FEDERAL RESERVE BANK OF NEW YORK

AT CIR No. 8525
February 21, 1979

BANK HOLDING COMPANY RATING SYSTEM

To All Bank Holding Companies 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 rating system for evaluating the performance and financial condition of bank holding companies:

The Federal Reserve Board today [*February 7*] adopted a system for appraising and rating the performance and financial condition of bank holding companies.

The bank holding company rating system extends a program of intensified supervision of bank holding companies the Federal Reserve put into effect at the beginning of 1978. That program includes requirements for annual on-the-spot inspections of most bank holding companies with consolidated assets greater than $300 million as well as the application to such companies of standardized examination criteria.

Building on this supervisory program, the Board adopted a system that will be used nationwide by the Federal Reserve to rate the strengths and weaknesses of parent bank holding companies, their bank and nonbank subsidiaries, and to assess certain operational characteristics such as the organization's earnings, the adequacy of its capital and its management.

Each of these component aspects of the holding company will be given a rating of one to five, with one representing the best rating and five the lowest.

The component ratings will then be combined into an overall financial composite rating, also on a scale of one (best) to five (lowest).

In addition, holding companies will be given a separate rating on the ability and competence of the company's management.

The bank holding company rating system adopted by the Board is similar in concept to the uniform interagency system for rating banks adopted by the Federal Reserve, Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation in May 1978.

Enclosed for bank holding companies is a copy of a description of the rating system. Any questions regarding the system may be directed to George Juncker, Chief, Bank Analysis Division (Tel. No. 212-791-6710).

PAUL A. VOLCKER,
President.

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INTRODUCTION AND SUMMARY

The bank holding company rating system is a management information and supervisory tool which defines the condition of bank holding companies in a systematic way. The system adopts the "component" approach by: (1) evaluating the financial condition and risk characteristics of each major component of the bank holding company; (2) assessing the important interrelationships among the components; and (3) analyzing the strength and significance of key consolidated financial and operating performance characteristics. This approach is particularly appropriate since holding companies are to be a source of financial and managerial strength to their bank subsidiaries.

In order to arrive at an overall assessment of financial condition, the following elements of the bank holding company are evaluated and rated on a scale of one through five in descending order of performance quality:

Bank Subsidiaries

Other (Nonbank) Subsidiaries

Parent Company

Earnings - Consolidated

Capital Adequacy - Consolidated

The first three elements of the rating, i.e., the bank, other subsidiaries, and parent company, reflect the contribution of each to the fundamental financial soundness of the holding company. The rating of consolidated earnings and capital recognizes the importance that regulators place on these factors and their crucial role in maintaining the financial strength and supporting the risk characteristics of the entire organization.

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The ability and competence of holding company management bear importantly on every aspect of holding company operations and, consequently, is included as a major factor in the evaluation of each of the five principal elements of the bank holding company rating, as well as in the assignment of an overall holding company rating.

In addition to the individual elements described above, each company is accorded an overall or composite rating, comprising both a financial and managerial component. The financial composite rating is predicated upon an overall evaluation of the ratings of each of the five principal elements of the holding company's operations as defined above. The financial composite rating is also based upon a scale of one through five in descending order of performance quality. Thus, one represents the lowest and five the highest degree of supervisory concern. The managerial composite is predicated upon a comprehensive evaluation of holding company management as reflected in the conduct of the affairs of the bank and nonbank subsidiaries and the parent company. The managerial composite is indicated by the assignment of "S", "F", or "U" for, respectively, management that is found to be satisfactory, fair or unsatisfactory.

The complete rating represents a summary evaluation of the bank holding company in the form of a rating "fraction." The "numerator" reflects the condition of the principal components of the holding company and assessments of certain key consolidated financial and operating factors. The "denominator" represents the composite rating, as defined in greater detail below, including both its financial and managerial components. While the elements in the "numerator" represent the essential foundation upon which the composite rating is based, the composite need not reflect a simple arithmetic mean or rigid formula weighting of the individual performance dimensions.

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Any kind of formula could be misleading and inappropriate. Rather, the composite should reflect the rater's judgment of the overall condition of the bank holding company based upon his knowledge and experience with the company. Thus, the complete rating is displayed as follows:

$$\frac{\text{Bank(s)} - \text{Other Subsidiaries} - \text{Parent} - \text{Earnings} - \text{Capital}}{\text{Financial Composite} - \text{Managerial Composite}}$$

The bank holding company rating system parallels the uniform interagency bank rating system to some degree by utilizing similar rating scales and performance definitions to evaluate both the individual elements and the summary or overall condition of the holding company. This framework will provide for consistency and facilitate the adoption and use of the holding company rating system. The rating system is also sufficiently flexible to allow for appropriate differences in appraising shell bank holding companies.

Since shell bank holding companies comprise the majority of supervised companies, and involve a substantial volume of banking assets, they must also be addressed by the rating system. The procedure would be similar to that so far described; however, the other (nonbank) subsidiaries, consolidated earnings, and consolidated capital ratings would be dropped since these components have little relevance for the shell company. This leaves the parent (with emphasis on cash flow and debt servicing ability), bank and composite (both financial and managerial) as remaining elements of the shell bank holding company rating.

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FINANCIAL COMPOSITE RATING

The five composite ratings are defined and distinguished as follows:

Composite 1

Bank holding companies in this group are sound in almost every respect; any negative findings are basically of a minor nature and can be handled in a routine manner. Such holding companies and their subsidiaries are resistant to external economic and financial disturbances and readily generate cash flow which is more than adequate to service their debt and other fixed obligations with no harm to subsidiaries.

Composite 2

Bank holding companies in this group are also fundamentally sound but may reflect modest weaknesses correctable in the normal course of business. Such holding companies and their subsidiaries generate cash flow which is adequate to service their obligations; 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

Bank holding companies in this group exhibit a combination of weaknesses ranging from fair to moderately severe. Such holding companies and their subsidiaries are less resistant to the onset of adverse business conditions and could likely deteriorate if concerted action is not effective in correcting the areas of weakness. The company's cash flow is sufficient to meet immediate obligations but, unless action is taken to

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correct weaknesses, parent cash flow needs could adversely affect the financial condition of the subsidiaries. Consequently, such bank holding companies are vulnerable and require more than normal supervision. Overall strength and financial capacity, however, are still such as to pose only a remote threat to the viability of the company.

Composite 4

Bank holding companies and their subsidiaries in this group have an immoderate volume of asset weaknesses, or a combination of other conditions that are less than satisfactory. An additional weakness may be that the holding company's cash flow needs are met only by upstreaming imprudent dividends and/or fees from its subsidiaries. Unless prompt action is taken to correct these conditions, they could impair future viability. Bank holding companies in this category require close supervisory attention and increased financial surveillance.

Composite 5

The volume and character of the weaknesses of bank holding companies in this category are so critical as to require urgent aid from shareholders or other sources to prevent insolvency. The imminent inability of such companies to service their fixed obligations and/or prevent capital depletion from severe operating losses places their viability seriously in doubt. Such companies require immediate corrective action and constant supervisory attention.

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MANAGEMENT COMPOSITE RATING

The management rating is intended to reflect an overall evaluation of the capabilities and competence of the management of the parent company and senior management of the bank(s) and nonbanks subsidiaries. The assessment of management must take place within the context of the situation and circumstances surrounding the individual holding company under evaluation. Since business complexities and operating problems vary with the size and type of holding company activity, management that is competent to effectively discharge responsibilities under one set of conditions may be less competent as these conditions change. Management performance must be evaluated against virtually all factors necessary to operate the holding company's activities in a sound and prudent manner. In addition to objective operating results, important subjective considerations in assessing management performance include the following:

1. Technical competence, leadership, administrative ability, management depth and succession;
2. Knowledge of and compliance with the Bank Holding Company Act and related regulations, and all other relevant laws and regulations;

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3. History of serving the banking needs of the community;
4. Ability to plan and respond to changing circumstances;
5. Ability of parent management to monitor and direct subsidiary operations in order to insure prudent operation and compliance with established holding company policies;
6. Adequacy and scope of internal audit systems and controls and evaluation of them as contained in audit reports; and
7. Attitude toward risk as indicated by any undue reliance on resources of subsidiary bank(s) to support nonbank activities.

A rating of satisfactory (S) 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 parent's or subsidiaries' affairs. Management rated satisfactory is knowledgeable concerning relevant laws and regulations, and has demonstrated an understanding of the need to insulate the subsidiary bank(s) from any undue risk associated with nonbank activities. A rating of fair (F) reflects performance that is lacking in some measure of ability desirable to meet responsibilities of the situation in which management is found. Either it is characterized by modest talent when above-average abilities are called for, or it is distinctly below average for the type and size of organization in which it operates. Thus, its responsiveness or ability to correct less than satisfactory conditions may be lacking. Moreover, such management may

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reflect a less than satisfactory understanding of relevant holding company laws and regulations. A rating of unsatisfactory (U) is indicative of a management that is demonstrably inferior or incompetent in relation to the responsibilities or problems it faces. This rating may also be indicative of management that has demonstrated an inclination to subject the subsidiary bank(s) to excessive or unwarranted risk as a result of the activities of the nonbank subsidiaries. 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.

PERFORMANCE EVALUATION

The five components of holding company operations--bank subsidiaries, nonbank subsidiaries, parent only, consolidated earnings and capital--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 and obviates the need for supervisory concern.

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 holding company and its subsidiaries.

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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. Such performance requires management attention due to the distinct possibility of further deterioration.

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.

BANK CONDITION

The bank condition component is intended to reflect the overall condition of the banking subsidiary or subsidiaries. For this purpose, use is made of the subsidiary bank CAMEL composite rating(s). In the case of multibank companies, each bank's composite rating should be weighted according to its asset size to arrive at an average bank composite rating. Weighting implies that, in most cases, the bank

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condition component in the holding company rating system will usually reflect the lead bank's composite according to the bank rating system (CAMEL).

To highlight the presence of one or more problem bank(s) in a multibank holding company whose bank condition component, based on weighted averages, might not otherwise reveal their presence (i.e., bank condition ratings of 1, 2 or 3), a problem identifier, "P," would be attached to the bank condition rating (e.g., 1P, 2P, 3P). Thus, 2P would indicate that, while on balance the banking subsidiaries are rated satisfactory, there exists a problem bank (composite 4 or 5) among the banking subsidiaries. The problem identifier is unnecessary when the bank condition component is rated 4 or 5. Although the bank condition component is a weighted average, it can be adjusted for subjective, judgmental reasons at the discretion of the rater.

OTHER (NONBANK) SUBSIDIARIES

The other subsidiaries rating is designed to assess the condition of the nonbank subsidiaries in the context of their overall impact on the financial condition of the holding company and the subsidiary bank(s). In so doing, emphasis must be placed on the asset quality of credit-extending subsidiaries and the profitability and operating soundness of noncredit-extending subsidiaries.

The evaluation of other subsidiaries should concentrate on the quality and condition of nonbank assets defined as:

1. The underlying assets of credit-extending nonbank subsidiaries; and

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2. The parent's investment in and advances to noncredit-extending subsidiaries.

The inclusion of No. 2 in the definition recognizes the fact that poorly run servicing or other noncredit-extending subsidiaries can pose significant risk exposure to the holding company which should be explicitly reflected in the rating. Such exposure might result, for example, from operating losses or off-balance sheet items such as guarantees. In many cases, since noncredit-extending subsidiaries are not heavy borrowers from external sources, the parent's investments in and advances to such companies will serve as a proxy for the magnitude of their operations. The degree of risk associated with the noncredit-extending subsidiaries may be quantified for the purpose of analyzing nonbank asset quality by classifying the parent's investments in and advances to such subsidiaries where appropriate. However, to the extent that the potential liability may be in excess of the parent's investments and advances, this fact should be recognized. In assessing the investment in or advance to a noncredit-extending subsidiary, the analysis should parallel that for any asset appraisal, with particular attention given to the subsidiary's purpose and operating efficiency, management reporting procedures and profitability. Also, foreign subsidiaries should be assessed in a manner similar to that for the company's domestic nonbank investments.

The degree of risk associated with credit-extending subsidiaries is determined by the classification of the underlying assets of the subsidiaries. The severity of both problem investments and classified assets should be reflected by using the following weights: 100 per cent of loss,

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50 per cent of doubtful, and 20 per cent of substandard.

A major step in rating nonbank activities is first to appraise their significance to the company's overall financial performance. The appraisal should focus on the potential loss exposure these activities pose to the bank holding company. One way of estimating this exposure is to compare total nonbank assets as defined above, plus any additional exposure not reflected in total assets, to total consolidated capital. As a general rule, other subsidiaries should be rated whenever nonbank assets exceed 5 per cent of consolidated capital or $10 million, whichever is lower. If neither of these conditions is met, a "0" should be entered for the rating of other subsidiaries. Other subsidiary assets that do not meet the significance conditions may be rated if, in the opinion of the rater, not to do so would significantly misrepresent the condition of the holding company.

When a rating is assigned to nonbank assets, considerations should include:

1. The relationship of problem investments in and advances to noncredit-extending subsidiaries plus classified assets in the credit-extending nonbank subsidiaries to total nonbank assets as defined above;

2. The relationship of problem investments and advances plus classified assets to the sum of parent company and nonbank valuation reserves and ex-bank consolidated equity capital, or to any more appropriate or refined capital index or measure, if warranted;

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3. The ability of nonbank management to supervise and exercise overall control over nonbank subsidiary operations in order to insure prudent operation, sound asset administration, and compliance with established holding company policies and relevant laws and regulations; and

4. Management attitudes toward risk as indicated by any undue reliance on resources of affiliated bank(s) to support nonbank subsidiaries.

The specific delineation of the above considerations is not meant to preclude taking into account other relevant factors such as profitability, operating efficiency, management controls, reporting procedures and any other relevant factors that, in the judgment of the rater, are necessary to accurately assess the condition of the nonbank subsidiaries.

An asset quality rating of 1 obviates the need for supervisory concern due to the existence of sound, well-managed nonbank operations, investments and loan portfolios. A 2 rating may indicate the existence of some asset problems or other minor operational weaknesses, but still represents fundamentally sound, well-managed asset conditions warranting minimal supervisory concern. A 2 may also reflect asset problems that are clearly of little supervisory concern, given their unlikely impact on ~~the~~ bank(s) and the size and overall strength of the holding company. Problems associated with a 2 rating can readily be resolved in the normal course of business. A 3 rating represents the existence of deficiencies such as a significant upward trend in classifications, management control weaknesses or other problems that, if left unchecked, could cause sub-

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stantial deterioration and have an adverse impact on the banking subsidiaries. A 4 rating represents an increased need for supervisory surveillance and concern due to any combination of poor operations, weak management or severe asset problems that are currently having a serious impact on the holding company or the banking subsidiaries. A 5 rating applies to a critical level of nonbank problems.

PARENT COMPANY

The parent company rating reflects the financial condition of the parent company by focusing on: (1) its ability to readily service its debt and other fixed obligations; and (2) the quality of direct parent credit extensions to entities that are not subsidiaries of the holding company. (Investments in and advances to holding company subsidiaries are treated above in connection with the evaluation of the nonbank subsidiaries.)

In analyzing the parent company, consideration should be given to its ability to generate adequate cash flow from its on-going operations and the liquidity of its assets. Potential sources of cash flow to the parent include, for example, bank and nonbank dividends, loan repayments, management and service fees, tax benefits, interest income and liquidation of assets; while cash needs would include interest and operating expenses, debt retirement and preferred and common stock dividends. The analysis should also take into account the capacity of the parent company to safely obtain liquidity from its subsidiaries by, for example, the prudent upstreaming of additional subsidiary dividends.

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Factors which should be incorporated in the analysis of the parent company include:

1. Volume and composition of parent company debt, and cash flow needs deriving therefrom;
2. Comparison of the maturities of parent company borrowings with the maturities of the investments which they fund;
3. Quality of credits to nonaffiliated companies;
4. Ability to readily convert assets to cash without incurring serious loss or adversely affecting the banking subsidiaries;
5. Ability of management to plan for liquidity and cash flow needs and respond to changing conditions in the markets for short-term funds;
6. Ability of the company to obtain long and short-term funds on reasonable terms, and the existence of firm back up lines of credit;
7. Reasonableness of any bank management or service fees paid to the parent;
8. Demonstrated performance in meeting past and current servicing requirements; and
9. Ability of parent management to supervise and exercise overall control over subsidiary and parent operations in order to insure prudent operation, sound asset administration, and compliance with established holding company policies and relevant laws and regulations.

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Also of importance, but treated elsewhere, are the use of parent debt to fund equity investments in subsidiaries, the adequacy of the company's capital and capital plans and the strength of corporate earnings.

The shell company would be appraised in a manner similar to that outlined above. Cash flow to service parent company debt would be the major aspect of the analysis, with attention focused on its effects on the subsidiary bank's capital position. In addition, the amount of parent company debt should be compared to the parent's proportionate interest in the subsidiary bank's equity capital. This serves as a good estimate of the company's ability to carry existing debt or borrow additional funds should an unexpected need arise.

A parent company rating of 1 indicates that the holding company can readily generate cash flow which is more than adequate to service its debt obligations and other cash flow needs and provide for the smooth rollover of debt without adverse affect on its subsidiaries. The rating also reflects good management and the absence of significant asset problems. A 2 rating, while reflecting a fundamentally sound situation, indicates a possible trend toward tighter liquidity due to lower earnings, asset quality, or other relevant operating indices. A rating of 3 represents a decidedly tight, but still manageable, cash flow situation. The company will likely have little or no liquidity in its asset portfolio and/or be overly dependent on potentially harmful dividends and fees from its subsidiaries. Weak earnings

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might also be expected to complicate such a situation. The 3 rating would reflect increasing difficulty for the parent company in obtaining short-term funds on favorable terms. A rating of 4 indicates serious cash flow problems caused or exacerbated by severe asset deterioration or poor or no corporate earnings. Companies so rated may be seriously draining funds from bank subsidiaries to service cash flow needs and may be completely unable to serve as a source of funds or financial strength to their subsidiaries. A rating of 5 may represent an inability to enter money markets. Moreover, the problems represented by a rating of 5 would reflect an imminent danger of default or insolvency of the parent company.

EARNINGS - CONSOLIDATED

The rating of earnings is based on the assessment of fully consolidated profitability. This approach is appropriate since consolidated earnings serve as a source of financial strength and capital growth for the entire organization.

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Profitability has two dimensions, quantity and quality, both of which must be incorporated in the evaluation of earnings. Quantity refers to the absolute level of net income and its adequacy in relation to the considerations listed below. The appraisal of quality is an attempt to determine the strength of operating earnings (i.e., the ability to generate on-going revenues and hold down expenses), and the degree to which earnings reflect the impact of unusually large securities gains or losses, unusual tax items (i.e., credits, carry-forwards, etc.), or other large, nonrecurring, extraordinary gains or losses. Quality of earnings also refers to the effect on net income of adequately providing additions to the loan loss reserve in order to properly recognize the impact of poor, overstated or loss assets carried on the balance sheet. Other things equal, consolidated net income that relies unduly on unusually large, nonrecurring gains or that fails to reflect adequate loan loss provisions is of lower quality than net income of equal magnitude that reflects strong operations and adequate loss provisions. On the other hand, the concept of quality "works both ways." While care must be taken to avoid attempting to predict the future, net income that otherwise appears somewhat low may be of high quality and, consequently, suggests stronger future net income. This would especially be the case if current earnings reflected a level of charge-offs that was not expected to recur, given the relatively high quality of the company's assets.

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Generally, consolidated earnings since the prior inspection will be rated with emphasis given to the most recent year's performance. In light of the above discussion, earnings will be rated with respect to the following considerations:

1. The ability to adequately cover charge-offs, maintain public confidence, and provide for the safe on-going operation of the company;

2. Return on consolidated assets, historical earnings trends, and peer group comparisons;

3. Quality of earnings as reflected by: (i) extent of reliance on nonrecurring gains or losses or unusual tax effects, and (ii) the sufficiency of loss provisions in view of the condition of the asset portfolio and the adequacy of the loan loss reserves;

4. Ability of management to plan and devise realistic earnings projections in light of the risk structure and quality of assets;

5. Outlook for earnings as implied by the current risk structure and quality of assets; and

6. Ability of earnings to provide for the growth of capital in light of recent and planned asset growth.

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Inclusion of No. 6 is not meant to suggest that the level or adequacy of current capital determines the rating for earnings; capital per se is treated elsewhere. It simply recognizes that retained earnings is a primary source of capital. Should a company opt for rapid growth, its earnings must enable it to raise the necessary capital either through retention or by permitting ease of entry into the capital markets. While this notion must be kept in mind in evaluating a company's profitability, it is quite possible for a company to simultaneously have low capital and good earnings or vice versa.

Earnings rated 1 are sufficient to make full provision for the absorption of losses and accretion of capital when due consideration is given to asset quality and bank holding company growth. Generally, holding companies so rated will have earnings well above peer group averages. A company 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, companies 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 fully adequate to make sufficient provisions for the absorption of losses and the accretion of capital in relation to company growth. The earnings pictures of such companies may be further clouded by static or inconsistent earnings trends, chronically insufficient earnings, or less than satisfactory asset quality. Earnings of such

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companies are generally below peer group averages. Earnings rated 4, while generally positive, are clearly not adequate to make full provision for losses and the necessary accretion of capital. Companies with earnings rated 4 may be characterized by erratic fluctuations in net income, poor earnings and the likelihood of the development of a further downward trend, intermittent losses, chronically depressed earnings, or a substantial drop from the previous year. Earnings of such companies are ordinarily substantially below peer group averages. Bank holding companies with earnings accorded a 5 rating should be experiencing losses or reflecting a level of earnings that is worse than defined in rating 4 above. Such losses, if not reversed, could represent a distinct threat to the holding company's solvency through the erosion of capital.

CAPITAL ADEQUACY - CONSOLIDATED

Capital is to be evaluated with regard to the volume and risk of the operations of the consolidated corporation. Emphasis on capital from the standpoint of the consolidated entity is appropriate since holding company management exercises some discretion with respect to the allocation of capital resources within the corporation.

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Thus, it is the holding company's capital on a consolidated basis that must serve as the ultimate source of support and strength to the entire corporation.

To be considered adequate, holding company capital must: (a) support the volume and risk characteristics of all parent and subsidiary activities; (b) provide a sufficient cushion to absorb unanticipated losses arising from holding company and subsidiary activities; (c) support the level and composition of corporate and subsidiary borrowing; and (d) serve as a source of strength by providing an adequate base for the growth of risk assets and permitting entry into the capital markets as the need arises. An essential step in the analysis of capital is the assessment of the risk characteristics and capital requirements deriving from the lending activities and operations of the parent and each of the operating subsidiaries.

The analysis of capital should incorporate the following considerations:

1. The relationship of consolidated capital to consolidated assets as reflected in (i) the ratio of equity to consolidated assets, and (ii) the ratio of equity plus long-term subordinated notes and debentures to consolidated assets;

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2. Capital requirements that derive from the asset quality and risk associated with each holding company activity;

3. Relationship of consolidated debt to equity;

4. Extent of reliance on long-term debt in the capital structure as indicated by the ratio of long-term debt to the sum of long-term debt plus equity;

5. Extent of the use of debt at the parent level to fund equity investments in subsidiaries;

6. Trends of indices of capital adequacy and peer group ratio comparisons;

7. Management's ability to devise adequate capital plans and retention policies in light of any capital deficiency and/or planned expansion of risk assets; and

8. Capacity to enter capital markets or tap other sources of long-term debt and equity.

As suggested in Nos. 1 and 4 above, long-term debt has certain of the characteristics of equity capital and can be used to some degree to correct a capital deficiency or strengthen the existing capital base. Over-reliance on long-term debt, however, can weaken the capital structure and severely restrict management options for raising additional

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capital funds. Other things equal, the lower the level of earnings and the higher the current level of long-term debt, the less acceptable is the inclusion of long-term debt in the capital structure for purposes of the analysis of capital adequacy.

Bank holding companies with capital rated 1 or 2 are considered to have adequate capital, although the ratios, strength of support, and ratio trends of the former will generally reflect a more favorable situation than the latter. Capital rated 3, while marginally sufficient to support the volume and risk associated with current operations, would quickly become inadequate in the event of further asset deterioration. Holding companies with 3 rated capital generally have capital ratios below peer group norms and typically above-average levels of debt. Moreover, such companies could find themselves forced to pay premiums in order to successfully tap the capital markets. Companies with ratings of 4 and 5 are clearly inadequately capitalized. A 4 capital rating implies ratios well below peer group norms and significant difficulty in entering the capital markets. The subsidiaries of such companies may also be undercapitalized because of the need to upstream substantial fees and dividends to the parent. A 5 rating represents a situation of such gravity as to threaten viability and requires urgent assistance from shareholders or other external sources of financial support.

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