FEDERAL RESERVE BANK
OF NEW YORK

AT CIR No 8349
May 18, 1978

UNIFORM INTERAGENCY BANK RATING SYSTEM

To the Chief Executive Officer of Each State Member Bank in the Second Federal Reserve District:

Following is the text of a statement issued by the Board of Governors of the Federal Reserve System announcing the adoption of a uniform interagency system for rating the condition and soundness of commercial banks:

The three Federal bank regulatory agencies today [May 11] announced that they have adopted a uniform interagency system for rating the condition and soundness of the nation's commercial banks.

The new rating system is being implemented by the Federal Deposit Insurance Corporation (for insured State chartered banks that are not members of the Federal Reserve System), by the Federal Reserve Board (for State chartered member banks) and by the Office of the Comptroller of the Currency (for national banks).

The new Uniform Interagency Bank Rating System has two main elements:

1. An assessment by Federal bank examiners 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 (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. A combination of these basic factors into a composite -- overall -- 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 agencies agreed upon the qualitative characteristics that would place a bank in one or another of the five overall groups, with Composite Rating Group 1 being the best and Composite Rating Group 5 being the weakest.

Until adoption of the uniform rating system the three agencies used systems with technical differences that made difficult meaningful reporting to the Congress on the overall soundness of the nation's banking system.

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It is expected that agreement on what factors constitute the main characteristics of a bank's condition and soundness, and on how these factors should be combined into an overall rating, will provide a basis for comparable judgements by supervisors about all Federally insured banks.

The Federal Deposit Insurance Corporation has indicated that it will continue to maintain its existing problem bank list for insurance exposure purposes.

Enclosed is a copy of the "Uniform Interagency Bank Rating System," as adopted by the three Federal bank regulatory agencies. Any questions regarding the rating system may be directed to George Juncker, Chief, Bank Analysis Division (Tel. No. 212-791-6710).

PAUL A. VOLCKER,
President.

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Uniform Interagency Bank Rating System

Overview

The rating system is based upon an evaluation of five critical dimensions of a bank's operations that reflect in a comprehensive fashion an institution's financial condition, compliance with banking regulations and statutes and overall operating soundness. The specific dimensions that are to be evaluated are the following:

Capital adequacy
Asset quality
Management/Administration
Earnings
Liquidity

Each of these dimensions is to be rated on a scale of one through five in descending order of performance quality. Thus, 1 represents the highest and 5 the lowest (and most critically deficient) level of operating performance.

Each bank is accorded a summary or composite rating that is predicated upon the evaluations of the specific performance dimensions The composite rating is also based upon a scale of one through five in ascending order of supervisory concern. In arriving at a composite rating, each financial dimension must be weighed and due consideration given to the interrelationships among the various aspects of a bank's operations. The delineation of specific performance dimensions does not preclude consideration of other factors that, in the judgment of the examiner or reviewer, are deemed relevant to accurately reflect the overall condition and soundness of a particular bank. However, the assessment of the specific performance dimensions represents the essential foundation upon which the composite rating is based.

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Composite Rating

The five composite ratings are defined and distinguished 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 business conditions 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 quite 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, how-

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ever, 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 financial surveillance.

Composite 5

This category is reserved for banks whose conditions are worse than defined under No. 4 above. The volume and character 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.

Performance Evaluation

As already noted, the five key performance dimensions -- capital adequacy, asset quality, management/administration, earnings, and liquidity -- are to be evaluated on a scale of one to five. Following is a description of the gradations to be utilized in assigning performance ratings:

Rating No. 1 - indicates strong performance.

It is the highest rating and is indicative of performance that is significantly higher than average.

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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.

Capital Adequacy

Capital is rated (1 through 5) in relation to: (a) the volume of risk assets; (b) the volume of marginal and inferior quality assets; (c) bank growth experience, plans, and prospects; and (d) the strength of management in relation to (a), (b) and (c). In addition, consideration may be given to a bank's capital ratios relative to its peer group, its earnings retention and its access to capital markets or other appropriate sources of financial assistance.

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Banks rated 1 or 2 are considered to have adequate capital, although the former's capital ratios will generally exceed those of the latter. A 3 rating should be ascribed to a bank's capital position when the relationship of the capital structure to points (a), (b) or (c) is adverse even giving weight to management as a mitigating factor. In most instances such banks would have capital ratios below peer group averages. Banks rated 4 and 5 are clearly inadequately capitalized, the latter representing a situation of such gravity as to threaten viability and solvency. A 5 rating also denotes a bank that requires urgent assistance from shareholders or other external sources of financial support.

Asset Quality

Asset quality is rated (1 through 5) in relation to (a) the level, distribution and severity of classified assets; (b) the level and composition of nonaccrual and reduced rate assets; (c) the adequacy of valuation reserves; and (d) demonstrated ability to administer and collect problem credits. Obviously, adequate valuation reserves and a proven capacity to police and collect problem credits mitigate to some degree the weaknesses inherent in a given level of classified assets. In evaluating asset quality, consideration should also be given to any undue degree of concentration of credits or investments, the nature and volume of special mention classifications, lending policies, and the adequacy of credit administration procedures.

Asset quality ratings of 1 and 2 represent situations involving a minimal level of concern. Both ratings represent sound portfolios although the level and severity of classifications of the

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latter generally exceed those of the former. A 3 asset rating indicates a situation involving an appreciable degree of concern, especially to the extent that current adverse trends suggest potential future problems. Ratings 4 and 5 represent increasingly more severe asset problems; rating 5, in particular, represents an imminent threat to bank viability through the corrosive effect of asset problems on the level of capital support.

Management/Administration

Management's performance must be evaluated against virtually all factors considered necessary to operate the bank within accepted banking practices and in a safe and sound manner. Thus, management is rated (1 through 5) with respect to (a) technical competence, leadership and administrative ability; (b) compliance with banking regulations and statutes; (c) ability to plan and respond to changing circumstances; (d) adequacy of and compliance with internal policies; (e) depth and succession; (f) tendencies toward self-dealing; and (g) demonstrated willingness to serve the legitimate banking needs of the community.

A 1 rating is indicative of management that is fully effective with respect to almost all factors and exhibits a responsiveness and ability to cope successfully with existing and foreseeable problems that may arise in the conduct of the bank's affairs. A 2 rating reflects some deficiencies but generally indicates a satisfactory record of performance in light of the bank's particular circumstances. A rating of 3 reflects performance that is lacking in some measure of competence desirable to meet responsibilities of the situation in which management is found. Either it is characterized by modest talent when above-average abilities

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are called for, or it is distinctly below average for the type and size of bank in which it operates. Thus, its responsiveness or ability to correct less than satisfactory conditions may be lacking. The 4 rating is indicative of a management that is generally inferior in ability compared to the responsibilities with which it is charged. A rating of 5 is applicable to those instances where incompetence has been demonstrated. In these cases, problems resulting from management weakness are of such severity that management must be strengthened or replaced before sound conditions can be brought about.

Earnings

Earnings will be rated (1 through 5) with respect to (a) the ability to cover losses and provide for adequate capital; (b) earnings trends; (c) peer group comparisons; and (d) quality and composition of net income. Consideration must also be given to the interrelationships that exist between the dividend payout ratio, the rate of growth of retained earnings and the adquacy of bank capital. A dividend payout rate that is sufficiently high as to cause an adverse relationship to exist suggests conditions warranting a lower rating despite a level of earnings that might otherwise warrant a more favorable appraisal. Quality is also an important factor in evaluating this dimension of a bank's performance. Consideration should be given to the adequacy of transfers to the valuation reserve and the extent to which extraordinary items, securities transactions, and tax effects contribute to net income. Earnings rated 1 are sufficient to make full provision for the absorption of losses and the accretion of capital when due consideration is given to asset quality and bank growth. Generally, banks so rated will have earnings well above

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peer group averages. A bank whose earnings are relatively static or even moving downward may receive a 2 rating provided its level of earnings is adequate in view of the considerations discussed above. Normally, banks so rated will have earnings that are in line with or slightly above peer group norms. A 3 should be accorded earnings that are not sufficient to make full provision for the absorption of losses and the accretion of capital in relation to bank growth. The earnings pictures of such banks may be further clouded by static or inconsistent earnings trends, chronically insufficient earnings, a high dividend payout rate or less than satisfactory asset quality. Earnings of such banks are generally below peer group averages. Earnings rated 4, while generally positive, may be characterized by erratic fluctuations in net income, the development of a downward trend, intermittent losses or a substantial drop from the previous year. Earnings of such banks are ordinarily substantially below peer group averages. Banks with earnings accorded a 5 rating should be experiencing losses or reflecting a level of earnings that is worse than defined in No. 4 above. Such losses may represent a distinct threat to the bank's solvency through the erosion of capital.

Liquidity

Liquidity is rated (1 through 5) with respect to (a) the volatility of deposits; (b) reliance on interest-sensitive funds and frequency and level of borrowings; (c) technical competence relative to structure of liabilities; (d) availability of assets readily convertible into cash; and (e) access to money markets or other ready sources of cash. Ultimately, the bank's liquidity must be evaluated on the basis of

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its capacity to promptly meet the demand for payment of its obligations and to readily fill the reasonable credit needs emanating from the communities which it serves. In appraising liquidity, attention should be directed to the bank's average liquidity over a specific time period as well as its liquidity position on any particular date. Consideration should be given, where appropriate, to the overall effectiveness of asset-liability management strategies and compliance with and adequacy of established liquidity policies. The nature, volume and anticipated usage of a bank's credit commitments are also factors to be weighed in arriving at an overall rating for liquidity.

A liquidity rating of 1 indicates a more than sufficient volume of liquid assets and/or ready and easy access on favorable terms to external sources of liquidity within the context of the bank's overall asset-liability management strategy. A bank developing a trend toward decreasing liquidity and increasing reliance on borrowed funds, yet still within acceptable proportions, may be accorded a 2 rating. A 3 liquidity rating reflects an insufficient volume of liquid assets and/or a reliance on interest-sensitive funds that is approaching or exceeds reasonable proportions for a given bank. Ratings of 4 and 5 represent increasingly serious liquidity positions. Banks with liquidity positions so critical as to constitute an imminent threat to continued viability should be accorded a 5 rating. Such banks require immediate remedial action or external financial assistance to allow them to meet their maturing obligations.

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