

BOARD OF GOVERNORS

OF THE

FEDERAL RESERVE SYSTEM

WASHINGTON, D.C. 20551

DIVISION OF BANKING SUPERVISION AND REGULATION

SR 12-4

March 1, 2012

TO THE OFFICER IN CHARGE OF SUPERVISION AT EACH FEDERAL RESERVE BANK

SUBJECT: Upgrades of Supervisory Ratings for Banking Organizations with \$10 Billion or Less in Total Consolidated Assets

Applicability to Community Banking Organizations: This guidance applies to all institutions supervised by the Federal Reserve with total consolidated assets of \$10 billion or less, including state member banks and bank holding companies.

The Board of Governors is issuing guidance to describe the factors the Federal Reserve will consider in evaluating whether to upgrade an institution's supervisory ratings. The concepts outlined in this letter provide a basic outline for analyzing whether or not a community banking organization's composite ratings could be upgraded consistent with interagency rating guidance and Federal Reserve risk management rating guidance. While the factors discussed below are particularly relevant for state member community banks with consolidated assets of \$10 billion or less and address situations encountered recently, they can be applied to other types of community institutions supervised by the Federal Reserve.

Composite Rating Upgrade Considerations

This guidance is being issued to clarify application of the interagency ratings guidelines¹ when in a period of stabilized or generally improving economic conditions. When assigning ratings, examiners are expected to use balanced judgment and consider progress by banking organizations in addressing supervisory issues and in restoring the organization to satisfactory condition. Examiners should consider an upgrade of a banking organization's supervisory rating when there is a demonstrated improvement in the organization's financial condition and risk management practices, and where improvement is likely to continue. In particular, the Federal Reserve will evaluate the strength of core financial components, overall risk management,² and board of directors' oversight in assessing whether an upgrade is warranted.

¹ See SR letter 96-38, "Uniform Financial Institutions Rating System."

² SR letter 95-51, "Rating the Adequacy of Risk Management Processes and Internal Controls at State Member Banks and Bank Holding Companies"

Additional specific considerations include the extent to which:

- The level of capital and capital planning process are appropriate relative to risk characteristics.
- Core earnings have improved, and this trend is demonstrably sustainable.
- Asset quality is improving, as evidenced by a material decline of adversely classified and nonperforming assets, and this trend is expected to continue.
- Liquidity and interest rate risk positions generally are managed prudently and in a manner consistent with applicable supervisory guidance.
- Management's projections and assumptions related to core financial factors referred to above are reasonable and subject to regular board review and oversight.
- Risk management capabilities have improved to address principal weaknesses that
 contributed to prior ratings, and policies and practices have been implemented that
 focus on sustainability commensurate with the bank's risk profile.
- The board provides strategic review and oversight of the banking organization's core financial factors and risk management and actively engages in the process of correcting deficiencies.

The Federal Reserve will also consider whether the firm has made demonstrable and sustained improvement in particular areas relevant to the firm's operation and financial condition as noted in reports of examination and condition.

Contacts

If you have questions related to this guidance, please contact Rick Watkins, Assistant Director, Supervisory Oversight, at (202) 452-3421. In addition, questions may be sent via the Board's public website.³

Michael S. Gibson Director

Cross references:

- SR letter 96-38, "Uniform Financial Institutions Rating System"
- <u>SR letter 95-51</u>, "Rating the Adequacy of Risk Management Processes and Internal Controls at State Member Banks and Bank Holding Companies"

³ See http://www.federalreserve.gov/apps/contactus/feedback.aspx.