A New Supervisory System for Rating Banks

The commercial banking system which serves the United States is a very diverse one. Its nearly 14,500 banks range from single-office institutions, with less than $1 million in assets and serving a limited market area, to the international banking giants with hundreds of offices located in the world's financial centers and with assets which total many billions of dollars. Federal supervision of such a diverse banking system is necessarily a complex and demanding task for the three agencies that share responsibility for seeing that the banking system is safe and sound and serves the financial needs of the nation. While all three Federal agencies have approached the analysis of bank condition in a somewhat similar way, past differences in bank rating procedures and techniques used by the agencies had complicated the task of evaluating the condition of the banking system as a whole. In May, the Federal Reserve System, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation (FDIC) announced adoption of a uniform system for rating the condition of the nation's commercial banks.

The new rating system gives senior officials at the supervisory agencies a capsule summary of the condition of individual banks as well as an indication of the health of groups of banks or the overall banking system. The ratings are intended as a tool to focus attention on real and potential problems and to permit the effective allocation of supervisory resources among the banks. Federal law gives primary supervisory responsibility for the nation's 4,700 national banks to the Office of the Comptroller of the Currency. The Federal Reserve System exercises direct supervisory authority over about 1,000 banks that are chartered by state banking authorities and that are members of the Federal Reserve System. The FDIC provides Federal supervision over more than 8,700 insured, state-chartered commercial banks that are not members of the Federal Reserve System. In addition, the Federal Reserve System is charged with primary responsibilities for supervising the more than 2,000 bank holding companies in the United States with one or more commercial bank subsidiaries.

The new Uniform Interagency Bank Rating System will help ensure consistency in the way the Federal bank supervisors' view individual banks within the banking system. The new rating system has two main elements:

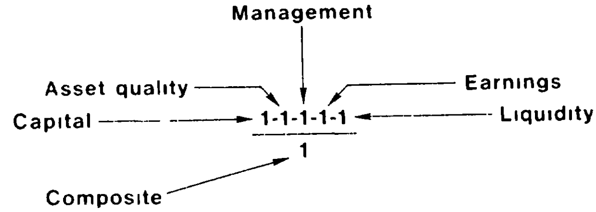
(1) An assessment by Federal bank examiners or analysts of five critical aspects of a bank's operations and condition. These are adequacy of the bank's capital, the quality of the bank's assets (primarily its loans and investments), the ability of the bank's management and administration, the quantity and quality of the bank's earnings, and the level of its liquidity.

(2) An overall judgment incorporating these basic factors and other factors considered significant by the examiners or analysts, expressed as a single composite rating of the bank's condition and soundness. Banks will be placed in one of five groups, ranging from banks that are sound in almost every respect to those with excessive weaknesses requiring urgent aid.

The new rating system builds upon the foundation of earlier systems used by the three agencies. These rating systems date back to at least as early as 1926 when the Federal Reserve Bank of New York used a simple system to categorize over 900 member banks then in the Second District.[1] Each of the three Federal banking supervisors adopted its own rating system in the mid-1930's after extensive interagency discussion. These systems tended to be very complex and attempted to combine subjective judgments and quantitative standards.[2] Probably because of their rigidity and complexity, coupled with improvements in the strength and stability of the nation's economy and banking system, these rating systems began to fall into disfavor in the 1940's as simplified approaches were sought. In 1952, the Federal Reserve System and the Office of the Comptroller of the Currency agreed on the basic structure of a rating system. That system, like the new uniform system, provided for separate ratings for capital adequacy, asset quality, and management and included an overall judgment of the bank's condition.[3]

The Federal Reserve's responsibility for supervising the activities of the nation's registered bank holding companies created particular interest in the design of an improved system for rating banks which could be used by all three Federal bank regulatory agencies. The new uniform system was designed, in large part, by a group headed by Eugene A. Thomas, vice president of the Federal Reserve Bank of San Francisco, working under the direction of the Federal Reserve Bank Presidents' Conference Committee on Regulations, Bank Supervision, and Legislation.

Under the new system, each performance characteristic and the composite is rated on a scale from one to five, which indicates the extent of the bank's strength or weakness. A rating of "1" indicates strength; "5" indicates a degree of weakness requiring urgent corrective actions. Thus, the strongest possible rating for a bank would be:



On the other hand, a rating of $\frac{4\text{-}5\text{-}4\text{-}5\text{-}3}{4}$ would indicate a bank with critical problems with asset quality and earnings and an overall condition that is less than satisfactory. Close supervisory attention and financial monitoring would be indicated by such a rating.

The examiner-analyst in using the new system evaluates each of the five elements of a bank's condition and the composite rating independently according to specifically defined standards. (See box for the definitions of each composite rating and the description of each performance zone as agreed upon by the three agencies.) While the five performance dimensions are somewhat interdependent, each is rated separately. Similarly, the composite is not determined by calculating an average of the separate components but rather is based on an independent judgment of the overall condition of the bank. Other factors, such as local economic conditions and prospects, trends in financial performance, and affiliation with a bank holding company, are evaluated by the examiner-analyst and incorporated into his overall assessment of the bank's condition.

Arriving at a six number representation of a bank's condition is an exercise which requires sound analytical judgment. It is admittedly an attempt to reduce to quantified terms a very complex judgmental evaluation process. A single ratio or group of ratios cannot fully or accurately describe all the underlying factors that influence a bank's past, present, or future performance. Thus, consistency in the new system depends not, for example, on rigid definitions of what constitutes adequate earnings but rather on an appreciation by the examiner-analyst of the several roles earnings play in making a bank sound and the matching of the bank's particular and peculiar situation to the agreed-upon definitions.

The first of the five performance dimensions—*capital adequacy*—gives recognition to the role that capital plays as the foundation supporting business risks within the bank. The greater the risks faced by a bank, the greater is its need for a strong capital base. In appraising these risks, the Federal supervisors review the risk "mix" of the asset portfolio as well as the skill

[1] This rating system went by the name of MERIT Based heavily upon management and asset quality in relation to capital, a rating of M was assigned for banks in good condition, E for satisfactory condition, R for fair, I for unsatisfactory, and T for serious

[2] One system "scored" six characteristics—management, loans, securities, capital account, deposit growth, and earnings—and combined these numeric scores with a series of weighting factors Judgmental inputs on factors not specifically measured were not permitted, making the resulting score difficult to interpret either as an absolute measure of condition or even in its relationship to other scores

[3] The Federal Reserve and the Comptroller of the Currency have used what is essentially this rating system almost continuously since it was originally adopted The specific definitions used in that system were included in former Governor Robert Holland's testimony before the Committee on Banking, Housing, and Urban Affairs, United States Senate (February 6, 1976)

I. Composite Rating

The five composite ratings are defined as follows:

Composite 1
Banks in this group are sound institutions in almost every respect; any critical findings are basically of a minor nature and can be handled in a routine manner. Such banks are resistant to external economic and financial disturbances and capable of withstanding the vagaries of the business cycle more ably than banks with lower composite ratings.

Composite 2
Banks in this group are also fundamentally sound institutions but may reflect modest weaknesses correctable in the normal course of business. Such banks are stable and also able to withstand business fluctuations well; however, areas of weakness could develop into conditions of greater concern. To the extent that the minor adjustments are handled in the normal course of business, the supervisory response is limited.

Composite 3
Banks in this group exhibit a combination of weaknesses ranging from moderately severe to unsatisfactory. Such banks are only nominally resistant to the onset of adverse business conditions and could easily deteriorate if concerted action is not effective in correcting the areas of weakness. Consequently, such banks are vulnerable and require more than normal supervision. Overall strength and financial capacity, however, are still such as to make failure only a remote possibility.

Composite 4
Banks in this group have an immoderate volume of asset weaknesses, or a combination of other conditions that are less than satisfactory. Unless prompt action is taken to correct these conditions, they could reasonably develop into a situation that could impair future viability. A potential for failure is present but is not pronounced. Banks in this category require close supervisory attention and monitoring of financial condition.

Composite 5
This category is reserved for banks whose conditions are worse than those defined under Composite 4. The intensity and nature of weaknesses are such as to require urgent aid from the shareholders or other sources. Such banks require immediate corrective action and constant supervisory attention. The probability of failure is high for these banks.

II. Performance Evaluation

The five key performance dimensions—capital adequacy, asset quality, management-administration, earnings, and liquidity—are evaluated on a scale of one to five defined as follows:

Rating No. 1 indicates *strong* performance. It is the highest rating and is indicative of performance that is significantly higher than average.

Rating No. 2 reflects *satisfactory* performance. It reflects performance that is average or above; it includes performance that adequately provides for the safe and sound operation of the bank.

Rating No. 3 represents performance that is flawed to some degree; as such, is considered *fair*. It is neither satisfactory nor marginal but is characterized by performance of below-average quality.

Rating No. 4 represents *marginal* performance which is significantly below average; if left unchecked, such performance might evolve into weaknesses or conditions that could threaten the viability of the institution.

Rating No. 5 is considered *unsatisfactory*. It is the lowest rating and is indicative of performance that is critically deficient and in need of immediate remedial attention. Such performance by itself, or in combination with other weaknesses, could threaten the viability of the institution.

with which management plans ahead and minimizes risks. The vitality of a bank's market area is also included in the analysis. The examiner-analyst also reviews the bank's capital-to-risk assets relationship, its trend, and a comparison of the bank's ratio with other banks of similar size and doing similar types of business.

An appraisal of the quality and collectibility of a bank's loans and investments has traditionally been one of the key parts of a Federal supervisory examination. The *asset quality* performance rating is largely based upon data on the overall quality of the assets held by the bank as developed during a supervisory examination. The new system, like earlier ones, relies heavily upon the classification of the bank's credits into loss, doubtful, and substandard categories according to the likelihood of the bank's actually absorbing a loss on a credit.[4] Loan and investment policies, the adequacy of valuation reserves, and management's demonstrated ability to collect problem credits would also be considered by the examiner-analyst in coming to a judgment regarding overall asset quality.

The third element in the rating evaluates the quality of a bank's corporate *management* including its board of directors. Management's technical competence, leadership, and administrative ability are evaluated along with the internal controls and operating procedures that have been installed. The bank's compliance with banking laws and regulations is another factor in the appraisal, as are the provisions for management succession. Judgments regarding management's willingness and ability to serve the legitimate banking needs of the community are also considered.

The strength of the bank's *earnings* is the fourth element in the performance rating. Here, a judgment is rendered on the adequacy of earnings to provide a sufficient return to the bank's stockholders, to generate sufficient cash flows for the normal needs of borrowers, and to provide for the future needs through the development of capital. The "quality" of earnings is also analyzed, with particular attention paid to the adequacy of the bank's additions to valuation reserves and to the tax effects on net income. Peer-group comparisons and trends in earnings provide additional quantitative evidence for the rating.

The *liquidity* rating is based upon the bank's ability to manage its assets and liabilities in such a way as to ensure that it can meet the demands of both depositors and borrowers without undue strain. Among the factors considered in evaluating liquidity are the availabilty of assets readily convertible into cash, the bank's formal and informal commitments for future lending or investment, the structure and volatility of deposits, the reliance on interest-sensitive funds including money market instruments and other sources of borrowing, and the ability to adjust rates on loans when rates on interest-sensitive sources of funds fluctuate. The examiner-analyst will review the frequency and level of borrowings and include judgments of the bank's ability to sustain any level of borrowings over the business cycle or to attract new sources of funds. These judgments also include analyses of the bank's present and future access to traditional money market sources of funds and other domestic and foreign sources. The bank's average liquidity experience over a period of time, as well as its liquidity position on the examination date, would be considered. For Federal Reserve member banks, the use of the discount window is also reviewed to determine if borrowings are for other than seasonal or short-term adjustment purposes.

After analyzing the five key factors, the examiner-analyst arrives at a *composite rating* which summarizes the agency's overall view of the bank's condition and reflects the level of continuing supervisory attention which the bank's condition seems to warrant. A composite "1" rated bank would receive little supervisory attention between examinations, while a composite "5" bank would be subject to constant monitoring and a corrective action program developed by the bank's management and directors and accepted by its Federal supervisors.

The new rating system provides a uniform structure for use by the three Federal supervisory agencies in evaluating the condition of the nation's commercial banks. This uniformity of approach is expected to lead to more consistent and even-handed supervisory treatment. It should also enable more informed judgments regarding trends in the condition of the banking system as a whole.

George R. Juncker

[4] The usual rule of thumb used for interpreting these classifications is that all credits classified loss will indeed represent eventual losses, 50 percent of aggregate credits classified doubtful will be charged off, as well as 20 percent of substandard classifications Of course, actual loss experiences vary from credit to credit and bank to bank depending upon a wide variety of circumstances