Thrift Bulletin

Handbook: **Thrift Activities**
Subject: **Overall Conclusions**
CAMELS Ratings

Sections: 070, 071
TB 69-1

April 4, 1997

Joint Interagency Common Questions and Answers on the Revised Uniform Financial Institutions Rating System

Summary: The Task Force on Supervision of the Federal Financial Institutions Examination Council has approved the issuance of joint interagency common questions and answers for the revised Uniform Financial Institutions Rating System. The questions and answers are being distributed to industry management and examiners by each federal depository institution regulatory agency to ensure consistent and uniform implementation of the revised rating system.

For Further Information Contact: Your OTS Regional Office or William J. Magrini (202-906-5744) of Supervision Policy, Washington, DC.

Thrift Bulletin 69-1

Background

On December 9, 1996, the Federal Financial Institutions Examination Council (FFIEC) adopted the revised Uniform Financial Institutions Rating System (UFIRS or CAMELS rating system). The UFIRS is an internal rating system used by the federal and state regulators for assessing the soundness of financial institutions on a uniform basis and for identifying those insured institutions requiring special supervisory attention. A final notice was published in the *Federal Register* on December 19, 1996 (61 FR 67021), effective January 1, 1997.

OTS made the revised rating system effective for examinations that commenced after January 31, 1997.

The agencies have developed common responses to questions that have been asked to date regarding the revised rating system.

The agencies believe it may be useful to provide questions and answers as a means of providing additional interagency guidance and clarification on the revised rating system.

The attached questions and answers are being distributed to institution management and examiners to ensure consistent and uniform implementation of the revised rating system.

Attachment

John F. Downey
Executive Director,
Supervision

OFFICE OF THE COMPTROLLER OF THE CURRENCY
OFFICE OF THRIFT SUPERVISION
BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
FEDERAL DEPOSIT INSURANCE CORPORATION

March 4, 1997

Joint Interagency Common Questions and Answers on the Revised Uniform Financial Institutions Rating System

On March 4, 1997, the Task Force on Supervision of the Federal Financial Institutions Examination Council approved the issuance of common questions and answers about the recently revised Uniform Financial Institutions Rating System. The Office of the Comptroller of the Currency (OCC), the Office of Thrift Supervision (OTS), the Federal Reserve Board (FRB), and the Federal Deposit Insurance Corporation (FDIC) collectively developed common responses to questions asked to date by bankers and examiners regarding the revised rating system. The responses were coordinated with the Conference of State Bank Supervisors. The purpose of the questions and answers is to provide additional interagency guidance and clarification regarding the revised rating system.

On December 9, 1996, the Federal Financial Institutions Examination Council (FFIEC) adopted the revised Uniform Financial Institutions Rating System (UFIRS or CAMELS rating system). The UFIRS is an internal rating system used by the federal and state regulators for assessing the soundness of financial institutions on a uniform basis and for identifying those insured institutions requiring special supervisory attention. A final notice was published in the *Federal Register* on December 19, 1996 (61 FR 67021), effective January 1, 1997.

The major changes to UFIRS include an increased emphasis on the quality of risk management practices and the addition of a sixth component called "Sensitivity to Market Risk." The updated rating system also reformats and clarifies component rating descriptions and component rating definitions, revises composite rating definitions to parallel the other changes in the rating system, and highlights risks that may be considered in assigning component ratings.

The attached questions and answers are being distributed to bankers and examiners to ensure consistent and uniform implementation of the revised rating system.

Common Questions and Answers on the Revised Uniform Financial Institutions Rating System

(1) How will the new Sensitivity to Market Risk (S) component rating be determined?

The rating assigned to the S component should reflect a combined assessment of both the level of market risk and the ability to manage market risk. Low market risk sensitivity alone may not be sufficient to achieve a favorable S rating. Indeed, institutions with low risk, but inadequate market risk management, may be subject to unfavorable S ratings. Conversely, institutions with moderate levels of market risk and the demonstrated ability to ensure that market risk is, and will remain, well controlled may receive favorable S component ratings.

In assessing the level of market risk exposure and the risk management process in place to control it, examiners will rely on existing supervisory guidance issued by their respective agencies, including guidance issued on interest rate risk, investment, financial derivatives, and trading activities.

(2) Will institutions be expected to have formal, sophisticated risk management processes in order to receive the favorable ratings for S?

In line with the general thrust of the agencies' various guidance on market risk, the sophistication of an institution's risk management system is expected to be commensurate with the complexity of its holdings and activities and appropriate to its specific needs and circumstances. Institutions with relatively noncomplex holdings and activities, and whose senior managers are actively involved in the details of daily operations, may be able to rely on relatively basic and less formal risk management systems. If the procedures for managing and controlling market risks are adequate, communicated clearly, and well understood by all relevant parties, these basic processes may, when combined with low to moderate levels of exposure, be sufficient to receive a favorable rating for the S component.

Organizations with more complex holdings, activities and business structures may require more elaborate and formal market risk management processes in order to receive ratings of 1 or 2 for the S component.

(3) How much weight should be placed on the S component in determining the composite rating?

The weight attributed to any individual component in determining the composite rating should vary depending on the degree of supervisory concern associated with the component. The composite rating does not assume a predetermined weight for each component and it does not represent an arithmetic average of assigned component ratings. As a result, for most institutions where market risk is not a significant issue, less weight should be placed on the S component in determining a composite rating than on other components.

(4) **How should the S rating be applied when evaluating small community banks or thrifts with limited asset/liability management processes?**

For most small community banks or thrifts, sensitivity to market risk will primarily reflect interest rate risk. Regardless of the size of an institution, the quality of risk management systems must be commensurate with the nature and complexity of its risk-taking activities, and management's ability to identify, measure, monitor and control the risk. Evaluation of this component will be based on the degree to which interest rate risk exposure can affect the institution's earnings and capital, and the effectiveness of the institution's asset/liability or interest rate risk management system, given its particular situation.

(5) **If the levels of market risk change between examinations, is it always necessary to change the rating assigned to the S component?**

The rating assigned to the S component should reflect a combined assessment of both the level of market risk and the ability to manage market risk. Accordingly, changes in either quantitative or qualitative aspects of market risk exposure or management may necessitate changes in the rating assigned to the S component. While changes in the level of market risk between examinations may in some circumstances necessitate a change in the rating assigned to the S component, this does not automatically imply a rating change. For example, an institution that accepts additional market risk between examinations, but maintains risk management processes and earnings and capital levels commensurate with the level of risk, need not have its S rating changed.

(6) **Does the increased emphasis on market risk management practices place new and burdensome requirements on institutions or examiners?**

The updated rating system incorporates examination considerations that were not explicitly noted in the prior rating system. Under the prior rating system, examiners considered market risk exposure and risk management practices when assigning component and composite ratings. Consequently, examiners are not required to perform any additional procedures, and institutions are not required to add to their management procedures or practices, solely because of the updated rating system.

(7) **Will the revised rating system, with the addition of the new Sensitivity to Market Risk (S) component and increased emphasis on the quality of risk management practices, result in a change in a bank's or thrift's composite rating?**

The revised rating system generally should not result in a change in the composite rating assigned to a particular bank or thrift simply because of the addition of the new component and the increased emphasis on risk management practices. The level of market risk has traditionally been taken into consideration when evaluating an institution's capital, earnings and liquidity. The quality of an institution's risk management practices has also traditionally been considered by examiners when assessing an institution's condition and assigning ratings, particularly in the Management component.

(8) How much weight should be given to risk management practices versus the level of exposure, as measured by specific ratios, when assigning a component rating?

The CAMELS rating system assesses an institution's overall condition based on both quantitative and qualitative elements. Quantitative data such as the level of classified assets remain an integral part of that measurement. Qualitative elements, such as the adequacy of board and senior management oversight, policies, risk management practices, and management information systems are also central to the evaluation of components. The relative importance given to the qualitative considerations for each component depends on the circumstances particular to the institution. Risk management systems should be appropriate for the nature and level of risks the institution assumes. However, unacceptable risk levels or an unsatisfactory financial condition will often outweigh other factors and result in an adverse component rating.

(9) Why aren't peer data comparisons specifically mentioned in the revised rating system? May they still be used in assigning ratings?

Peer data are an integral part of the evaluation process and, when available and relevant, may be used in assigning a rating. However, peer data should be used in conjunction with other pertinent evaluation factors and not relied upon in isolation when assigning a rating.

(10) Agency guidelines require examiners to discuss with senior management and, when appropriate, with the board of directors the evaluation factors they considered in assigning component ratings and a composite rating. Are examiners limited to only those evaluation factors listed in the revised rating system and must each evaluation factor be addressed when assessing a component area?

No. Examiners have the flexibility to consider any other evaluation factors that, in their judgment, relate to the component area under review. The evaluation factors listed under a component area are not intended to be all-inclusive, but rather a list of the more common factors considered under that component. Only those factors believed relevant to fully support the rating being assigned by the examiner need be addressed in the report and in discussions with senior management.

(11) With multiple references to some items across several components, such as market risk and management's ability to identify, measure, monitor, and control risk, are we "double counting" these and other items when assigning a rating?

Each component is interrelated with one or more other components. For example, the level of problem assets in an institution is a primary consideration in assigning an asset quality component rating. But it is also an item that affects the capital and earnings component ratings. The level of market risk and the quality of risk management practices are elements that also can affect several components. Examiners consider relevant factors and their interrelationship among components when assigning ratings.

(12) To what extent should market risk be carved out of the earnings or capital evaluation? Should institutions with high market risk receive an adverse rating in the earnings or capital components as well as the market sensitivity component?

Market risk is evaluated primarily under the new S component and is only one of several evaluation factors used to assess the earnings and capital components. Whether the institution's exposure to market risk results in an unfavorable rating for earnings or capital, however, is based on a careful analysis of the effect of this factor in relation to the other factors considered under these components. The capital component is evaluated based on the risk profile of an institution, including the effect of market risk, and whether the level of capital supports those risks. The earnings component evaluates the ability of earnings to support operations and maintain adequate capital after considering factors, such as market risk exposure, that affect the quantity, quality, and trend of earnings. The importance accorded to an evaluation factor should thus depend on the situation at the institution.