FEDERAL RESERVE BANK OF NEW YORK

[Circular No. 8692
November 29, 1979]

UNIFORM BANK RATING SYSTEM

*To All State Member Banks, and Others Concerned,
in the Second Federal Reserve District:*

The Federal Financial Institutions Examinations Council has recommended the adoption of a uniform rating system for evaluating the soundness of federally supervised banks and thrift institutions and their compliance with law. The following is quoted from the Council's statement:

In announcing the recommendation, John G. Heimann, Comptroller of the Currency and Chairman of the Council, said:

The rating system that the Council wishes to see adopted by Federal regulators of commercial banks, mutual savings banks, savings and loan associations and credit unions provides for a general framework of evaluation which takes into account all significant financial, operational and compliance factors addressed in the examination of these institutions.

The rating system proposed by the Council has a two-fold purpose. First, it is designed to reflect in a comprehensive and uniform fashion an institution's financial condition, its compliance with applicable laws and regulations, and its overall soundness. Second, the rating system the Council proposes it meant to assist the public and the Congress in assessing the aggregate strength and soundness of our financial system.

The Council asked for action by Federal agencies represented on the Council by December 15. The rating system would become operative when approved by the agencies.

The proposed system allows for recognition of distinctions among credit unions, savings and loan associations, mutual savings banks and commercial banks while at the same time promoting overall uniformity and consistency of supervision. The system would provide for uniform definitions of five summary (composite) rating categories and agreed-upon uniform standards for identifying problem financial institutions.

Continuing existing agency practice, the ratings for individual institutions would not be made public or supplied to the institutions examined. However, adoption of the proposed uniform rating system is expected to be of substantial assistance to those seeking to compare the various aggregate data made available annually to the Congress by the five agencies.

The proposed five composite ratings—in which institutions may be classed according to a combination of their ratings on many different subjects—range from Composite Rating No. 1—for financial institutions that are found to be basically sound in every respect—to Composite Rating No. 5—which would include institutions rated as having a high probability of immediate or near-term failure.

It is a basic purpose of the proposed rating system to identify any institution—whether a commercial bank, savings and loan association, credit union or mutual savings bank—that is a problem institution. These would fall into categories four or five, calling for special supervisory surveillance. Institutions in the third category would be those whose composite rating indicated some combination of financial, operational or compliance weaknesses, ranging from moderately severe to unsatisfactory, but not indicating a danger of failure. Such institutions would, however, require more than normal supervisory attention. Those in category two would be institutions regarded as fundamentally sound, but with weaknesses that can be corrected in the normal course of business and which consequently do not require special supervisory attention except to ensure adjustments to overcome their minor weaknesses. Institutions in the first category are more capable of withstanding the vagaries of business conditions than institutions with lower ratings and would be subject only to minor criticism that can be corrected routinely.

The rating system proposed by the Council parallels the Uniform Interagency Bank Rating System announced in our letter of May 18, 1978 and the Bank Holding Company Rating System announced in our letter of February 21, 1979. A more complete description of the Uniform Interagency Bank Rating System was included in the Summer 1978 issue of this Bank's *Quarterly Review.*

Enclosed—for State member banks in this District—is a description of the rating system; additional copies will be furnished upon request. Questions on the rating system may be directed to Nathan Bednarsh, Chief, Bank Analysis Division (Tel. No. 212-791-6710).

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First Vice President.

November 13, 1979

UNIFORM FINANCIAL
INSTITUTIONS RATING SYSTEM*

Introduction

The rating system provides a general framework for evaluating and assimilating all significant financial, operational and compliance factors in order to assign a summary or composite supervisory rating to each Federally regulated commercial bank, savings and loan association, mutual savings bank and credit union. The purpose of the rating system is to reflect in a comprehensive and uniform fashion an institution's financial condition, compliance with laws and regulations and overall operating soundness. In addition to serving as a useful tool for summarizing the condition of individual institutions, the rating framework will also assist the public and Congress in assessing the aggregate strength and soundness of the financial industry.

Although it is acknowledged that to some degree each type of financial institution poses its own set of supervisory issues and concerns, the uniform rating system is predicated upon certain features and functions, including qualitative and quantitative factors, common to all categories of institutions. In general, financial institutions provide a wide range of essential credit, depository and related financial services to individuals, private commercial enterprises and governments. In so doing, financial institutions play an important and integral role in the stability and growth of economic activity at the local, regional, national or international level. Institutions are best able to carry out these essential functions and accommodate the demand for financial services when they are operated in a sound and prudent manner in full compliance with relevant laws and regulations.

*The term "financial institution" with respect to the rating system refers to certain institutions whose primary Federal supervisory agencies are represented on the Federal Financial Institutions Examination Council, i.e., Federally supervised commercial banks, savings and loan associations, mutual savings banks and credit unions.

Overview

Each financial institution is assigned a uniform composite rating that is predicated upon an evaluation of pertinent financial and operational standards, criteria and principles. The rating is based upon a scale of one through five in ascending order of supervisory concern. Thus, "1" represents the highest rating and, consequently, the lowest level of supervisory concern; while "5" represents the lowest, most critically deficient level of performance and, therefore, the highest degree of supervisory concern. Each of the five composite ratings is described in greater detail below.

In assigning a composite rating, all relevant factors must be weighed and evaluated. In general, these factors include: the adequacy of the capital base, net worth and reserves for supporting present operations and future growth plans; the quality of loans, investments and other assets; the ability to generate earnings to maintain public confidence, cover losses and provide adequate security and return to depositors; the ability to manage liquidity and funding; the ability to meet the community's or membership's legitimate needs for financial services and cover all maturing deposit obligations; and the ability of management to properly administer all aspects of the financial business and plan for future needs and changing circumstances. The assessment of management and administration includes the quality of internal controls, operating procedures and all lending, investment and operating policies; compliance with relevant laws and regulations; and the involvement of the directors, shareholders and officials. In general, assignment of a composite rating may incorporate any other factors that bear significantly on the overall condition and soundness of the financial institution.

Notwithstanding the use of common summary ratings, specific performance benchmarks, standards and principles will continue to recognize existing structural, operational and regulatory distinctions among different types of financial institutions.

Thus, while each financial institution will be evaluated upon criteria relating to its particular industry, the assignment of a uniform composite rating will help to direct uniform and consistent supervisory attention in such a way that does not depend solely upon the nature of an institution's charter or business, or the identity of its primary Federal regulator. While distinctions among credit unions, savings and loan associations, commercial banks and mutual savings banks are recognized, overall uniformity and consistency of supervision will be strengthened by the existence of common supervisory ratings.

The primary purpose of the uniform rating system is to help identify those institutions whose financial, operating or compliance weaknesses require special supervisory attention and/or warrant a higher than normal degree of supervisory concern. In an effort to accomplish this objective, the rating system identifies certain institutions whose financial, operational or managerial weaknesses are so severe as to pose a serious threat to continued financial viability. These institutions are, depending upon degree of risk and supervisory concern, rated Composite "4" or "5". Such institutions are generally characterized by unsafe, unsound or other seriously unsatisfactory conditions and carry a relatively high possibility of failure or insolvency. The uniform identification of such institutions will help to ensure:

1) That the degree of supervisory attention and the type of supervisory response are based upon the severity and nature of an institution's problems;

2) That supervisory attention and action are, to the extent possible, administered uniformly and consistently, regardless of the type of institution or the identity of the regulatory agency; and

3) That appropriate supervisory action is taken to address those institutions whose financial problems entail the greatest potential for hardship or inconvenience to depositors, borrowers or the public; or those institutions whose potential weaknesses would most seriously disrupt the proper and efficient functioning of the financial system.

The rating system also identifies a category of institutions that have some combination of financial or compliance deficiencies that, while posing little or no threat to financial viability under present circumstances, do warrant more than normal supervisory concern. These institutions are not deemed to present a significant risk of failure, or of loss or hardship to depositors, borrowers, or the public, but do require a higher than normal level of supervision. The delineation of this category will assist supervisory authorities in separating the most serious and critical problem institutions whose viability may be in question from those institutions whose financial or compliance deficiencies may require a specific supervisory response but do not constitute a significant risk of failure, insolvency or bankruptcy. Institutions that warrant some supervisory concern but do not entail a relatively high possibility of failure or insolvency are generally rated Composite "3".

Composite Ratings

Composite ratings are defined and distinguished as follows:

Composite 1

Institutions in this group are basically sound in every respect; any critical findings or comments are of a minor nature and can be handled in a routine manner. Such institutions are resistant to external economic and financial disturbances and more capable of withstanding the vagaries of business conditions than institutions with lower ratings. As a result, such institutions give no cause for supervisory concern.

Composite 2

Institutions in this group are also fundamentally sound, but may reflect modest weaknesses correctable in the normal course of business. The nature and severity of deficiencies, however, are not considered material and, therefore, such institutions are stable and also able to withstand business fluctuations quite well. While areas of weakness could develop into conditions of greater concern, the supervisory response is limited to the extent that minor adjustments are resolved in the normal course and operations continue satisfactory.

Composite 3

Institutions in this category exhibit a combination of financial, operational or compliance weaknesses ranging from moderately severe to unsatisfactory. When weaknesses relate to financial condition, such institutions may be vulnerable to the onset of adverse business conditions and could easily deteriorate if concerted action is not effective in correcting the areas of weakness. Institutions which are in significant non-compliance with laws and regulations may also be accorded this rating. Generally, these institutions give cause for supervisory concern and require more than normal supervision to address deficiencies. Overall strength and financial capacity, however, are still such as to make failure only a remote possibility.

Composite 4

Institutions in this group have an immoderate volume of serious financial weaknesses or a combination of other conditions that are unsatisfactory. Major and serious problems or unsafe and unsound conditions may exist which are not being satisfactorily addressed or resolved. Unless effective action is taken to correct these conditions, they could reasonably develop into a situation that could impair future viability, constitute a threat to the interests of depositors and/or pose a potential for disbursement of funds by the insuring agency. A higher potential for failure is present but is not yet imminent or pronounced. Institutions in this category require close supervisory attention and financial surveillance and a definitive plan for corrective action.

Composite 5

This category is reserved for institutions with an extremely high immediate or near term probability of failure. The volume and severity of weaknesses or unsafe and unsound conditions are so critical as to require urgent aid from stockholders or other public or private sources of financial assistance. In the absence of urgent and decisive corrective measures, these situations will likely require liquidation and the payoff of depositors, disbursement of insurance funds to insured depositors, or some form of emergency assistance, merger or acquisition.