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

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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.

AGENCY SPECIFIC Q&As - OCC

The following issues specifically represent OCC supervisory or examination processes raised by national banks or OCC examiners concerning the revised CAMELS rating system.

1. How do the revised rating system and the OCC's supervision by risk program interrelate?

They exist in tandem. The revised rating system now makes direct references to the various types of risk categories (most of which are identified and defined in the OCC's supervision by risk program) that are considered within each component area, as well as the quality of risk management practices. The CAMELS rating system remains a measurement of the bank's current overall financial, managerial, operational, and compliance performance. Supervision by risk prospectively assesses not only the quality of risk management and the quantity of risks, but also the direction of risk. The OCC's supervision by risk program allows examiners to plan future examination activities and the scope of those activities based on the institution's quantity of risk, quality of risk management, aggregate risk, and direction of risk.

2. The revised rating system appears to put more emphasis on the adequacy of a bank's policies. How will the revised rating system affect conducting examinations in noncomplex community banks?

   It should not have a significant effect on noncomplex community bank examinations. Examiners will continue to use existing procedures to review bank activities and assess the institution's condition based primarily on the bank's performance. As is currently the case, examiners use the results of the performance-oriented examination to reach conclusions on the risk management practices of the institution. Thus, there is no need to obtain additional information or perform additional examination procedures to determine a bank's component and composite ratings. For areas of higher risk in these banks, examiners continue to have the option to expand examination procedures for those activities or areas, as needed.

3. When can examiners disclose numeric component ratings to management and the board?

   OCC 97-1 states that, during exit meetings, discussions will include informing senior management and the board of directors of the numeric rating for all component areas. The OCC's "Bank Supervision Process" booklet requires that exit meetings be conducted at the completion of each examination. This booklet further states that, before conducting an exit meeting, examiners should discuss significant findings with the appropriate OCC supervisory office. Therefore, discussions with the supervisory office should include the examiner's recommended component ratings. The examiners can then discuss recommended ratings during exit meetings and indicate that the ratings are preliminary. Composite and component ratings are not considered final until issuance of a final report of examination or other written communication from the OCC.4. Will bankers be able to appeal component ratings?

Yes. Examination ratings are an example of the type of material supervisory determinations that may be appealed by an institution. The OCC, in its Bulletin 96-18, established its appeals process and a bank should follow the appropriate process for filing a formal appeal if it so desires. However, the OCC remains committed to fairly, amicably, expeditiously, and informally resolving disputes arising during the supervisory process. National banks are encouraged to resolve disagreements through informal discussions with examiners during an examination before filing a formal appeal. If bankers have questions on the appeals process, they should contact the OCC Ombudsman's office at 713/650-0475.

5. When specialty examinations are conducted in conjunction with safety and soundness examinations, who should discuss specialty component ratings with management and when?

   The specialty component ratings should be discussed as part of an exit meeting where findings and conclusions about the specialty area are being discussed with management or the board of directors. Either the EIC or the specialty cadre examiner can discuss the specialty component ratings. This will be a matter of coordination between the EIC and the specialty cadre.

6. OCC 97-1 states that, during exit meetings, examiners will discuss factors considered in assigning each component rating. This could result in a very lengthy exit meeting, especially in the case of a combined examination, if the examiner has to disclose composite and component ratings for each area examined and discuss risk assessment evaluations. Is there some flexibility from the bulletin's requirements for discussing each rating?

   Yes. For exit meetings, the "Bank Supervision Process" handbook states that EICs are to prioritize issues identified in the examination and discuss those areas that present the most risk to the bank. That guidance can be applied to discussion of preliminary component ratings during exit meetings. To avoid lengthy discussions that detract from the focus of exit meetings, examiners can provide management with a listing of the preliminary component ratings. Exit meeting discussions can then focus on the most significant items of supervisory concern incorporating reference to numerical ratings as appropriate; for example, component areas rated 3 or worse or those that have been downgraded from 1 to 2 due to exhibited deficiencies or declining trends. Component area discussions do not have to address every factor considered in assigning the rating, but rather those factors that have the most effect on the evaluation of the component.

7. To what extent should the actual definition of each composite and component rating be addressed in reports of examination?

To avoid cluttering up the report with a long, all-inclusive list of component rating definitions, it may be best to make reference to or offer to give management copies of appropriate supervisory issuances or sections thereof. Definitions for assigned composite ratings can be included on the Examination Conclusions and Comments (ECC) page or on an appendix page, or ECC comments can refer readers to an appropriate OCC issuance. Documents that can be referenced are:

- OCC 97-1 for revised safety and soundness composite and component rating definitions;
- BC 246 for Consumer Compliance, BIS or Fiduciary composite rating definitions;
- The FFIEC Information Systems Examination Handbook, Chapter 5 for details on the Uniform Interagency Rating System for Data Processing Operations;
- The Comptroller's Handbook Consumer Compliance Examination "Overview" booklet for details on the Uniform Interagency Consumer Compliance Rating System; and
- The Comptroller's Handbook for Fiduciary Activities for details on the Uniform Interagency Trust Rating System.

8. When component ratings are changed between onsite examinations, how should such changes be communicated formal letter to the board or management, or by phone call?

Consistent with current supervisory policy, any change in a bank's component ratings between full scope, onsite examinations should be communicated in writing to its board of directors.

9. Composite and Management ratings sections address compliance performance. How is a bank's compliance performance incorporated in these two ratings when a compliance examination is not performed in conjunction with a safety and soundness examination?

Compliance as used in the mentioned sections refers to overall compliance with all banking laws and regulations. However, as noted in the Overview portion of the rating system, specialty examination findings (such as consumer compliance) are taken into consideration, as appropriate, in assigning a CAMELS composite or component rating. Generally, specialty examination findings affect the composite rating and the Management component. When specialty examinations are not conducted in conjunction with a safety and soundness examination, the results of the most recent specialty examinations should be considered when assigning a management component rating and a composite rating.

10. In the Sensitivity to Market Risk component, each rating definition refers to earnings performance and capital positions being "adversely affected". Can "adversely affected" be defined or standardized measurement parameters given?

    No. The diverse nature of risk profiles of national banks makes standard measurement benchmarks and defining "adversely affected" difficult. The OCC will rely on its existing supervisory guidance and examination processes to make determinations about a national bank's level of market risk (interest rate risk, foreign exchange risk, commodity price risk or equity price risk) exposure, the quality of its risk management practices, and potential effect on its earnings performance or capital position. Such guidance includes the June 1996 Joint Policy Statement on Interest Rate Risk and other guidance for investments, financial derivatives, trading and other activities. The OCC will continue to use various quantitative tools, as provided in its supervisory guidance, in identifying national banks that may have high exposure or a complex risk profile.

11. With the addition of a new report page on Sensitivity to Market Risk, where would examiners comment about significant findings for areas such as mortgage banking, financial derivatives, or payment systems risk?

    Examiners have the flexibility to address significant findings, conclusions, or supervisory concerns under the section of the report of examination that is most appropriate. Many activities can entail several types of risks (credit, liquidity, transaction or operation, price, or interest rate among others) that may affect more than one component. If there are concerns with counterparty credit risk or other credit quality problems, these should be addressed under Asset Quality. For significant issues, such as the high sensitivity of a bank's earnings and capital to changes in interest rates or the inadequacy of interest rate risk management practices, Sensitivity to Market Risk is the appropriate place for comments. For issues about the ability (or inability) to readily sell assets or servicing rights, comments under Liquidity will be appropriate. Issues concerning operation or transaction risk are probably best addressed under Management. However, examiners should avoid repeating the description of a problem in other report comments. Each comment should address the concern or issue associated with the applicable component report comment and refer readers to other report comments as needed.

12. In the M component, the bullet point addressing

"responsiveness to recommendations from auditors and supervisory authorities" could be interpreted to mean responses to any recommendations, regardless of their significance, and that responses must be positive or favorable. Is this correct?

No. This bullet point was intended to address the quality of board or management responses to or actions on significant deficiencies or unwarranted risks, such as matters requiring board attention (MRBA), or other significant recommendations of a systemic nature included in the report of examination or discussed with bank management. It is generally expected that the board's or management's response or action on a MRBA or other significant recommendation is one that will lead to alleviating or resolving the problem. However, as noted in the "Bank Supervision Process" booklet, examiners should not request burdensome commitments from management to address weaknesses of a less significant nature.13. What training or other guidance will examiners receive to ensure accuracy and consistency in the application of component and composite ratings?

Existing examiner training sessions will discuss application of the rating system as appropriate. An interagency Q&A document, to which this addendum is attached, is being distributed and will be updated in the future as warranted for additional issues raised by bankers and examiners. In addition, a system is being established to monitor assigned ratings and follow up on unusual or significant trends in ratings. The OCC also has quality assurance programs that can help in this endeavor.

14. Will there be outreach efforts or educational forums on a national level for assisting bank boards and management in understanding the relationship between component ratings and how we arrive at the composite rating? Should examiners be given "talking points" concerning composite and component ratings to cover with management and the board?

The manner in which a composite or component rating is assigned has not changed as a result of the revisions to the rating system. The composite rating never was, and won't be, a function of some arithmetical formula or rigid weighting of numerical component ratings. Elements of subjectivity and examiner judgment, especially as they relate to qualitative assessments, are still important elements in assigning ratings. Formal outreach programs on a national level are not planned at this time. Questions about the CAMELS rating system will no doubt come up at various forums and OCC representatives will respond to those questions. The distribution of this Q&A document is also a means to address issues about the rating system.

The evaluation factors noted in the revised rating system can be used to guide discussions with management and the board. Examiners have the discretion to provide management or the board appropriate material in advance of meetings with them.