

Attachment

Institution Monitoring Metrics, Procedures, and Write-Ups

Outlier List

The Outlier List identifies emerging risks at state member banks (SMBs) and top-tier bank and savings and loan holding companies (HCs); 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 (for example, capital, liquidity, credit, earnings, and operations).¹ The Outlier List includes all SMBs and top-tier HCs (FR Y-9C filers only) categorized as High risk within at least one risk or performance dimension.

Metrics: The algorithms can be based on a broad range of approaches, the details of which may evolve over time. They are designed for use both in monitoring and in examination and inspection scoping, providing examiners and other supervisory staff with early signals of an institution's risk-taking. For HCs, Outlier Metrics are limited to companies filing the FR Y-9C, *Consolidated Financial Statements for Holding Companies*.

Procedures: When the quarterly Outlier List becomes available through the web application Performance Report Information and Surveillance Monitoring (PRISM), the Board's Surveillance Section notifies Surveillance Contacts at the Reserve Banks, separately for SMBs and HCs. Supporting metrics and interactive risk assessment tools are provided via another web application, the *Focus Report*, helping examiners and other supervisory staff delve into risk issues, as needed. Reserve Bank staff are encouraged to utilize the Outlier List to monitor risk profiles and promote adequate risk management and mitigation at supervised institutions, bolstering institutions' capacity to prevent or buffer financial losses.

The Outlier List and its metrics also assist supervisory staff in scoping SMB examinations and HC inspections, particularly at community banking organizations (CBOs) and regional banking organizations (RBOs). More specifically, the Outlier List is used by Reserve Banks to allocate more examiner resources to review high-risk institutions and conserve examiner resources at lower risk ones. The examiner-in-charge should exercise prudent supervisory judgment and consider an institution's Outlier List status and all other available information sources when determining the scope and nature of the examination or inspection work required.

Write-Ups: No regular write-up or documentation requirement is tied to the Outlier List.

¹ Outlier Metrics are a product of an analytical effort across the Federal Reserve System (System). The System Risk Council sponsors the algorithms, with a Metrics and Categorization workgroup assessing their predictive accuracy and a Reports and Response workgroup integrating them into supervisory processes. The Board's Surveillance Section verifies the algorithms' forward-looking information content, updates them to reflect best practices in risk modeling, and evaluates them for effectiveness in guiding supervisory resources. While initially targeting community and regional banking organizations, the algorithms are being expanded and customized for banks and HCs of differing size and complexity. Outlier Metrics are housed at the Board of Governors. Outlier Metric development has only recently begun, with full implementation not expected until 2017; metrics are rolled into production as work on individual risk and performance dimensions is completed.

Watch List

The Watch List identifies emerging financial weaknesses at SMBs and HCs. The Watch List includes all SMBs and top-tier HCs (FR Y-9C filers only) with a most recent composite safety-and-soundness rating consistent with financial viability, but a surveillance grade of ‘D’ or ‘F,’ pointing to the possibility of deterioration in examination or inspection findings in the future.²

Metrics: An early-warning model, Supervision and Regulation Statistical Assessment of Bank Risk (SR-SABR), assigns a rating to every SMB and has driven the Watch List for SMBs since year-end 2005. An SR-SABR rating consists of the composite safety-and-soundness rating assigned to an SMB at its most recent examination, coupled with a surveillance letter grade (A, B, C, D, or F) reflecting the bank’s estimated financial condition relative to others with the same composite safety-and-soundness rating. An SR-SABR grade of ‘A’ denotes a bank with strong indicators relative to others in the same rating class, while an ‘F’ indicates major weaknesses. Two grades are assigned to each SMB, one reflecting the estimated probability of a downgrade to a worse rating class (Adverse Change) and another reflecting the estimated probability of critical undercapitalization or failure (Viability).³ The overall SR-SABR rating is based on the worse of the two grades.

Much like the SR-SABR model, the Holding Company Statistical Assessment of Bank Risk (HC-SABR) early-warning model uses financial and supervisory information to assign a rating to each HC filing consolidated financial statements on the FR Y-9C. An 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, as indicated by the estimated probability of a downgrade to a worse rating class.⁴

SR-SABR and HC-SABR ratings are designed for use in both monitoring and examination and inspection scoping. An accompanying Schedule of Risk Factors (SRF) highlights specific indicators leading the models to flag a particular SMB or HC as strong or weak.⁵

² Banks and HCs already identified through the examination and inspection processes as harboring viability threatening weaknesses are described in examination and inspection reports and regularly scrutinized. Because these situations are well known and addressed through supervisory channels, surveillance Watch List placement is generally not needed in such cases. Through this functional distinction, the Watch List is allowed to maintain its focus on early indications of emerging financial weaknesses.

³ The Adverse Change and Viability probabilities can be estimated using a variety of approaches, such as logistic regression. Likewise, a variety of input variables can be used, most commonly financial ratios based on the *Consolidated Reports of Condition and Income*, or Call report. Both the estimation vehicle and the input variables may vary over time. The Adverse Change grade emphasizes financial condition, whereas the Viability grade, while incorporating financial condition indicators, also includes proxies for risk-taking, as with the companion Outlier Metrics.

⁴ The probability of a downgrade can be estimated using a variety of approaches, such as logistic regression, and a variety of input variables can be used, most commonly financial ratios based on the FR Y-9C.

⁵ SR-SABR, HC-SABR, and the accompanying SRF are housed at the Board of Governors and are products of analytical effort across the System. The models are flexible, and if the underlying supervisory rating system for

Procedures: The Board’s Surveillance Section notifies Surveillance Contacts at the Reserve Banks when the quarterly Watch List and SRF are available via PRISM, separately for SMBs and HCs. Upon notification that the Watch List is ready for review, the Surveillance Contacts should exercise prudent supervisory judgment in performing the following procedures as part of the normal supervisory process, while taking into account institution-specific circumstances:

1. Review each Watch List institution to assess its financial condition and risk position and determine whether substantial deterioration is evident or impending. Reserve Bank staff should consider recent examination or inspection findings and relevant information included in correspondence between an institution and Reserve Bank.
2. In cases where substantial deterioration in an institution’s financial condition is evident or impending, determine whether an examination, inspection, or other supervisory initiative might be needed.

Much like the Outlier List and its metrics, in addition to ongoing monitoring the Watch List can also be used in scoping SMB examinations and HC inspections to target potentially deteriorating situations for the most extensive reviews.

Write-Ups: In many instances, Reserve Bank staff need to provide supporting documentation explaining the reasons for an institution’s placement on the Watch List from a safety-and-soundness perspective and outlining the appropriate supervisory response. For non-CBO institutions, this type of information is typically already contained in quarterly supervisory write-ups outside of the Watch List process. However, if these other write-ups for non-CBO institutions are not completed quarterly or do not address surveillance findings, Reserve Bank staff should complete separate surveillance write-ups.

Because quarterly supervisory write-ups are not regularly produced for CBOs, surveillance write-ups are routinely required for CBOs on the Watch List. Reserve Bank staff should produce a surveillance write-up for each CBO (SMB or HC) on the Watch List meeting **any** of the following criteria:

1. The current SR-SABR or HC-SABR rating is worse than the prior quarter,⁶ or
2. The SR-SABR or 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 the write-up should be brief and supported by the necessary analysis. A Watch List write-up should accomplish the following:

SMBs or HCs changes, SR-SABR and HC-SABR adapt accordingly, while maintaining their primary function of detecting relative strength and weakness within rating classes. Working with the Board’s Surveillance Section, a System workgroup, the Statistical Surveillance Production Group, assesses model performance on a quarterly basis.

⁶ For an x-level composite rating system, SR-SABR and HC-SABR ratings are ordered from best to worst first by composite rating and then within each composite rating by surveillance grade, as follows: 1A, 1B, 1C, 1D, 1F . . . xA, xB, xC, xD, xF.

1. Summarize the factors leading to Watch List placement;
2. Describe any response from the institution 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 examination or inspection should be accelerated.

For CBOs meeting surveillance write-up criteria, Reserve Bank staff should post a surveillance write-up to the System's designated text repository no more than 30 days after receiving SMB or HC Watch List results, using the designated posting mechanism. Each write-up should be posted as a "Surveillance Watch List Write-Up" and assigned a date corresponding to the quarterly surveillance cycle. A Surveillance Contact at each Reserve Bank should notify the Board's Surveillance Section once all surveillance write-ups required for SMBs have been posted and again when all HC write-ups have been posted.

Beyond these minimum expectations, the Board's Surveillance Section may under special circumstances request from Reserve Bank staff additional information regarding institutions on the Watch List.

SMB and HC Monitoring Screens

The SMB and HC Monitoring Screens identify complex operations, monitor compliance with regulations and supervisory guidance, and more generally can be used to detect novelties or departures from expected patterns. The monitoring screens identify the institutions that have failed the key screening criteria. The screening criteria are updated periodically and will expand over time to leverage more fully the growing and increasingly varied data reported by supervised institutions, particularly the largest companies. Related to these screens, the Surveillance Program also includes a Problem SMB List and Problem HC List based on supervisory ratings.

The HC Monitoring Screen includes a focus on the parent company and non-depository subsidiaries; addresses issues such as cash flow, leverage, and complexity; and identifies risks to depository institution subsidiaries. A variety of data sources can be used beyond the consolidated FR Y-9C, such as *Parent Company Only Financial Statements for Large Holding Companies* (FR Y-9LP) and *Parent Company Only Financial Statements for Small Holding Companies* (FR Y-9SP).

Metrics: Many of the included metrics provide supervisory staff with additional perspective on the risk position and financial condition of institutions by supplementing the Outlier List and Watch List on a quarterly basis. Some of these metrics and tracking mechanisms consist of simple financial ratios and rules. Other metrics can employ more involved approaches, including machine learning and signal processing techniques.

Procedures: The Board's Surveillance Section notifies the Reserve Bank Surveillance Contacts when the SMB and HC Monitoring Screens are available in PRISM. Reserve Bank staff are encouraged to review the SMB and HC Monitoring Screen results quarterly and follow up with

supervisory initiatives when appropriate. Detailed instructions may be included in supervision-oriented policy letters.

Write-Ups: Unless otherwise instructed in supervision-oriented policy letters, Reserve Bank staff are not generally expected to submit write-ups or maintain documentation tied to an institution on the SMB or HC Monitoring Screen.

Intercompany Transactions Exception List

The Intercompany Transactions Exception List (ITEL) tracks compliance with section 23A of the Federal Reserve Act.

Metrics: The Surveillance Program includes a specialized monitoring process related to intercompany transactions, utilizing data from the FR Y-8, *The Bank Holding Company Report of Insured Depository Institutions' Section 23A Transactions with Affiliates*, and information from the Call report.

Procedures: The Board's Surveillance Section notifies the Reserve Bank Surveillance Contacts when ITEL utilizing data from the FR Y-8 is available via PRISM. For each depository institution possibly exceeding section 23A limits, Reserve Bank staff should: (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.

Write-Ups: No more than 30 days after receiving ITEL, Reserve Bank staff should submit a written review of their findings for each depository institution on the list. The review should address any apparent violations or reporting errors and any corrective action taken. A full assessment is not necessary for institutions reviewed within the last 12 months; for such cases, notation indicating the previous review will normally suffice. The written review should be posted to the System's designated text repository as a "Surveillance FR Y-8 Review" and assigned a date corresponding to the quarterly surveillance cycle. A Surveillance Contact at each Reserve Bank should notify the Board's Surveillance Section once all required reviews have been posted.

Bank Holding Company Performance Report

The Bank Holding Company Performance Report (BHCPR) is a computer-generated report of current and historical financial information produced quarterly for HCs, based on the FR Y-9C and FR Y-9LP.

Metrics. The BHCPR includes statistics on average performance within HC peer groups. The financial ratios produced by the BHCPR are used in financial analysis of HCs and leveraged in surveillance models such as HC-SABR.⁷

Procedures. The Board's Surveillance Section notifies the Reserve Bank Surveillance Contacts when the quarterly BHCPR is available. The BHCPR is distributed to the public via the Federal Reserve's National Information Center website.⁸

Write-Ups: While write-ups are not typically needed in response to BHCPR information, 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, such as low levels of investment in depository subsidiaries, could be considered atypical. To support this process, Reserve Bank staff annually submit a list of atypical HCs to the Board's Surveillance Section. Submissions are due March 31st and include atypical HCs as of the previous year-end. A submission is sent by each Reserve Bank even when no atypical HCs have been identified. The atypical HC list provides (1) the name, location, and ID RSSD of the company; and (2) the reason why the HC is considered atypical. HCs removed from the atypical list relative to the previous year are identified and discussed.

Summary

The following summarizes the coverage of the various institution monitoring mechanisms deployed for HCs and SMBs:

HC and SMB Monitoring Summary					
	HCs				
	No FR Y-9C	FR Y-9C		SMBs	
		CBOs	Other	CBOs	Other
Outlier List		x	x	x	x
Watch List		x	x	x	x
Watch List Write-Ups		x	‡	x	‡
Monitoring Screens	x	x	x	x	x
ITEL*	x	x	x	x	x
ITEL Write-Ups*	x	x	x	x	x
BHCPR		x	x		

* An organization filing the FR Y-8 shows transactions separately for each insured depository institution it controls, all of which (not only SMBs) are monitored by ITEL.

‡ Only for surveillance findings not addressed in supervisory write-ups outside the Watch List process.

⁷ The Federal Reserve's BHCPR for HCs parallels the Federal Financial Institutions Examination Council's Uniform Bank Performance Report (UBPR) for banks.

⁸ For more information, see <http://www.ffiec.gov/nicpubweb/nicweb/nichome.aspx>.