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DEPARTMENT OF FINANCIAL AND PROFESSIONAL REGULATION

DIVISION OF BANKING

BUREAU OF BANKS AND TRUST COMPANIES

INTERNATIONAL BANKING

RATING SYSTEM FOR U.S. BRANCHES AND AGENCIES OF FOREIGN BANKING ORGANIZATIONS

Effective Date: July 1997

The rating system for US branches of FBOs is a management information and supervisory tool designed to assess the condition of a branch and to identify significant supervisory concerns at a branch in a systematic and consistent fashion. The rating system has been revised from the previous rating system of asset quality, internal controls, and management (AIM), to better assess the condition of a branch within the context of the FBO, of which it is an integral part, and to pinpoint the key areas of concern in a branch office.

For evaluation purposes, the rating system divides a branch's overall activities into three individual components: risk management, operational controls, and compliance. These components represent the major activities or processes of the branch that may raise supervisory concern. The rating system also provides for a specific rating of the quality of the branch's stock of assets as of the examination date.

COMPOSITE RATING

The overall or composite rating indicates whether, in the aggregate, the operations of the branch may present supervisory concerns and the extent of any concerns. While the individual component ratings are taken into consideration in arriving at the branch's overall assessment, the composite rating should not be merely an arithmetic average of the individual components. The examiner should assign and justify in the report a composite rating using definitions provided below as a guide.

The composite rating is based on a scale of one through five in ascending order of supervisory concern. Thus, one represents the lowest level of supervisory concern while five represents the highest level. The five composite ratings are defined as follows.

Composite Rating 1

Branches in this group are strong in every respect. These branches require only normal supervisory attention.

Composite Rating 2

Branches in this group are in satisfactory condition, but may have modest weaknesses that can be connected by branch management in the normal course of business. Generally, they do not require additional or more than normal supervisory attention.

Composite Rating 3

Branches in this group are viewed as fair due to a combination of weaknesses in risk management, operational controls, and compliance, or asset quality problems that, *in combination with* the condition of the FBO or other factors, cause supervisory concern. In addition, branch and/or head office management may not be taking the necessary collective actions to address substantive weaknesses. This rating may also be assigned when risk management, operational controls, or compliance is individually viewed as unsatisfactory. Generally, these branches raise supervisory concern and require more than normal supervisory attention to address their weaknesses.

Composite Rating 4

Branches in this group are in marginal condition due to serious weaknesses as reflected in the assessments of the individual components. Serious problems or unsafe and unsound banking practices or operations exist, which have not been satisfactorily addressed or resolved by branch and/or head office management. Branches in this category require close supervisory attention and surveillance monitoring and a definitive plan for corrective action by branch and head office management.

Composite Rating 5

Branches in this group are in unsatisfactory condition due to a high level of severe weaknesses or unsafe and unsound conditions and consequently require urgent restructuring of operations by branch and head office management.

DISCLOSURE

Following approval of the rating by appropriate senior supervisory officials at the examining agency, the numeric ratings for all components as well as the overall composite rating should be disclosed in the open, summary section of the examination report. This also applies when conducting meetings with senior management. In disclosing the rating, its meaning should be explained clearly using the appropriate composite rating definition. The report should also make it clear that the rating is part of the overall findings of the examination and is thus confidential. Any rating disclosed or discussed at an examination closeout meeting should be held out by the examiner-in-charge to be tentative.

COMPONENT EVALUATIONS

Similar to the composite rating, the individual rating components are evaluated on a scale of one to five, where one represents the lowest level of supervisory concern and five represents the highest. Each component is discussed below followed by a description of the individual performance ratings.

Risk Management

Risk is an inevitable component of any financial institution. Risk management, or the process of identifying, measuring, and controlling risk, is therefore an important responsibility of any financial institution. In a branch, which is typically removed from its head office by location and time zone, an effective risk management system is critical not only to manage the scope of its activities but to achieve comprehensive, ongoing oversight by branch and head office management. In the examination process, examiners will therefore determine the extent to which risk management techniques are adequate (i) to control risk exposures that result from the branch's activities and (ii) to ensure adequate oversight by branch and head office management and thereby promote a safe and sound banking environment.

The primary components of a sound risk management system are a comprehensive risk assessment approach; a detailed structure of limits, guidelines, and other parameters used to govern risk taking; and a strong management information system for monitoring and reporting risks.

The process of risk assessment includes the identification of all the risks associated with the branch's balance sheet and off-balance-sheet activities and grouping them into appropriate risk categories. These categories broadly relate to credit, market, liquidity, operational, and legal risks. All major risks should be measured explicitly and consistently by branch management; risks should also be reevaluated on an ongoing basis as underlying risk assumptions relating to economic and market conditions vary and as the branch's activities change. The branch's expansion into new products or business lines should not outpace proper risk management or supervision by head office. Where risks cannot be explicitly measured, management should demonstrate knowledge of their potential impact and a sense of how to manage such risks.

Risk identification and measurement are followed by an evaluation of the tradeoff between risks and returns to establish acceptable risk exposure levels, which are stated primarily in the branch's lending and trading policies subject to the approval of head office management. These policies should give standards for evaluating and undertaking risk exposure in individual branch activities as well as procedures for tracking and reporting risk exposure to monitor compliance with established policy limits or guidelines.

Head office management has a role in developing and approving the branch's risk management system as part of its responsibility to provide a comprehensive system of

oversight for the branch. Generally, the branch's risk management system, including risk identification, measurement, limits or guidelines, and monitoring should be modeled on that of the FBO as a whole to provide for a fully-integrated risk management system.

In assigning the risk management rating, examiners should evaluate the current, ongoing situation and concentrate on developments since the previous examination. The rating should not concentrate on past problems, such as those relating to the current quality of the branch's stock of assets, if risk management techniques have improved significantly since those problems developed.

More specifically, in rating the branch's risk management procedures, examiners should consider the following.

- The extent to which the branch is able to manage the risks inherent in its lending, trading, and other activities, specifically its ability to identify, measure, and control these risks.
- The soundness of the qualitative and quantitative assumptions implicit in the risk management system.
- Whether risk policies, guidelines, and limits at the branch are consistent with its lending, trading, and other activities; management's experience level; and the overall financial strength of the branch and/or the FBO.
- Whether the management information system and other forms of communication are consistent with the level of business activity at the branch and sufficient to accurately monitor risk exposure, compliance with established limits, and sufficient to enable the head office to monitor the real performance and risks of the branch.
- Management's ability to recognize and accommodate new risks that may arise from the changing environment, and to identify and address risks not readily quantified in a risk management system.

For example, in the lending area, a branch is expected to have (1) experienced lending officers, an effective credit approval and review function, and, where appropriate, credit workout personnel; (2) a credit risk evaluation system that is adequate in assessing relative credit risks; (3) branch officer lending limits, lending guidelines, and portfolio policies consistent with the abilities of branch personnel and the financial expertise and resources of the FBO; (4) a system that identifies existing and potential problem credits, a method for assessing the likely impact of those credits on existing and future profits, and procedures for accurately informing head office of the credit quality of the portfolio and possible credit losses; and (5) procedures for assessing the impact on the portfolio of specific or general changes in the business climate.

A rating of 1 indicates that management has a fully integrated risk management system that effectively identifies and controls all major types of risk at the branch, including

those from new products and the changing environment. This assessment, in most cases, will be supported by a superior level of financial performance and asset quality at the branch. No supervisory concerns are evident.

A rating of 2 indicates that the risk management system is fully effective with respect to almost all major risk factors. It reflects a responsiveness and ability to cope successfully with existing and foreseeable exposures that may arise in carrying out the branch's business plan. While the branch may have residual risk-related weaknesses, these problems have been recognized and are being addressed by the branch and/or head office. Any such weaknesses will not have a material adverse affect on the branch. Generally, risks are being controlled in a manner that does not require additional or more than normal supervisory attention.

A rating of 3 signifies a risk management system that is lacking in some important measures. Its effectiveness in dealing with the branch's level of risk exposures is cause for more than normal supervisory attention, and deterioration in financial performance indicators is probable. Current risk-related procedures are considered fair, existing problems are not being satisfactorily addressed, or risks are not being adequately identified and controlled. While these deficiencies may not have caused significant problems yet, there are clear indications that the branch is vulnerable to risk-related deterioration.

A rating of 4 represents a marginal risk management system that generally fails to identify and control significant risk exposures in many important respects. Generally, such a situation reflects a lack of adequate guidance and supervision by head office management. As a result, deterioration in overall performance is imminent or is already evident in the branch's overall performance since the previous examination. Failure of management to correct risk management deficiencies that have created significant problems in the past warrants close supervisory attention.

A branch rated 5 has critical performance problems that are due to the absence of an effective risk management system in almost every respect. Not only are there a large volume of problem risk exposures, the problems are also intensifying. Management has not demonstrated the capability to stabilize the branch's situation. If corrective actions are not taken immediately, the operations of the branch are severely endangered.

Operational Controls

This component assesses the effectiveness of the branch's operational controls, including accounting and financial controls. The assessment is based on the expectation that branches should have an independent internal audit function and/or an adequate system of head office or external audits as well as a system of internal controls consistent with the size and complexity of their operations. In this regard, internal audit and control procedures should ensure that operations are conducted in accordance with internal guidelines and regulatory policies and that all reports and

analyses provided to the head office and branch senior management are timely and accurate.

The rating of operational controls should include the following.

- The adequacy of controls and the level of adherence to existing procedures and systems. (These are separate but related factors.)
- The frequency, scope and adequacy of the branch's internal and external audit function, relative to the size and risk profile of the branch, and the independence of the internal audit function from line management.
- The number and severity of internal control and audit exceptions.
- Whether internal control and audit exceptions are effectively tracked and resolved in a timely manner.
- The adequacy and accuracy of management information reports. This assessment should be based primarily on whether reports and analyses are sufficient to properly inform head office management of the branch's condition on a timely basis, and whether there are sufficient procedures to ensure the accuracy of those reports.
- Whether the system of controls is regularly reviewed to keep pace with changes in the branch's business plan and laws and regulations.

A branch that is rated 1 has a fully comprehensive system of operational controls that protects against losses from transactional and operational risks and ensures accurate financial reporting. Branch operations are fully consistent with sound market practices. The branch also has a well-defined and independent audit function that is appropriate to the size and risk profile of the branch. No supervisory concerns are evident.

A rating of 2 may indicate some minor weaknesses, such as the presence of new business activities where some modest control deficiencies exist, but which management is addressing. Some recommendations may be noted. Overall, the system of controls, including the audit function, is considered satisfactory and effective in maintaining a safe and sound branch operation. Only routine supervisory attention is required.

A rating of 3 indicates that the branch's system of controls, including the quality of the audit function, is lacking in some important respects, particularly as indicated by continued control exceptions and/or substantial deficiencies in or failure to adhere to written policies and procedures. As a result, more than normal supervisory attention is required.

A branch that is rated 4 signifies that the system of operational controls has serious deficiencies that require substantial improvement. In such a case, the branch may lack control functions, including those related to the audit function, that meet minimal expectations; therefore, adherence to bank and regulatory policy is questionable. Head office management has failed to give the branch proper support to maintain operations in accordance with U.S. norms. Close supervisory attention is required.

A branch that is rated 5 lacks a system of operational controls to such a degree that its operations are in serious jeopardy. The branch either lacks or has a wholly deficient audit function. Immediate substantial improvement is required by branch and head office management, along with strong supervisory attention.

Special audit procedures are required when both the O component and the composite rating are 3 or worse. If both the O component and the composite rating are 3, the special audit procedures may be performed by the internal audit function if, and only if, the audit function is considered satisfactory. If the internal audit function is less than satisfactory, or if both the O component and composite rating are 4 or worse, then an external audit is required. An external audit also is required if the internal auditors had performed the special audit procedures following the previous examination, and the O and composite ratings are again assigned a 3 rating. As significant internal control weaknesses in the operations of one office may be an indication of systemic weaknesses in other branches as well, the special audit procedures may be applied to other U.S. offices of the FBO. SR 96-27 provides additional guidance regarding these special audits.

Compliance

In addition to maintaining an effective system of operational controls, branches should also demonstrate compliance with all applicable state and federal laws and regulations, including reporting and special supervisory requirements. To the extent possible given the size, risk profile and organizational structure of the branch, these responsibilities should be vested in a branch official or compliance officer whose function is separate from line management. Branch management should also ensure that all appropriate personnel are properly trained in meeting regulatory requirements on an ongoing basis. The scope of the branch's audit function also should ensure that the branch is meeting all applicable regulatory requirements.

Accordingly, the branch's level of compliance should be rated based on the following factors.

- The level of adherence to applicable state and federal laws and regulations and any supervisory follow-up actions.
- The effectiveness of (i) written compliance procedures and (ii) training of line personnel charged with maintaining compliance with regulatory requirements.

- Management's ability to submit required regulatory reports in a timely and accurate manner.
- Management's ability to identify and correct compliance issues.
- Whether the internal audit function checks for compliance with applicable state and federal laws and regulations.

A branch accorded a rating of 1 demonstrates an outstanding level of compliance with applicable laws, regulations, and reporting requirements. No supervisory concerns are evident.

A rating of 2 indicates that compliance is generally effective with respect to most factors. Compliance monitoring and related training programs are sufficient to prevent significant problems. Minor reporting errors may be present, but they are being adequately addressed by branch management. Only normal supervisory attention is warranted.

A branch that is rated 3 has deficiencies in management and training systems that result in an atmosphere where significant compliance problems could and do occur. Such deficiencies could include a lack of written compliance procedures, no system for identifying possible compliance issues, or a substantial number of minor or repeat violations or deficiencies. More than normal supervisory attention is warranted.

A rating of 4 indicates that compliance matters are not given proper attention by branch and head office management and close supervisory attention is warranted. The lack of an effective compliance program, including an ongoing training program, may be evident along with a failure to meet significant regulatory requirements and/or significant, widespread inaccuracies in regulatory reports.

A rating of 5 would signal that attention to compliance matters is wholly lacking at the branch to the extent that immediate supervisory attention is warranted.

Asset Quality

Generally, asset quality is evaluated to determine whether a financial entity has sufficient capital to absorb prospective losses and, ultimately, whether it can maintain its viability as an ongoing entity. The evaluation of asset quality in a branch does not have the same result because a branch is not a separately capitalized entity. Instead, a branch relies on the financial and managerial support of the FBO as a whole.

Nonetheless, the evaluation of asset quality is important both in assessing the effectiveness of credit risk management and in the event of a possible liquidation of a branch. However, as indicated above, a branch is not strictly limited by its own internal and external funding sources in meeting solvency and liquidity needs. The ability of a branch to honor its liabilities ultimately is based upon the condition and level of support from the FBO, a concept that is integral, to the FBO supervision program. This concept

states that if the condition of the FBO is satisfactory, the FBO is presumed to be able to support the branch with sufficient resources on a consolidated basis. As a result, the assessment of asset quality in such circumstances would not in and of itself be a predominant factor in the branch's overall assessment, if existing risk management techniques are satisfactory. If, however, support from the FBO is questionable, the evaluation of asset quality should be carefully considered in determining whether supervisory actions are needed to improve the branch's ability to meet its obligations on a stand-alone basis. In cases where a branch is subject to asset maintenance, it is expected that asset quality issues will be addressed by disqualifying classified assets as eligible assets.

The quality of the branch's stock of assets is evaluated based on the following factors. *Generally, credit administration concerns should be addressed in rating risk management.*

- The level, distribution, and severity of asset and off-balance-sheet exposures classified for credit and transfer risk.
- The level and composition of nonaccrual and reduced rate assets.

A branch rated 1 has strong asset quality.

A branch rated 2 has satisfactory asset quality.

A branch rated 3 has fair asset quality.

A branch rated 4 has marginal asset quality.

A branch rated 5 has unsatisfactory asset quality.

[Revised: October, 2005]