to disclose their CAMELS rating during the underwriting process when those institutions had sought directors' and officers' liability (D&O) coverage.³ The agencies responded by issuing the advisory to remind all banking organizations that, except in very limited circumstances, they are prohibited by law from disclosing their bank holding company's RFI/C(D) rating or their financial institution's CAMELS rating, or other nonpublic rating, and other supervisory information to insurers as well as other nonrelated third parties without permission from their appropriate federal banking agency. (See SR-05-4, SR-04-18 and its attachment, SR-96-26, and SR-88-37.)

Federal banking regulations provide that the bank holding company inspection report, which contains the RFI/C(D) rating, or the financial institution examination report, which contains its CAMELS rating, is nonpublic information and the property of the agency issuing the report.⁴ These regulations specifically provide that, except in very limited circumstances, bank holding companies, banks, and other financial institutions may not disclose their inspection or examination report findings or any portion of the report, nor make any representations concerning the report or the report's findings, without the prior written permission of the appropriate federal banking agency.⁵ The circumstances for release of nonpublic supervisory information may include disclosure to a parent holding company, a director, an officer, an attorney, an audi-

tor, or another specified third party, as indicated in the regulations of the appropriate federal banking agency.⁶ Any person who discloses or uses nonpublic information except as expressly permitted by one of the appropriate federal banking agencies or as provided by the agency's regulations may be subject to the criminal penalties provided in 18 U.S.C. 641.

The legal prohibition on the release of nonpublic supervisory information applies to all financial institutions supervised by the agencies, including bank and thrift holding companies, Edge corporations, and the U.S. branches or agencies of foreign banking organizations, that receive confidential supervisory ratings, including the RFI/C(D) rating, ROCA rating, CORE rating, and CAMEO rating.⁷ As with the CAMELS rating, these ratings are transmitted to the regulated institutions in inspection or examination reports, which are the property of the agencies.

Financial institutions that receive requests for confidential supervisory ratings should refer all requesters to the following publicly available information in lieu of disclosing any confidential regulatory information, including the CAMELS rating. (See the National Information Center on the Federal Financial Institutions Examination Council [FFIEC] website: www.ffiec.gov.)

- for banks, an institution's quarterly reports of condition (Call Reports) (see 12 U.S.C. 1817)
- for holding companies or foreign banks with U.S. operations, an institution's quarterly and annual FR Y or H-(b)11 reports (see 12 U.S.C. 1844, 3106, 3108, 601–604a, and 611–631)

the Federal Deposit Insurance Corporation (FDIC), and the Office of Thrift Supervision (OTS).

3. As part of the bank holding company inspection process, a bank holding company RFI/C(D) confidential supervisory rating is assigned to each bank holding company regulated by the FRB. (Each BHC is assigned a Composite rating 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). In addition, the main component ratings are also assigned for Risk management, Financial condition, and potential Impact of the parent company and nondepository subsidiaries on the BHC's subsidiary depository institutions.) See section 4070.0 for a complete description of the RFI/C(D) rating system. For financial institution examinations, a confidential supervisory rating called a CAMELS rating is assigned to each depository institution regulated by the agencies. (A CAMELS rating is based on an evaluation of the financial institution's Capital, Assets, Management, Earnings, Liquidity, and Sensitivity to market risk; the rating may range from 1 to 5, with 1 being the highest rating.) See the appendix of the *Commercial Bank Examination Manual*, section A.5020.1, for a complete description of the CAMELS rating system.

4. See 12 C.F.R. 261.2(c)(1), 261.20(g), and 261.22(e).

5. See 12 C.F.R. 261.22.

6. See 12 U.S.C. 326, and 12 C.F.R. 261.20(b) (exceptions).

7. RFI/C(D), ROCA, and CAMEO ratings are assigned by the Federal Reserve Board as a result of an examination or inspection. As of January 1, 2005, the Federal Reserve Board adopted a new rating system, RFI/C(D) ratings, for bank holding companies that replaces the former BOPEC rating system. RFI/C(D) ratings components are Risk management, Financial condition, potential Impact of the parent and nondepository subsidiaries on the subsidiary depository institutions, Composite, and Depository institution. For noncomplex bank holding companies with assets of \$1 billion or less, only risk-management and composite ratings are assigned. ROCA ratings are assigned to the U.S. branches, agencies, and commercial lending companies of foreign banking organizations. The ROCA rating components are Risk management, Operational controls, Compliance, and Asset quality. CORE ratings are assigned to complex holding company enterprises. The CORE rating components are Capital, Organizational structure, Relationship, and Earnings. CAMEO ratings are assigned to Edge corporations and the overseas branches and subsidiaries of U.S. banks. The CAMEO ratings components are Capital, Asset quality, Management, Earnings, and Operations and internal controls.

- for national banks, the annual disclosure statement (see 12 C.F.R. 18.3)
- for banks, an institution's Uniform Bank Performance Report (UBPR), which is available to all interested parties at www.ffiec.gov and is designed for summary and in-depth analysis of banks; for savings associations, the Uniform Thrift Performance Report (UTPR) is available from the Office of Thrift Supervision upon request
- an institution's publicly available filings, if any, filed with the appropriate federal banking agency (15 U.S.C. 78(I)(i)) or with the U.S. Securities and Exchange Commission
- any reports or ratings on the institution compiled by private companies that track the performance of financial institutions⁸
- any reports or ratings issued by private rating services on public debt issued by an institution
- any publicly available cease-and-desist order or enforcement proceeding against an institution⁹
- any reports or other sources of information on institution performance or internal matters created by the institution that do not contain information prohibited from release by law or regulation

The National Association of Insurance Commissioners (NAIC) was advised by the agencies that some insurers were inappropriately requesting or requiring disclosure of CAMELS ratings as a part of the underwriting process. The agencies requested NAIC's assistance in notifying insurance companies that this practice should be discontinued because of the confidential nature of the CAMELS rating.

4070.5.3 CONFIDENTIALITY PROVISIONS IN THIRD-PARTY AGREEMENTS

Reports of BHC inspections and their ratings are strictly confidential and cannot be disclosed

without the approval of the Board, or in the case of a subsidiary bank, the bank's primary regulator. Under the Board's rules regarding the availability of information, Board-supervised banking organizations are prohibited from disclosing confidential supervisory information without prior written permission of the Board's General Counsel.¹⁰ Confidential supervisory information includes information related to the supervision or inspection of a banking organization.¹¹ Board staff has taken the position that identification of information requested by, or provided to, supervisory staff—including the fact that an inspection has taken or will take place—is related to an inspection and falls within the definition of confidential supervisory information. It is contrary to Federal Reserve regulation and policy for agreements to contain confidentiality provisions that (1) restrict the banking organization from providing information to Federal Reserve supervisory staff; (2) require or permit, without the prior approval of the Federal Reserve, the banking organization to disclose to a counterparty that any information will be or was provided to Federal Reserve supervisory staff; or (3) require or permit, without the prior approval of the Federal Reserve, the banking organization to inform a counterparty of a current or upcoming Federal Reserve inspection or any nonpublic Federal Reserve supervisory initiative or action. Banking organizations that have entered into agreements containing such confidentiality provisions are subject to legal risk. (See SR- 07-19, SR-97-17, and section 1040.0.)

8. For bank rating services, see the guidance at www.fdic.gov/bank/individual/bank/index.html.

9. Information on enforcement actions taken by the Federal Reserve may be found at www.federalreserve.gov/boarddocs/enforcement/search.cfm. Information on enforcement actions taken by other federal agencies, such as the Securities and Exchange Commission, the Financial Crimes Enforcement Network, and the Department of Justice, as well as foreign authorities, may also be publicly available.

10. See 12 C.F.R. 261.20(g).

11. See the definition in 12 C.F.R. 261.2(c)(1)(i).

Supervisory Guidance for Assessing Risk Management at Supervised Institutions with Total Consolidated Assets Less than \$50 Billion

Section 4071.0

Managing risks is fundamental to the business of banking. Accordingly, the Federal Reserve places significant supervisory emphasis on an institution's management of risk, including its system of internal controls, when evaluating the overall effectiveness of an institution's risk management. An institution's failure to establish a management structure that adequately identifies, measures, monitors, and controls the risks of its activities has long been considered unsafe-and-unsound conduct. Principles of sound management should apply to the entire spectrum of risks facing an institution including, but not limited to, credit, market, liquidity, operational, compliance, and legal risk:

- *Credit risk* arises from the potential that a borrower or counterparty will fail to perform on an obligation.
- *Market risk* is the risk to a financial institution's condition resulting from adverse movements in market rates or prices, including, but not limited to, interest rates, foreign exchange rates, commodity prices, or equity prices.
- *Liquidity risk* is the potential that a financial institution will be unable to meet its obligations as they come due because of an inability to liquidate assets or obtain adequate funding (referred to as "funding liquidity risk") or that it cannot easily unwind or offset specific exposures without significantly lowering market prices because of inadequate market depth or market disruptions (referred to as "market liquidity risk").
- *Operational risk* is the risk resulting from inadequate or failed internal processes, people, and systems or from external events.¹
- *Compliance risk* is the risk of regulatory sanctions, fines, penalties or losses resulting from failure to comply with laws, rules, regulations, or other supervisory requirements applicable to a financial institution.
- *Legal risk* is the potential that actions against the institution that result in unenforceable contracts, lawsuits, legal sanctions, or adverse judgments can disrupt or otherwise negatively affect the operations or condition of a financial institution.

1. This definition conforms to the Basel Committee on Banking Supervision's "Principles for the Sound Management of Operational Risk," June 2011, Bank for International Settlements.

The risk-management expectations outlined in this guidance are applicable to all supervised institutions with total consolidated assets less than \$50 billion, including state member banks, bank holding companies, savings and loan holding companies, and foreign banking organizations with combined total U.S. assets of less than \$50 billion. This guidance also applies to insurance and commercial savings and loan holding companies with total consolidated assets less than \$50 billion by providing core risk-management guidance. Reserve Bank staff may further consult with Board staff on appropriately tailoring this guidance for these institutions.

These risks and the activities associated with them are addressed in greater detail in the Federal Reserve's supervision manuals and other guidance documents.² In practice, an institution's business activities present various combinations, concentrations, and interrelationships of these risks depending on the nature and scope of the particular activity. The following discussion provides guidelines for the supervisory assessment of the overall effectiveness of an institution's risk management and its formal or informal systems for identifying, measuring, monitoring, and controlling these risks. Refer to SR-16-11 and its attachment.

4071.0.1 ELEMENTS OF RISK MANAGEMENT

When evaluating the risk management at an institution as part of the evaluation of the overall effectiveness of management, examiners should place primary consideration on findings relating to the following elements of a sound risk-management system:

- board³ and senior management oversight
- policies, procedures, and limits

2. Refer to the Federal Reserve's *Commercial Bank Examination Manual*, this *Bank Holding Company Supervision Manual*, *Examination Manual for U.S. Branches and Agencies of Foreign Banking Organizations*, and relevant FFIEC Examination Manuals.

3. For the purpose of this guidance, for foreign banking organizations, "board of directors" refers to the equivalent governing body of the U.S. operations of the FBO.

- risk monitoring and management information systems
- internal controls

Each of these elements is described further below, along with a list of considerations relevant to assessing each element. Examiners should recognize that the considerations specified in these guidelines are intended only to assist in the evaluation of risk-management practices and are not a checklist of requirements for each institution.

An institution's risk-management processes are expected to evolve in sophistication, commensurate with the institution's asset growth, complexity, and risk. At a larger or more complex organization, the institution should have more sophisticated risk-management processes that address the full range of risks regardless of where the activity is conducted in the organization. Moreover, while a holding company should be able to assess the major risks of the consolidated organization, examiners should expect a parent company that centrally manages the operations and functions of its subsidiary banks to have more comprehensive, detailed, and developed risk-management systems than a parent company that delegates the management of risks to relatively autonomous subsidiaries.⁴

For a small community banking organization (CBO) engaged solely in traditional banking activities and whose senior management is actively involved in the details of day-to-day operations, relatively basic risk-management systems may be adequate. In accordance with the *Interagency Guidelines Establishing Standards for Safety and Soundness*, a CBO is expected, at a minimum, to have internal controls, information systems, and internal audits that are appropriate for the size of the institution and the nature, scope, and risk of its activities.⁵

The risk-management processes of a regional banking organization (RBO) would typically contain detailed guidelines that set specific prudent limits on the principal types of risks rel-

evant to a RBO's consolidated activities.⁶ Furthermore, because of the diversity and the geographic dispersion of their activities, these institutions will require relatively more sophisticated information systems that provide management with timely information that supports the management of risks. The information systems, in turn, should provide management with information that present a consolidated and integrated view of risks that are relevant to the duties and responsibilities of individual managers, senior management, and the board of directors.⁷

Consistent with the principle of national treatment,⁸ the Federal Reserve has the same supervisory goals and standards for the U.S. operations of FBOs as for domestic organizations of similar size, scope, and complexity. Given the added element of foreign ownership, an FBO's risk-management processes and control functions for the U.S. operations may be implemented domestically or outside of the United States. In cases where these functions are performed outside of the United States, the FBO's oversight function, policies and procedures, and information systems need to be sufficiently transparent to allow U.S. supervisors to assess their adequacy. Additionally, the FBO's U.S. senior management need to demonstrate and maintain a thorough understanding of all relevant risks affecting the U.S. operations and the associated management information systems, used to manage and monitor these risks within the U.S. operations.

The information systems at a larger institution will naturally require frequent monitoring and testing by independent control areas and by both internal and external auditors, to ensure the integrity of the information used by the board of directors and senior management in overseeing compliance with policies and limits. Therefore, an institution's risk oversight function needs to be sufficiently independent of the business lines to achieve an adequate separation of duties and the avoidance of conflicts of interest.

4. If these subsidiaries are regulated by another federal banking agency, Federal Reserve examiners should rely to the fullest extent possible on the conclusions drawn by relevant regulators regarding risk management. See also, SR-16-4, "Relying on the Work of the Regulators of the Subsidiary Insured Depository Institution(s) of Bank Holding Companies and Savings and Loan Holding Companies with Total Consolidated Assets of Less than \$50 Billion."

5. Refer to 12 CFR 208, Appendix D-1, the *Interagency Guidelines Establishing Standards for Safety and Soundness*.

6. The Federal Reserve considers an RBO to be a midsize financial institution with total consolidated assets between \$10 and \$50 billion.

7. Additionally, the Federal Reserve's Regulation YY includes specific and enhanced prudential standard requirements regarding risk management for RBOs.

8. National treatment requires nondiscrimination between domestic and foreign firms, or treatment of foreign entities that is no less favorable than that accorded to domestic enterprises in like circumstances. The International Banking Act of 1978 generally gives foreign banks operating in the United States the same powers as domestic banking organizations and subjects them to the same restrictions and obligations.

4071.0.1.1 Board and Senior Management Oversight

The board of directors has the responsibility for establishing the level of risk that the institution should take. Accordingly, the board of directors should approve the institution's overall business strategies and significant policies, including those related to managing risks. Further, the board of directors should also ensure that senior management is fully capable of implementing the institution's business strategies and risk limits. In evaluating senior management, the board of directors should consider whether management is taking the steps necessary to identify, measure, monitor, and control these risks.

The board of directors should collectively have a balance of skills, knowledge, and experience to clearly understand the activities and risks to which the institution is exposed. The board of directors should take steps to develop an appropriate understanding of the risks the institution faces, through briefings from experts internal to their organization and potentially from external experts. The institution's management information systems should provide the board of directors with sufficient information to identify the size and significance of the risks. Using this knowledge and information, the board of directors should provide clear guidance regarding the level of exposures acceptable to the institution and oversee senior management's implementation of the procedures and controls necessary to comply with approved policies.

Senior management is responsible for implementing strategies set by the board of directors in a manner that controls risks and that complies with laws, rules, regulations, or other supervisory requirements on both a long-term and day-to-day basis. Accordingly, senior management should be fully involved in and possess sufficient knowledge of all activities to ensure that appropriate policies, controls, and risk monitoring systems are in place and that accountability and lines of authority are clearly delineated. Senior management is also responsible for establishing and communicating a strong awareness of the need for effective risk management, internal controls, and high ethical business practices. To fulfill these responsibilities, senior management needs to have a thorough understanding of banking and financial market activities and detailed knowledge of the institution's activities, including the internal controls that are necessary to limit the related risks.

In assessing the quality of the oversight provided by the board of directors and senior man-

agement, examiners should consider the following:

- The board of directors has approved significant policies to establish risk tolerances for the institution's activities and periodically reviews risk exposure limits to align with changes in the institution's strategies, address new activities and products, and react to changes in the industry and market conditions.
- Senior management has identified and has a clear understanding and working knowledge of the risks inherent in the institution's activities. Senior management also remains informed about these risks as the institution's business activities evolve or expand and as changes and innovations occur in financial markets and risk-management practices.
- Senior management has identified and reviewed risks associated with engaging in new activities or introducing new products to ensure that the necessary infrastructure and internal controls are in place to manage the related risks.
- Senior management has ensured that the institution's activities are managed and staffed by personnel with the knowledge, experience, and expertise consistent with the nature and scope of the institution's activities and risks.
- All levels of senior management provide appropriate management of the day-to-day activities of officers and employees, including oversight of senior officers or heads of business lines.
- Senior management has established and maintains effective information systems to identify, measure, monitor, and control the sources of risks to the institution.

4071.0.1.2 Policies, Procedures, and Limits

Although an institution's board of directors approves an institution's overall business strategy and policy framework, senior management develops and implements the institution's risk-management policies and procedures that address the types of risks arising from its activities. Once the risks are properly identified, the institution's policies and procedures should provide guidance for the day-to-day implementation of business strategies, including limits designed to prevent excessive and imprudent risks. An institution should have policies and procedures that

address its significant activities and risks with the appropriate level of detail to address the type and complexity of the institution's operations. A smaller, less complex institution that has effective senior management directly involved in day-to-day operations would generally not be expected to have policies as sophisticated as larger institutions. In a larger institution, where senior managers rely on widely-dispersed staffs to implement strategies for more varied and complex businesses, far more detailed policies and procedures would generally be expected. In either case, senior management is expected to ensure that policies and procedures address the institution's material areas of risk and that policies and procedures are modified when necessary to respond to significant changes in the institution's activities or business conditions.

The following guidelines should assist examiners in evaluating an institution's policies, procedures, and limits

- The institution's policies, procedures, and limits provide for adequate identification, measurement, monitoring, and control of the risks posed by its significant risk-taking activities.
- The institution's policies, procedures, and limits are consistent with its stated strategy and risk profile.
- The policies and procedures establish accountability and lines of authority across the institution's activities.
- The policies and procedures provide for the review and approval of new business lines, products, and activities, as well as material modifications to existing activities, services, and products, to ensure that the institution has the infrastructure necessary to identify, measure, monitor, and control associated risks before engaging in a new or modified business line, product, or activity.

4071.0.1.3 Risk Monitoring and Management Information Systems

Institutions of all sizes are expected to have risk monitoring and management information systems in place that provide the board of directors and senior management with timely information and a clear understanding of the institution's business activities and risk exposures. The sophistication of risk monitoring and management information systems should be commensurate with the complexity and diversity of the institu-

tion's operations. Accordingly, a smaller and less complex institution may require less frequent management and board reports to support risk monitoring activities. For example, these reports may include, daily or weekly balance sheets and income statements, a watch list for potentially troubled loans, a report on past due loans, an interest rate risk report, and similar items. In contrast, a larger, more complex institution would be expected to have much more comprehensive reporting and monitoring systems, which includes more frequent reporting to board and senior management, tighter monitoring of high-risk activities, and the ability to aggregate risks on a fully consolidated basis across all business lines, legal entities, and activities.

In assessing an institution's measurement and monitoring of risk and its management reports and information systems, examiners should consider whether these conditions exist:

- The institution's risk monitoring practices and reports address all of its material risks.
- Key assumptions, data sources, models, and procedures used in measuring and monitoring risks are appropriate and adequately documented and tested for reliability on an ongoing basis.⁹
- Reports and other forms of communication address the complexity and range of an institution's activities, monitor key exposures and compliance with established limits and strategy, and as appropriate, compare actual versus expected performance.
- Reports to the board of directors and senior management are accurate, and provide timely and sufficient information to identify any adverse trends and to evaluate the level of risks faced by the institution.

4071.0.1.4 Internal Controls

An effective internal control structure is critical to the safe and sound operation of an institution. Effective internal controls promote reliable financial and regulatory reporting, safeguard assets, and help to ensure compliance with relevant laws, rules, regulations, supervisory requirements, and institutional policies. Therefore, an institution's senior management is responsible for establishing and maintaining an effective system of controls, including the enforcement of official lines of authority and the appropriate

⁹ See also SR-11-7, "Guidance on Model Risk Management."

segregation of duties.

Adequate segregation of duties is a fundamental and essential element of a sound risk management and internal control system. Failure to implement and maintain an adequate segregation of duties can constitute an unsafe-and-unsound practice and possibly lead to serious losses or otherwise compromise the integrity of the institution's internal controls. Serious lapses or deficiencies in internal controls, including inadequate segregation of duties, may warrant supervisory action, including formal enforcement action.

Internal controls should be tested by an independent party who reports either directly to the institution's board of directors or its designated committee, which is typically the audit committee.¹⁰ However, small CBOs whose size and complexity do not warrant a full scale internal audit function may rely on regular reviews of essential internal controls conducted by other institution personnel. Given the importance of appropriate internal controls to institutions of all sizes and risk profiles, the results of audits or reviews, whether conducted by an internal auditor or by other personnel, should be adequately documented, as should management's responses to the findings. In addition, communication channels should allow for adverse or sensitive findings to be reported directly to the board of directors or to the relevant board committee.

In evaluating internal controls, examiners should consider whether these conditions are met:

- The system of internal controls is appropriate to the type and level of risks posed by the nature and scope of the institution's activities.
- The institution's organizational structure establishes clear lines of authority and responsibility for risk management and for monitoring adherence to policies, procedures, and limits.
- Internal audit or other control functions, such as loan review and compliance, provide for independence and objectivity.
- The official organizational structures reflect actual operating practices and management responsibilities and authority over a particular business line or activity.
- Financial, operational, risk management, and

regulatory reports are reliable, accurate, and timely; and wherever applicable, material exceptions are noted and promptly investigated or remediated.

- Policies and procedures for control functions support compliance with applicable laws, rules, regulations, or other supervisory requirements.
- Internal controls and information systems are adequately tested and reviewed; the coverage, procedures, findings, and responses to audits, regulatory examinations, and other review tests are adequately documented; identified material weaknesses are given appropriate and timely, high-level attention; and management's actions to address material weaknesses are objectively verified and reviewed.
- The institution's board of directors, or audit committee, and senior management are responsible for developing and implementing an effective system of internal controls and that the internal controls are operating effectively.

4071.0.1.5 Conclusions

Examiners are expected to assess risk management for an institution and assign formal ratings of "risk management" as described in the *Commercial Bank Examination Manual* for state member banks, the *Bank Holding Company Manual* for bank holding companies, and the *Examination Manual for U.S. Branches and Agencies of Foreign Banking Organizations*.¹¹ In reports of examination or inspection, and in transmittal letters to the boards of directors of state member banks, holding companies,¹² and to the FBO officer of the U.S. operations, examination staff should specifically reference the types and nature of corrective actions that need

11. Refer to section A.5020.1 of the *Commercial Bank Examination Manual*; section 4070.1 of the *Bank Holding Company Supervision Manual*; and section 2003.1 of the *Examination Manual for U.S. Branches and Agencies of Foreign Banking Organizations*. For savings and loan holding companies, see also SR-11-11, "Supervision of Savings and Loan Holding Companies (SLHCs);" SR-13-8, "Extension of the Use of Indicative Ratings for Savings and Loan Holding Companies;" and SR-14-9, "Incorporation of Federal Reserve Policies into the Savings and Loan Holding Company Supervision Program."

12. SR-16-11 applies to insurance and commercial savings and loan holding companies with total consolidated assets less than \$50 billion by providing core risk-management guidance. Reserve Bank staff should further consult with Board staff on appropriately tailoring this guidance for these institutions.

10. Given the importance of the internal audit function, several additional policy statements have been issued. For comprehensive guidance on internal audit, see SR-03-5, "Amended Interagency Guidance on the Internal Audit Function and its Outsourcing" and for institutions with more than \$10 billion in assets, see SR-13-1/ CA-13-1, "Supplemental Policy Statement on the Internal Audit Function and Its Outsourcing."

to be taken by an institution to address noted risk management and internal control deficiencies. Where appropriate, the Federal Reserve will advise an institution that supervisory action will be initiated, if the institution fails to timely remediate risk-management weaknesses when such failures create the potential for serious losses or if material deficiencies or situations threaten its safety and soundness. Such supervisory actions may include formal enforcement actions against the institution, or its responsible officers and directors, or both, and would require the immediate implementation of all necessary corrective measures.

If bank or holding company subsidiaries are regulated by another federal banking agency, Federal Reserve examiners should rely to the fullest extent possible on the conclusions drawn by relevant regulators regarding risk management. See also, SR-16-4, “Relying on the Work of the Regulators of the Subsidiary Insured Depository Institution(s) of Bank Holding Companies and Savings and Loan Holding Companies with Total Consolidated Assets of Less than \$50 Billion.”

Federal Reserve System BHC Surveillance Program

Section 4080.0

WHAT'S NEW IN THIS REVISED SECTION

The BHC Surveillance Program is incorporating a new early-warning model (Holding Company Statistical Assessment of Bank Risk) and other risk identification algorithms (“Outlier Metrics”), while extending its coverage to savings and loan holding companies.

The Federal Reserve’s Holding Company (HC) Surveillance Program covers top-tier bank and savings and loan holding companies. It deploys risk identification algorithms and other surveillance products to process financial and economic data and generate forward-looking, actionable intelligence on HCs. Results are used to assess exposures, outlooks, and possible compliance shortcomings, with the goal of calibrating supervisory resources to risk. (Refer to SR-15-16 and its attachment.)

Objectives fall under these headings: (1) HC monitoring, (2) industry analysis, and (3) metric distribution. In HC monitoring, forward-looking metrics target high-risk HCs and those with emerging financial difficulties for enhanced supervisory attention, while identifying low-risk HCs for more streamlined approaches. The metrics also detect possible regulatory violations or departures from supervisory guidance and feed into financial reports on individual HCs. In industry analysis, aggregate data views and accompanying financial analyses inform Federal Reserve leaders of broad financial institution conditions and trends. In metric distribution, web applications deliver surveillance results to examiners and other supervisory staff.

As fully integrated into the supervisory process, the HC Surveillance Program involves three distinct phases. First, data are processed by the risk identification algorithms, ranging from simple rules to financial models, machine learning, and signal processing. The algorithmic system’s main components are the Outlier List, Watch List, HC Monitoring Screen, and Intercompany Transactions Exception List, all described below. When the algorithms detect departures from expected patterns involving HCs, the results are transmitted via Performance Report Information and Surveillance Monitoring (PRISM), a web application available to Federal Reserve examiners and other supervisory staff for interactive data analysis.

The second phase begins as supervisory staff use additional surveillance products to solidify the initial impressions presented by first-phase

surveillance results. Key examples of these additional products are the BHC Performance Report (BHCPR), a quarterly financial report on individual HCs, described below, and the Focus Report, a web application available to Federal Reserve examiners and other supervisory staff for interactive risk assessment. In addition, aggregate data views and reports of financial condition at the supervisory portfolio and industry levels can help place a particular HC’s status in context.

The third phase involves the development of supervisory responses to the information generated in the first two. A primary goal is to focus supervisory resources on excessive risk-taking, the risk of emerging financial difficulties, and possible compliance shortcomings. When problems are identified, follow-up by examiners promotes correction and resolution. By also identifying low-risk situations, the HC Surveillance Program promotes the application of more streamlined supervisory approaches for such cases.

4080.0.1 OUTLIER LIST

An Outlier List highlights HCs with elevated risk-taking and identifies those with expanded or new areas of risk-taking. It is supported by “Outlier Metrics” in the form of algorithms generating risk classifications of Low, Moderate, or High for individual risk and performance dimensions. The Outlier List includes HCs (FR Y-9C filers only) categorized as High risk within at least one risk or performance dimension. The risk identification algorithms can be based on a broad range of approaches and may evolve over time.

Examiners and other supervisory staff use the Outlier List to monitor risk-taking and promote adequate risk management and mitigation, with the goal of bolstering HCs’ capacity to prevent or buffer financial losses. The Outlier List and its metrics also assist supervisory staff in scoping HC inspections. No regular write-up or documentation requirement is tied to the Outlier List.

4080.0.2 WATCH LIST

The Watch List identifies the risk of emerging financial weaknesses among HCs. It includes

HCs (FR Y-9C filers only) with composite safety-and-soundness ratings consistent with financial viability, but surveillance grades of 'D' or 'F,' pointing to the possibility of deterioration in inspection findings going forward.

To generate the surveillance grades, the Holding Company Statistical Assessment of Bank Risk (HC-SABR) early-warning model is applied to financial and supervisory information for each HC filing consolidated financial statements on the FR Y-9C. The HC-SABR rating consists of the composite rating most recently assigned to an HC via the inspection process, coupled with a surveillance letter grade (A, B, C, D, or F) reflecting the HC's estimated financial condition relative to others in the same rating class.

HC-SABR ratings are designed for use both in monitoring and in determining the scope of an inspection. An accompanying Schedule of Risk Factors (SRF) highlights specific indicators leading the model to flag a particular HC as strong or weak. Through ongoing monitoring, examiners and other supervisory staff review each Watch List HC to assess its financial condition and discern whether substantial deterioration is evident or impending. In such cases, they determine whether an inspection or other supervisory initiative might be needed. The Watch List, much like the Outlier List and its metrics, can also be used in scoping HC inspections to target potentially deteriorating situations for the most extensive reviews.

At times, Reserve Bank staff may need to produce supporting documentation to explain the reasons for an HC's placement on the Watch List and outline the appropriate supervisory response. For HCs other than community banking organizations (CBOs), this type of information is often already contained in quarterly supervisory write-ups outside of the Watch List process. Separate surveillance write-ups are required for CBO HCs on the Watch List when any of the following criteria are met:

1. The current HC-SABR rating is worse than the prior quarter; or
2. The HC-SABR rating is the same as the prior quarter, but the SRF identifies one or more new contributing factors; or
3. The most recent requirement for a write-up occurred four quarters earlier.

The assessments and conclusions comprising a write-up should be brief and supported by

analysis. A Watch List write-up should accomplish the following:

1. summarize the factors leading to Watch List placement;
2. describe any response from the HC to those factors;
3. assess the likelihood of further financial deterioration;
4. judge whether assigned safety-and-soundness ratings are accurate; and
5. determine whether the timing of the next inspection should be accelerated.

Corrective action associated with newly identified problems must be initiated promptly by Reserve Banks. Follow-up action may include correspondence or meetings with an HC's management or an on-site inspection. Problem situations should be closely monitored by supervisory staff until they have been corrected or otherwise resolved.

4080.0.3 HC MONITORING SCREEN

The HC Monitoring Screen includes a focus on the parent company and non-depository subsidiaries; addresses issues such as cash flow, leverage, and complexity; identifies risks to depository institution subsidiaries; and helps monitor compliance with regulations and supervisory guidance. It provides examiners and other supervisory staff with additional perspective on the risk position and financial condition of HCs by supplementing the Outlier List and Watch List. The FR Y-9SP is utilized, among other reports, allowing the HC Monitoring Screen to provide a surveillance view of smaller HCs. Those HCs that fail screening criteria are identified, with the criteria themselves updated periodically.

Examiners and other supervisory staff review HC Monitoring Screen results quarterly and follow up with supervisory initiatives when appropriate. Detailed instructions may accompany parts of the screen linked to specific supervisory programs, as for example, the guidance discussed in this manual's section 4080.1, "Surveillance Program for Small Holding Companies," and further described in SR-13-21. Unless otherwise instructed as part of a specific supervisory program, staff are not generally required to produce surveillance write-ups or maintain surveillance documentation for HCs on the HC Monitoring Screen.

4080.0.4 INTERCOMPANY TRANSACTIONS EXCEPTION LIST

The Intercompany Transactions Exception List (ITEL) helps track compliance with section 23A of the Federal Reserve Act; it is a specialized monitoring process utilizing data from the FR Y-8, together with information from the bank Call report.

For each depository institution possibly exceeding section 23A limits, supervisory staff perform the following: (1) follow up with the HC submitting the FR Y-8 to verify the data are accurate; (2) if an error caused the exception, require an amended report; and (3) if the data are correct, and a depository institution appears to have had covered transactions exceeding section 23A limits, determine the nature and extent of the apparent violation. Reserve Bank staff produce a written review of their findings for each depository institution on the list. The review addresses any apparent violations or reporting errors, along with any corrective action taken.

4080.0.5 THE SURVEILLANCE PROGRAM'S BHC PERFORMANCE REPORT

The HC Surveillance Program generates quarterly financial reports on individual HCs, including a publically available BHCPR consisting of consolidated and parent-only financial information and peer-group percentiles for HCs filing the FR Y-9C. The information is useful in analyzing HCs on the Outlier List, Watch List, or HC Monitoring Screen. By reviewing the performance reports, examiners and other supervisory staff gain insight into potential HC weaknesses. Parent leverage, cash-flow, and coverage ratios can indicate problems at the parent level that could adversely affect depository institution subsidiaries. Information on the parent's income from subsidiaries can help illuminate problems at non-depository subsidiaries that could negatively affect depository institution subsidiaries.

The financial indicators produced by the BHCPR are leveraged in surveillance models such as HC-SABR and used in the financial

analysis of HCs. Some documentation is required to help support the report. Specifically, the BHCPR's peer group analysis involves the identification of HCs that for a variety of reasons could be considered atypical.

To support this process, Reserve Bank staff annually produce a list of atypical HCs. The list provides (1) the name, location, and ID RSSD of a company; and (2) the reason why the HC is considered atypical. HCs removed from the atypical list relative to the previous year are also identified and discussed.

4080.0.6 ROLE IN INSPECTION PROCESS

HCs identified through the surveillance process as (1) taking on positions or pursuing strategies that could lead to problem situations, (2) having a weak or declining financial condition, or (3) failing to comply with regulations or supervisory guidance should, in general, be inspected more intensely and frequently than companies without such deficiencies.

Regarding the positions and strategies of HCs, the Outlier List is designed to identify excessive risk-taking, as are parts of the HC Monitoring Screen. Similarly, the Watch List is intended to identify companies having a weak or declining financial condition, as are parts of the HC Monitoring Screen. Also, the HC Monitoring Screen and the Intercompany Transactions Exception List help detect possible compliance problems among HCs and their subsidiaries.

The full array of risk identification algorithms and products deployed in the HC Surveillance Program can be used in the scheduling and scoping of HC inspections, so as to target, in a timely manner, the riskiest situations for the most extensive reviews, while conserving supervisory resources when risk is low. The examiner-in-charge should exercise prudent supervisory judgment and consider an HC's status on each surveillance list and screen, together with all other available information sources, including the BHCPR and Focus Report, when determining the scope and nature of the inspection work required.

Surveillance Program for Small Holding Companies

Section 4080.1

WHAT'S NEW IN THIS REVISED SECTION

This section has been modified to reflect changes to the small holding company surveillance program. (See SR-13-21.) The surveillance program for holding companies under \$1 billion in total consolidated assets currently includes both bank holding companies and savings and loan holding companies.

The surveillance program for holding companies having total consolidated assets of less than \$1 billion is described below. (See SR-13-21.) The surveillance program is a primary tool for identifying potentially significant changes in the condition of these organizations between reviews and for targeting the work of any on-site reviews. Quarterly surveillance screens identify potential parent-company and nonbank issues that may adversely affect affiliated insured depository institutions. In particular, the screens address parent-company cash flow; intercompany transactions; parent-company leverage; and consolidated capital ratios, where applicable. The surveillance screens are periodically updated to reflect industry trends and issues as well as changes in regulatory reporting requirements.

Upon receipt and finalization of Y-9 data, Board surveillance staff provide each Reserve Bank with the results of the small holding company surveillance screens on a quarterly basis, which identify companies that fail key screening criteria. Reserve Banks should evaluate this information and make a determination as to any appropriate supervisory actions within 45 days of receipt. In doing so, Reserve Banks should determine whether the screen results reveal that the holding company or its affiliates could pose or exacerbate a material risk to a depository institution subsidiary. If the screen results reveal no basis for a significant concern, a short note to examination files documenting this conclusion should be prepared and filed, and no further action is required.

If a Reserve Bank determines that the screen results reveal the potential for material risk to a depository institution, the Reserve Bank should

take appropriate follow-up action within 90 days after initially receiving the surveillance results from the Board. Follow-up actions may include

- contacting the holding company to obtain more information,
- requesting from the holding company a corrective action plan,
- implementing heightened monitoring procedures, or
- commencing an on-site review.

In most cases, follow-up action can be completed off-site. If an on-site review is recommended, the review is to commence within 90 days of the Reserve Bank's initial notification of the surveillance results from the Board. The ratings assigned as a result of the on-site review should be promptly entered into the National Examination Data System (NED) and communicated to the company, Board staff, and appropriate state and federal regulatory authorities within 120 days of that notification.

In addition to the surveillance monitoring screens, Board staff will provide Reserve Banks with program support screens that provide additional information to assist in the supervision of small bank holding companies. One set of support screens identifies companies that are classified as noncomplex, but which exhibit characteristics of complex organizations. Reserve Banks are to evaluate any of these companies to determine whether their designation as noncomplex should be changed and their supervision program modified accordingly. A second set of support screens monitors compliance of financial holding companies with the capital, managerial, and Community Reinvestment Act standards set forth in the Gramm-Leach-Bliley Act.

Surveillance information is crucial to identifying potential issues between reviews and for ensuring that on-site work is risk-focused. Accordingly, Reserve Banks are to continue taking steps to ensure the accuracy of the regulatory reports that are the basis for the surveillance program. In particular, System staff is to follow up promptly on identified inaccuracies.

WHAT'S NEW IN THIS REVISED SECTION

Effective January 2009, this section has been revised to recognize the supervisory guidance contained in SR-08-12 and its interagency attachment, "Changes to the Interagency Country Exposure Review Committee (ICERC) Process." A significant change was made to the ICERC rating process—ICERC will only rate countries that are in default.¹

4090.0.05 DEFINITION, COMPOSITION, AND EXPOSURES OF COUNTRY RISK AND EVALUATING THE ADEQUACY OF COUNTRY-RISK MANAGEMENT

Apart from the consideration of the creditworthiness of individual borrowers, holding companies engaged in international activities are subject to elements of country risk. Country risk encompasses the entire spectrum of risks arising from the economic, social, and political environments of a foreign country, as well as the governmental policies structured to respond to these conditions. These factors may have potentially favorable or adverse consequences for foreigners' debt and equity investments in a particular country. The Federal Reserve, along with the Office of the Comptroller of the Currency and Federal Deposit Insurance Corporation, have issued supervisory guidance concerning the elements of an effective country-risk management process for banking organizations. (See SR-02-05 and SR-08-12, including their attachments.)

Country risk is the risk that economic, social, or political conditions in a foreign country might adversely affect an organization's financial condition, primarily through impaired credit quality or transfer risk.² Country risk is also an important consideration when evaluating the level of credit risk associated with individual counterparties in a country. Regardless of the availability of foreign exchange, macroeconomic conditions and events that are beyond the control of

individual borrowers can strain or impair the financial capacity of otherwise sound borrowers. Significant depreciation of a country's exchange rate, for example, increases the cost of servicing external debt and can adversely affect not only transfer risk for the country, but also the credit risk associated with even the strongest counterparties in the country.

Country risk can occur in many different forms, and the nature of specific risks can change over time. It is essential that a U.S. banking organization with significant direct or indirect international exposure have in place an effective country-risk management process that is commensurate with the volume and complexity of its international activities. More specifically, country risk focuses on a borrower's capacity to obtain the foreign exchange required to service cross-currency debt. A borrower's debt-service capacity may also be affected by the risks of political and social upheaval, nationalization and expropriation, governmental repudiation of external indebtedness, exchange controls, and devaluation. Events such as these may materially affect the condition of investments and the profitability of lending activities overseas; examiners must alert management to those risks that may be difficult for the holding company and its subsidiaries to absorb.

Using uniform examination procedures and techniques for evaluating country-risk exposures for domestic banks, examiners segregate country-risk factors from the evaluation of other lending risks. The procedures emphasize diversification of exposure to individual countries as the primary method of moderating country risk in international portfolios. The approach generally consists of three parts:

1. measuring exposure in each country where a business relationship exists
2. analyzing exposure in relation to the bank's capital resources and the economic and financial conditions of each country in which the bank has outstanding credits
3. evaluating the risk-management system used by the bank in relation to the size and nature of its foreign lending activities

Examiners should evaluate the adequacy of the country-risk management process at internationally active bank holding companies. This risk-assessment process should include, at a

1. With the adoption of revised ICERC procedures in November 2008, the Federal Reserve and the other banking agencies eliminated the rating categories of Other Transfer Risk Problems, Weak, Moderately Strong, and Strong.

2. Transfer risk is the possibility that an asset cannot be serviced in the currency of payment because of a lack of, or restraints on the availability of, needed foreign exchange in the country of the obligor. For more information, see the "Guide to the Interagency Country Exposure Review Committee Process" (SR-08-12's attachment).

minimum, effective oversight by the board of directors, adequate risk-management policies and procedures, an accurate country-exposure reporting system, an effective country-risk analysis process, a country-risk rating system, country-exposure limits, ongoing monitoring of country conditions, periodic stress testing of foreign exposures, and adequate internal controls and an audit function. A bank holding company's country-risk management process should give particular attention to any concentrations of country risk, first at the consolidated level and then within the parent company and nonbank subsidiaries, as well as to any concentrations reported by supervisors at the bank subsidiaries.

4090.0.1 COUNTRY RISKS AND FACTORS

Country or sovereign risk encompasses the entire spectrum of risks and factors that arise from the economic, social, and political environments of a foreign country that may have potential consequences for foreigners' debt and equity investments in that country. A detailed description of these factors is described below.

4090.0.1.1 Macroeconomic Factors

The first factor affecting country risk is the size and structure of a country's external debt in relation to its economy, more specifically—

1. the current level of short-term debt and the potential effect that a liquidity crisis would have on the ability of otherwise creditworthy borrowers in the country to continue servicing their obligations, and
2. to the extent the external debt is owed by the public sector, the ability of the government to generate sufficient revenues, from taxes and other sources, to service its obligations.

The condition and vulnerability of the country's current account is also an important consideration, including—

1. the level of international reserves, including forward market positions of the country's monetary authority (especially when the exchange rate is fixed);
2. the level of import coverage provided by the country's international reserves;

3. the importance of commodity exports as a source of revenue, the existence of any price-stabilization mechanisms, and the country's vulnerability to a downturn in either its export markets or the price of an exported commodity; and
4. the potential for sharp movements in exchange rates and the effect on the relative price of the country's imports and exports.

The role of foreign sources of capital in meeting the country's financing needs is another important consideration in the analysis of country risk, including—

1. the country's access to international financial markets and the potential effects of a loss of market liquidity;
2. the country's relationships with private-sector creditors, including the existence of loan commitments and the attitude among bankers toward further lending to borrowers in the country;
3. the country's current standing with multilateral and official creditors, including the ability of the country to qualify for and sustain an International Monetary Fund or other suitable economic adjustment program;
4. the trend in foreign investments and the country's ability to attract foreign investments in the future; and
5. the opportunities for privatization of government-owned entities.

Past experience has highlighted the importance of a number of other important macroeconomic considerations, including—

1. the degree to which the country's economy may be adversely affected through the contagion of problems in other countries;
2. the size and condition of the country's banking system, including the adequacy of the country's system for bank supervision and any potential burden of contingent liabilities that a weak banking system might place on the government;
3. the extent to which state-directed lending or other government intervention may have adversely affected the soundness of the country's banking system, or the structure and competitiveness of the favored industries or companies; and
4. for both in-country and cross-border exposures, the degree to which macroeconomic conditions and trends may have adversely affected the credit risk associated with counterparties in the country.

4090.0.1.2 Social, Political, and Legal Climate

The analysis of country risk should also consider the country's social, political, and legal climate, including—

1. the country's natural- and human-resource potential;
2. the willingness and ability of the government to recognize economic or budgetary problems and implement appropriate remedial action;
3. the degree to which political or regional factionalism or armed conflicts are adversely affecting the government of the country;
4. any trends toward government-imposed price, interest-rate, or exchange controls;
5. the degree to which the country's legal system can be relied on to fairly protect the interests of foreign creditors and investors;
6. the accounting standards in the country and the reliability and transparency of financial information;
7. the extent to which the country's laws and government policies protect parties in electronic transactions and promote the development of technology in a safe and sound manner;
8. the extent to which government policies promote the effective management of the bank holding company's exposures; and
9. the level of adherence to international legal and business-practice standards.

4090.0.1.3 Factors Specific to Banking Organizations

Finally, a bank holding company's analysis of country risk should consider factors relating to the nature of its actual (or approved) exposures in the country, including, for example—

1. the bank holding company's business strategy and its exposure-management plans for the country;
2. the mix of exposures and commitments, including the types of investments and borrowers, the distribution of maturities, the types and quality of collateral, the existence of guarantees, whether exposures are held for trading or investment, and any other distinguishing characteristics of the portfolio;
3. the economic outlook for any specifically targeted industries within the country;
4. the degree to which political or economic developments in a country are likely to affect

the bank holding company's chosen lines of business in the country (for instance, the unemployment rate or changes in local bankruptcy laws may affect certain activities more than others);

5. for a bank holding company involved in capital markets, its susceptibility to changes in value based on market movements (As the market value of claims against a foreign counterparty rise, the counterparty may become less financially sound, thus increasing the risk of nonpayment (this is especially true for over-the-counter derivative instruments.));
6. the degree to which political or economic developments are likely to affect the credit risk of individual counterparties in the country (for example, foreign counterparties with healthy export markets or whose business is tied closely to supplying manufacturing entities in developed countries may have significantly less exposure to the local country's economic disruptions than do other counterparties in the country); and
7. the bank holding company's ability to effectively manage its exposures in a country through in-country or regional representation, or by some other arrangement that ensures the timely reporting of, and response to, any problems.

4090.0.2 RISK-MANAGEMENT PROCESS FOR COUNTRY RISK

Country risk has an overarching effect on a bank holding company's international activities and should explicitly be taken into account in the risk assessment of all exposures (including off-balance-sheet) to all public- and private-sector foreign-domiciled counterparties. The risk associated with even the strongest counterparties in a country will increase if, for example, political or macroeconomic conditions cause the exchange rate to depreciate and the cost of servicing external debt to rise. Country risk can occur in many different forms, and the nature of specific risks can change over time. A U.S. banking organization with significant direct or indirect international exposure should have in place an effective country-risk management process that is commensurate with the volume and complexity of its international activities. Examiners should be continually evaluating the adequacy of the country-risk management process at internation-

ally active bank holding companies, and they should regularly update their assessments. A bank holding company's country-risk management process should give particular attention to any concentrations of country risk at the parent level or within its bank and nonbank subsidiaries.

Country risk is not necessarily limited to banking organizations with direct international exposures. Domestic counterparties with significant economic dependence on a foreign country or region (for example, through export dependence) can pose an indirect country risk to banking organizations that do not have direct international activity. While banking organizations are not required to incorporate indirect country risk into a formal country-risk management process, they should, nevertheless, take these country-risk factors into account, where appropriate, when assessing the creditworthiness of domestic counterparties. Examiners should ensure that the overall credit-risk management process takes into account indirect country risk where applicable in all Federal Reserve-supervised banking organizations.

To effectively control the risk associated with international activities, bank holding companies must have a risk-management process that focuses on the broadly defined concept of country risk. The elements of a sound country-risk management process are discussed in further detail below.

4090.0.2.1 Oversight by the Board of Directors

If country risk is to be managed properly, the board of directors must oversee the process effectively. The board is responsible for periodically reviewing and approving policies governing its international activities to ensure that they are consistent with the bank holding company's strategic plans and goals. The board is also responsible for reviewing and approving limits on country exposure and ensuring that management is effectively controlling the risk. When evaluating the adequacy of the bank holding company's capital and allowance for loan and lease losses (ALLL), the board should take into account the volume of foreign exposures and the ratings of the countries to which it is exposed.

4090.0.2.2 Policies and Procedures for Managing Country Risk

Bank management is responsible for implementing sound, well-defined policies and procedures for managing country risk that—

1. establish risk-tolerance limits;
2. delineate clear lines of responsibility and accountability for country-risk management decisions;
3. specify authorized activities, investments, and instruments; and
4. identify both desirable and undesirable types of business.

Management should also ensure that country-risk management policies, standards, and practices are clearly communicated to the affected offices and staff.

4090.0.2.3 Country-Exposure Reporting System

To effectively manage country risk, the bank holding company must have a reliable system for capturing and categorizing the volume and nature of foreign exposures. The reporting system should cover all aspects of the bank holding company's operations, whether conducted through paper transactions or electronically. An accurate country-exposure reporting system is also necessary to support the regulatory reporting of foreign exposures on the quarterly Country Exposure Report, FFIEC 009, and the supplemental Country Exposure Information Report, FFIEC 009a.

The board of directors should regularly receive reports on the level of foreign exposures. If the level of foreign exposures in a bank holding company is significant,³ or if a country to which the bank holding company is exposed is considered to be high risk, exposures should be reported to the board at least quarterly. More frequent reporting is appropriate when a deterioration in foreign exposures would threaten the soundness of the bank holding company.

3. For purposes of this guidance, concentrations of exposures to individual countries that exceed 25 percent of the bank holding company's or bank's tier 1 capital plus the ALLL are considered significant. However, in the case of particularly troubled countries, lesser degrees of exposure may also be considered to be significant.

4090.0.2.4 Country-Risk Analysis Process

Although the nature of the country-risk analysis process and the level of resources devoted to it will vary, depending on the size and sophistication of the banking organization's international operations, a number of considerations are relevant to evaluating the process in all banking organizations:

1. Is there a quantitative and qualitative assessment of the risk associated with each country in which the banking organization is conducting or planning to conduct business?
2. Is a formal analysis of country risk conducted at least annually, and does the banking organization have an effective system for monitoring developments in the interim?
3. Does the analysis take into account all aspects of the broadly defined concept of country risk, as well as any unique risks associated with specific groups of counterparties the banking organization may have targeted in its business strategy?
4. Is the analysis adequately documented, and are conclusions concerning the level of risk communicated in a way that provides decision makers with a reasonable basis for determining the nature and level of the banking organization's exposures in a country?
5. Given the size and sophistication of the banking organization's international activities, are the resources devoted to the analysis of country risk adequate?
6. As a final check of the process, are the banking organization's conclusions concerning a country reasonable in light of information available from other sources, including external research and rating services and the Inter-agency Country Exposure Review Committee (ICERC)?

4090.0.2.5 Country-Risk Ratings

Country-risk ratings summarize the conclusions of the country-risk analysis process. The ratings are an important component of country-risk management because they provide a framework for establishing country-exposure limits that reflect the bank holding company's tolerance for risk.

Because some counterparties may be more exposed to local country conditions than others, it is a common and acceptable practice for banking organizations to distinguish between different types of exposures when assigning their

country-risk ratings. For example, trade-related and banking-sector exposures typically receive better risk ratings than other categories of exposure because the importance of these types of transactions to a country's economy has usually moved governments to give them preferential treatment for repayment.

The risk-rating systems of some banking organizations differentiate between public-sector and private-sector exposures. In some banking organizations, a country's private-sector credits cannot be rated less severely than its public-sector credits (that is, the banking organization imposes a "sovereign ceiling" on the rating for all exposures in a country). Both are acceptable practices.

A banking organization's country-risk ratings may differ from the ICERC-assigned transfer-risk ratings because the two ratings differ in purpose and scope. A banking organization's internally assigned ratings help it to decide whether to extend additional credit, as well as how it should manage existing exposures. Such ratings should, therefore, have a forward-looking and broad country-risk focus. The ICERC's more narrowly focused transfer-risk ratings are primarily a supervisory tool to identify countries where concentrations of transfer risk might warrant greater scrutiny and to determine whether some minimum level of reserves against transfer risk should be established. The ICERC rating process only rates countries in default. Default occurs when a country is not complying with its external debt-service obligations or is unable to service the existing loan according to its terms, as evidenced by failure to pay principal and interest fully and on time, arrearages, forced restructuring, or rollovers. For more information on ICERC ratings, see section 7040.3 of the *Commercial Bank Examination Manual* and SR-08-12.

4090.0.2.6 Country-Exposure Limits

As part of their country-risk management process, internationally active bank holding companies should adopt a system of country-exposure limits. Because the limit-setting process often involves divergent interests within the banking organization (such as the country managers, the bank holding company's overall country-risk manager, and the country-risk committee), country-risk limits will usually

reflect a balancing of several considerations, including—

1. the overall strategy guiding the bank holding company's international activities,
2. the country's risk rating and the bank holding company's appetite for risk,
3. perceived business opportunities in the country, and
4. the desire to support the international business needs of domestic customers.

Country-exposure limits should be approved by the board of directors, or a committee thereof, and communicated to all affected departments and staff. Exposure limits should be reviewed and approved at least annually—and more frequently when concerns about a particular country arise.

A bank holding company's board of directors and senior management should consider whether its international operations are such that it should supplement its aggregate exposure limits with more discrete controls. Such controls might take the form of limits on the different lines of business in the country, limits by type of counterparty, or limits by type or tenor of exposure. A bank holding company might also limit its exposure to local currencies. Bank holding companies that have both substantial capital-market exposures and credit-related exposures typically set separate aggregate exposure limits for each because exposures to the two lines of business are usually measured differently.

Although country-by-country exposure limits are customary, bank holding companies should also consider limiting (or at least monitoring) exposures on a broader (for example, regional) basis. A troubled country's problems often affect its neighbors, and the adverse effects may also extend to geographically distant countries with close ties through trade or investment. By monitoring and controlling exposures on a regional basis, bank holding companies are in a better position to respond if the adverse effects of a country's problems begin to spread.

For bank holding companies that are engaged primarily in direct lending activities, monthly monitoring of compliance with country-exposure limits is adequate. However, bank holding companies with more volatile portfolios, including those with significant trading accounts, should monitor compliance with approved limits more frequently. Exceptions to approved country-exposure limits should be

reported to an appropriate level of management or the board of directors so that it can consider corrective measures.

4090.0.2.7 Monitoring Country Conditions

The bank holding company should have a system in place to monitor current conditions in each of the countries where it is significantly exposed. The level of resources devoted to monitoring conditions within a country should be proportionate to the bank holding company's level of exposure and the perceived level of risk. If the bank holding company maintains an in-country office, reports from the local staff are an obviously valuable resource for monitoring country conditions. In addition, periodic country visits by the regional or country manager are important to properly monitor individual exposures and conditions in a country. The bank holding company may also draw on information from rating agencies and other external sources.

Communication between senior management and the responsible country managers should be regular and ongoing. The bank holding company should not rely solely on informal lines of communication and ad hoc decision making in times of crisis. Established procedures should be in place for dealing with exposures in troubled countries, including contingency plans for reducing risk and, if necessary, exiting the country.

4090.0.2.8 Stress Testing

Bank holding companies should periodically stress-test their foreign exposures and report the results to the board of directors and senior management. As used here, stress testing does not necessarily refer to the use of sophisticated financial modeling tools, but rather to the need for all bank holding companies to evaluate in some way the potential impact different scenarios may have on their country-risk profiles. The level of resources devoted to this effort should be commensurate with the significance of foreign exposures in the bank holding company's overall operations.

4090.0.2.9 Internal Controls and Audit

Bank holding companies should ensure that their country-risk management process includes adequate internal controls and that an audit

mechanism ensures the integrity of the information used by senior management and the board to monitor compliance with country-risk policies and exposure limits. The system of internal controls should, for example, ensure that the responsibilities of marketing and lending personnel are properly segregated from the responsibilities of personnel who analyze country risk, rate country risk, and set country limits.

4090.0.3 REPORTING REQUIREMENTS

4090.0.3.1 Country Exposure Report (FFIEC 009)

Banks and bank holding companies required to file the Country Exposure Report (Form FFIEC 009, formerly Form FR 2036) when the bank or banks have a foreign branch, a foreign subsidiary, or an Edge corporation, and when they have, on a consolidated basis, total outstanding claims on residents of foreign countries of \$30 million or more. The report is to be filed quarterly within 45 days of the end of March, June, September, and December.

The report measures lending to residents of foreign countries by U.S. banking organizations. It is used to provide information on the distribution, by country, of foreign claims held by such banking organizations to (1) determine the degree of risk in bank portfolios and how adverse developments in particular countries affect the U.S. banking system; (2) assess country risk for supervisory purposes, and (3) assist the Bank for International Settlements in compiling worldwide data on cross-border claims. The report also includes information on revaluation gains for off-balance-sheet items and for securities held in trading accounts.

4090.0.3.2 Country Exposure Information Report (FFIEC 009a)

The County Exposure Information Report (Form FFIEC 009a) supplements the Country Exposure Report. The purpose of FFIEC 009a is to provide public disclosure of significant country exposures of U.S. banking institutions. Every institution that submits the FFIEC 009 and that has exposures to a country that exceed 1 percent of total assets or 20 percent of capital of the reporting institution submits the FFIEC 009a. FFIEC 009a respondents also furnish a list of countries in which exposures were between

$\frac{3}{4}$ of 1 percent and 1 percent of total assets or between 15 and 20 percent of capital. Filing of the report is required.

4090.0.3.3 Country Exposure Report for U.S. Branches and Agencies of Foreign Banks (FFIEC 019)

The Country Exposure Report for U.S. Branches and Agencies of Foreign Banks (Form FFIEC 019) is similar to the FFIEC 009 report that is filed by U.S. banks. The FFIEC 019 report collects information, by country, on the direct claims, indirect claims, and total adjusted claims on foreign residents; information on direct claims on related non-U.S. offices domiciled in countries other than the home country of the parent bank that are ultimately guaranteed in the home country that are included in total adjusted claims on the home country; and information on the breakdown of adjusted claims on unrelated foreign residents. The data are used by the supervisory agencies to monitor significant foreign-country exposures of U.S. branches and agencies of foreign banks. The reports are also used to evaluate the financial condition of these branches and agencies.

The FFIEC 019 is collected quarterly from those branches and agencies of foreign banks that have, as of the quarterly report date, more than \$30 million in total direct claims on residents of foreign countries. The FFIEC 019 provides data on the foreign-risk exposure of each reporting branch and agency.

Respondents to the FFIEC 019 must prepare the data as of the close of each calendar quarter and submit the forms to the appropriate Reserve Bank no later than 45 days following the report date. Data are due at the Board 60 days following the report date. Bank holding companies should obtain, from the management of their respective foreign bank subsidiaries, written confirmation that the FFIEC 019 and all other Federal Reserve and FFIEC reports have been filed, as required.

4090.0.4 INSPECTION OBJECTIVES

1. If the bank holding company is internationally active, to determine the nature and extent of its direct and indirect country-risk exposures.
2. If the bank holding company has significant

direct or indirect international exposure, to evaluate and determine whether it has in place an effective country-risk management process that is commensurate with the volume and complexity of its international activities.

3. To review and determine if the bank holding company's system of policies, procedures, internal controls, rating system, and stress testing for country-risk management are adequate and reliable.
4. To determine if the bank holding company's board of directors oversees and regularly reviews its country-risk management process, approves limits on country exposure, provides for adequate capital that is commensurate with its direct and indirect country-risk exposures, and ensures that management is effectively controlling the risk.
5. To determine if management clearly communicates the bank holding company's country-risk management policies, standards, and practices to the affected offices and staff.
6. To (1) determine if the scope of the bank holding company's audit function is adequate and if the function is sufficiently comprehensive to ensure the integrity of the information senior management and the board use to monitor the bank holding company's country-risk management process, and (2) ensure that the board of directors or its audit committee has provided for adequate audit coverage of country-risk management functions.
7. To recommend corrective action if a bank holding company's country-risk management process and controls are deficient in relation to the level of country-risk exposure.
8. To determine if the bank holding company is properly preparing the Country Exposure Report, FFIEC 009, and the supplemental Country Exposure Information Report, FFIEC 009a, both of which are required to be filed quarterly with the respective Reserve Banks, as applicable.
9. To identify and report individual exposures considered significant in relation to the bank holding company's capital and the economic performance of the country.
10. To prepare a report on the bank holding company's country-exposure management system and on any noted deficiencies.

4090.0.5 INSPECTION PROCEDURES

When performing and updating the bank holding company's risk assessment, the central point of contact for the bank holding company should include an analysis of its direct and indirect country-risk exposures (including any significant country-risk concentrations) and of the adequacy and reliability of its country-risk management. The analysis of the bank holding company's country-risk management systems should consist of three important components.

One component is the provision for evaluation of economic trends, political developments, and the social fabric within countries where the bank holding company's funds are at risk. These so-called country studies are derived from economic data supplied by the borrower or published by institutional lenders; sociopolitical commentaries; on-site reports from bank branches, subsidiaries, or affiliates; or bank-officer visits to the country.

In the second component, the board of directors and senior management define the level of country exposure the bank is willing to assume. This undertaking normally includes the establishment of limits on aggregate outstandings, maturities, and categories of risk exposures by country, which serve as a guide to operating management in the development and servicing of the bank holding company's international credit portfolio.

The third component is the bank holding company's internal reporting system, which should be designed to monitor and control country exposure. A comprehensive reporting system is required to accurately assign risk exposures to the country of risk, ensure adherence to the directives of the board of directors, provide for at least an annual review of portfolio composition in individual countries, and establish a clear-cut methodology for reporting exceptions to established limits.

A summary of the country-risk management system should be prepared. Set forth below are guidelines and procedures for examiners to use in evaluating the systems banks use to monitor and control country-risk elements in their international loan portfolios. In assessing the quality of the country-risk management system, examiners should, as a matter of course, spot-check the accuracy of the data submitted on the Country Exposure Report, FFIEC 009, and the supplemental Country Exposure Information Report, FFIEC 009a, as applicable. The review should include a review of the exposures for at least several countries. The report page, Examiners' Comments and Matters Requiring Special Board

Attention, should be used to comment on material exceptions.

1. Obtain any written policies, procedures, or summaries of the bank holding company's country-risk management system. Determine whether the bank holding company's country-risk management system includes—
 - a. effective oversight by the board of directors,
 - b. adequate risk-management policies and procedures,
 - c. an accurate country-exposure reporting system,
 - d. an effective country-risk analysis process,
 - e. a country-risk rating system,
 - f. country-exposure limits,
 - g. ongoing monitoring of country conditions,
 - h. periodic stress testing of foreign exposures, and
 - i. adequate internal controls and an audit function. (See SR-02-05.)
2. Review international-lending policies and determine—
 - a. if the board of directors regularly reviews and gives final approval to the limits on country exposure at least annually (or quarterly, if the foreign exposures are high risk or the concentrations are significant);
 - b. who initiates the country ratings and country limits;
 - c. how frequently and by whom country ratings and limits are reviewed and changed;
 - d. how the bank holding company defines the ratings assigned to the various countries;
 - e. how country limits are determined;
 - f. who is responsible for monitoring compliance with country limits;
 - g. if country-risk limits consider—
 - (1) the overall strategy guiding the institution's international activities,
 - (2) the country's risk rating and the institution's appetite for risk,
 - (3) perceived business opportunities in the country, and
 - (4) the desire to support the international business needs of domestic customers;
 - h. to what extent country limits are viewed as guidelines that may be exceeded;
 - i. if the bank holding company has different sublimits for private- and public-sector credits;
 - j. if separate limits are established for private- and public-sector credits;
 - k. if the board of directors or a committee thereof periodically reviews country ratings and limits, and evaluates the bank holding company's performance against those standards;
3. Review reports furnished to the board or the appropriate committee to ensure that comprehensive and accurate information is being submitted on a timely basis.
4. Obtain the bank holding company's report on the general distribution and characteristics of the international loan portfolio and compare loan-category distributions for adherence to guidelines.
5. During a discussion with senior management, direct inquiries to—
 - a. gain insight into general management's international-lending philosophy, and
 - b. elicit management's responses for correction of deficiencies.
6. When reporting on the bank holding company's country-risk management system, consider factors such as—
 - a. the quality of internal policies, practices, procedures, and controls over the international-lending functions;
 - b. the scope and adequacy of the internal

-
- loan-review system as it pertains to country risk;
 - c. causes of existing problems;
 - d. commitments from management for correction of deficiencies;
 - e. expectations for continued sound international lending or correction of existing deficiencies;
 - f. the ability of management to monitor and control transfer risk;
 - g. the general level of adherence to internal policies, practices, procedures, and controls; and
 - h. the scope and adequacy of the bank holding company's analysis of country conditions.