

THE FEDERAL RESERVE BOARD'S NEW RATING SYSTEM  
FOR BANK HOLDING COMPANIES AND FINANCIAL  
HOLDING COMPANIES

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## I. INTRODUCTION

Traditionally the most important indicators of the financial health of bank holding companies (“BHCs”) and financial holding companies (“FHCs”) have included the organizations’ revenue, earnings, earnings per share, and stock price. However, hidden from public view is the Federal Reserve Board’s overall supervisory rating of the parent holding company (“Parent”), which should be the most important single indicator to the organizations’ senior management and board of directors. This rating is a very simple “1”, “2”, “3”, “4”, or “5”.<sup>1</sup>

Starting on January 1, 2005, and with minimal advance notice, the Federal Reserve Board (“Board”) significantly revised how it will evaluate and rate BHCs and FHCs.<sup>2</sup> This rating system is important because the supervisory rating is a critical determinant of an organization’s future. The supervisory rating affects an organization’s ability to engage in new businesses through both internal expansion and external acquisitions. The rating determines to what extent the Board will allow the organization to grow and the amount of regulatory hassle it will be subjected to.<sup>3</sup> In order to take advantage of less onerous regulatory procedures and to make acquisitions under delegated authority or without any need for prior approval, the BHC or FHC needs to have one of the two top ratings. That is, the organization needs to have an overall supervisory rating of “1” (strong) or “2” (satisfactory).<sup>4</sup>

Through this new rating system, the Board has moved away from rating holding companies using the more traditional approach of focusing on credit quality and financial condition, which includes capital, earnings and liquidity. The revised analysis is a more forward-looking evaluation of the organization’s risk management and financial factors.<sup>5</sup> Under the new rating system, there is a

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<sup>1</sup> Bank Holding Company Rating System, 69 Fed. Reg. 70,444 (Dec. 6, 2004) (“Bank Holding Company Rating System”). A “1” rating is the highest rating and means the organization is sound in almost every respect. A “5” rating is the lowest rating and means the organization is unsatisfactory and likely heading to insolvency.

<sup>2</sup> *Id.* at 70,446.

<sup>3</sup> *Id.* at 70,446 (noting that “the BHC rating forms the basis of supervisory responses and action . . . [and] determines whether the BHC is entitled to expedited applications processing and to certain regulatory exemptions”).

<sup>4</sup> *Id.*

<sup>5</sup> Bank Holding Company Rating System, Board of Governors of the Federal Reserve System, SR 04-18 (Dec. 6, 2004).

greater emphasis on both risk management and the significance of non-depository affiliates.<sup>6</sup> This shift in emphasis is due primarily to the enactment of the Gramm-Leach-Bliley Act in 1999 and the breaking down of Glass-Steagall.<sup>7</sup>

This new approach is captured in a 2005 speech given by Scott Alvarez, General Counsel of the Board, in which he said:

“Banking supervision at the Federal Reserve has long taken a consolidated view of risk management and compliance. The Gramm-Leach-Bliley Act (GLBA), which passed in 1999, reinforced this focus. Under the GLB Act, the Federal Reserve, as umbrella supervisor of banking organizations, has a special responsibility to determine whether bank holding companies are operated in a safe and sound manner that does not threaten the viability of affiliated depository institutions. Consolidated oversight of bank holding companies, and in particular the subset of bank holding companies that have elected financial holding company status in order to engage in a broader range of activities, is important because the risks associated with a bank holding company’s activities can transcend legal entities and business lines. That is, risks in one entity can have an impact on another entity or functional area--and ultimately on the enterprise as a whole.

Organizations that address risk management and compliance by business line can miss inherent conflicts of interest between lines of business. And individuals focused only on individual business lines can be motivated to support their line of business without due regard for the increased risk or potential for compliance failure that their actions create in other parts of the organization.

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<sup>6</sup> Bank Holding Company Rating System, 69 Fed. Reg. 70,444, 70,444 (Dec. 6, 2004).

<sup>7</sup> Gramm-Leach-Bliley Financial Services Modernization Act, Pub. L. No. 106-102, 113 Stat. 1338 (1999) (Glass-Steagall Act refers to sections 16, 20, 21, and 32 of the Banking Act of 1933, Pub. L. No. 73-66, 48 Stat. 162 (1933)).

To better reflect this supervisory approach, the Board recently changed its examination rating system. We replaced the BOPEC bank holding company rating system, with a new rating system comprised of ratings for risk management, financial strength, and the impact of non-depository legal entities on affiliated depository institutions; the system also includes a composite rating; and a depository institution rating. The acronym for this system RFICD is much harder to say (than) the old BOPEC. But, the new rating system will better emphasize risk management and the importance of the control environment. It is also designed to introduce a more comprehensive, more adaptable framework for analyzing and rating financial factors based on the unique structure of each holding company; and for the first time, will provide an explicit framework for rating the impact of the non-depository entities of a holding company on its affiliated depository institutions.”<sup>8</sup>

As a result, the Board is no longer evaluating BHCs and FHCs using the narrow BOPEC legal entity approach. In order to account for the impact of non-depository affiliates on the holding company, the Board now evaluates risk management across the entire organization.<sup>9</sup>

The BOPEC rating system, which was in place from 1979 to 2004, originally weighted each of the five factors equally.<sup>10</sup> Under the BOPEC system the Federal Reserve evaluated the financial

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<sup>8</sup> Scott G. Alvarez, General Counsel of the Board, Risk Management and Compliance from the Fed's Perspective, Address to Second Annual Minnesota CLE Banking Law Institute, March 7, 2005, *available at* <http://www.aba.com/NR/rdonlyres/B838E06D-5154-4DAE-88BA-675204386A6/38783/AlvarezRiskSpeech2005.pdf>.

<sup>9</sup> Bank Holding Company Rating System, 69 Fed. Reg. 70,444, 70,444 (Dec. 6, 2004).

<sup>10</sup> *Id.*; See generally Uniform Financial Institutions Rating System, Board of Governors of the Federal Reserve System, SR 96-38 (SUP) (Dec. 27, 1996); Provision of Individual Components of Supervisory Rating Systems to Management and Boards of Directors, Board of Governors of the Federal Reserve System, SR 96-26 (SUP) (Nov. 15, 1996). (Banking agencies adopted UFIRS on the recommendation of Federal Financial Institutions Examination Council. UFIRS, as applied to bank holding companies, took the form of BOPEC.)

condition of the bank holding company's bank subsidiaries (B), the other non-bank subsidiaries (O), the parent holding company (P), the holding company's earnings (E), and the holding company's capital (C).<sup>11</sup> Since 1995, each of the five BOPEC factors has been divided by the financial composite and the management composite.<sup>12</sup>

However, since 1979, the banking industry has become increasingly consolidated and complex. There are now mammoth American organizations with over one trillion dollars in consolidated assets (*e.g.*, Citigroup, Bank of America, JPMorgan Chase).<sup>13</sup> These organizations offer a wide array of products and services ranging from traditional banking products, such as loans and deposits, to more sophisticated derivative products and complex financial structuring. Also, the products offered by financial markets have increased in both their depth and sophistication, which has in turn increased the scope of activities engaged in by banking institutions. The enactment of Gramm-Leach-Bliley further increased the complexity of the banking industry by expanding the scope of permissible activities.<sup>14</sup>

Changing market conditions have therefore forced the Board to shift its exam focus away from the traditional historical financial analysis "towards more forward looking assessment of risk management and financial factors."<sup>15</sup> This will require a "comprehensive review of financial risk and the adequacy of risk management" across the institution rather than on an entity by entity basis.<sup>16</sup> The Board has been moving in that direction since 1995 when it issued a supervisory letter entitled "Rating the Adequacy of Risk Management Processes and Internal Control at State Member Banks and Bank Holding Companies."<sup>17</sup> In that supervisory letter, the Board directed its examiners to emphasize the importance of sound risk management processes and strong internal controls as part

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<sup>11</sup> *Id.*

<sup>12</sup> *Id.* at 70,444.

<sup>13</sup> American Banker Online, Top Bank and Thrift Holding Companies by Assets, October 31, 2006, available at [http://www.americanbanker.com/rankings.html?rankingchart=/BTHC/Assets/103106BTHC\\_Assets.htm](http://www.americanbanker.com/rankings.html?rankingchart=/BTHC/Assets/103106BTHC_Assets.htm).

<sup>14</sup> See Gramm-Leach-Bliley Financial Services Modernization Act, Pub. L. No. 106-102, 113 Stat. 1338 (1999).

<sup>15</sup> Bank Holding Company Rating System, 69 Fed. Reg. 70,444, 70,444 (Dec. 6, 2004).

<sup>16</sup> *See id.*

<sup>17</sup> Rating the Adequacy of Risk Management Processes and Internal Controls at State Member Banks and Bank Holding Companies, Board of Governors of the Federal Reserve System, SR 95-51 (Nov. 14, 1995).

of a safety and soundness exam and to assign to this review a supervisory rating from 1 to 5.<sup>18</sup> This was the first time the Board introduced a risk management rating for Holding Companies irrespective of their size.

By applying the new exam rating system, the Board is taking a more in depth look at the effectiveness of risk management and its processes and procedures and a more critical review of corporate governance. The Board executes its examination review in the broadest sense, not just at the board level but also with respect to internal management structures.<sup>19</sup> This review will also closely look at the independence of the audit and compliance functions.<sup>20</sup>

The increased focus on corporate governance is manifesting itself in a more expansive corporate governance exam, which not only focuses on the role of a board of directors in overseeing the operations of the holding company, but also looks at the internal management structures. The Board, as part of its examination, now examines factors such as the internal management committee structures, the qualifications of committee members and compensation, the committee charters, agendas, and operations, and the maintenance of extensive minutes of committee deliberations.<sup>21</sup> The examiners also reviews the reporting and flow of information up and down the communications chain from internal management committees to the appropriate board committee.<sup>22</sup> In addition, examiners expect the Board to view risk management as encompassing a review of how compensation is tied to risk.

It is important that a holding company achieve the highest rating possible so that managements' plans and strategies are not constrained by regulators or the regulatory environment. Accordingly, the rating of the holding company should concern each member of the board of directors and all senior managers.

As indicated above, the BOPEC rating was developed in 1979 and then modified in 1995 when the Federal Reserve examiners were told to assign a formal rating system to the adequacy of an institution's risk management process and its internal controls.<sup>23</sup> With the increase in the complexity of financial products, the

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<sup>18</sup> *Id.*

<sup>19</sup> Bank Holding Company Rating System, 69 Fed. Reg. 70,444, 70,447 (Dec. 6, 2004).

<sup>20</sup> *Id.*

<sup>21</sup> *See generally id.* at 70,447, 70,451.

<sup>22</sup> *Id.* at 70,453-4.

<sup>23</sup> *Id.* at 70,444.

enactment of the Gramm-Leach-Bliley Act's expansion and diversification of the scope of holding companies' activities, and increased concentration in the financial services industry, it is clear that a narrowly focused entity examination alone was inadequate.<sup>24</sup>

In addition to the increased focus on risk, the diversification of holding companies has caused a new factor to be weighed; that is, the impact non-depository entities can have on the subsidiary depository institution(s) and, thereby, the safety net.<sup>25</sup> As related financial activity has increased, so has the financial risk to both non-depository entities and holding companies that reside inside the safety net. The expansion of activities thus implicates a greater diversity of regulatory bodies.

There is a need for greater coordination among the Federal Reserve and the functional regulators (*e.g.*, SEC, state insurance regulators, and other banking regulators) as a result of Gramm-Leach-Bliley. However, as the primary regulator of the parent holding company,<sup>26</sup> the Board regards itself as the only regulator that can take a consolidated review. Such an approach could potentially cause a conflict between the Board and other regulators, both those governing the subsidiary banks (the OCC, the FDIC, the OTS, and various state regulators) and those governing important non-bank activities and entities (the SEC, NASD, and state securities and insurance regulators).<sup>27</sup> The Board has made clear that, whenever possible, it will defer to the functional and state regulators. When necessary, however, it will stake out its own position, apply its own criteria, and use its own decision-making capabilities in weighing the ratings of these subsidiaries.

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<sup>24</sup> See Alvarez, *supra* note 9 at 1.

<sup>25</sup> Bank Holding Company Rating System, 69 Fed. Reg. 70,444, 70,447 -8 (Dec. 6, 2004).

<sup>26</sup> See Bank Holding Company Act of 1956, 12 U.S.C. § 1844 (2006): see John D. Hawke, Jr., Remarks before the New York Bankers Association, April 6, 2000 ("The Federal Reserve has also been designated the (appropriate federal banking agency) for bank holding companies and their nonbank subsidiaries."); see John D. Hawke, Jr., Remarks before the Women in Housing and Finance, July 27, 2000 ("(Gramm-Leach Bliley) perpetuates the role of the Federal Reserve as the regulator of holding companies, with its traditional function of helping to protect banks from risks that might arise elsewhere in the corporate family, outside the bank.").

<sup>27</sup> See generally John D. Hawkes, Jr., Remarks before the Women in Housing and Finance, July 27, 2000 ("(Gramm-Leach-Bliley) required the Fed to give deference to the primary federal or state supervisor when seeking information on bank subsidiaries, requiring that the Fed use the examination reports of the primary supervisors to the fullest extent possible.").

As mentioned earlier, several factors have caused the supervisory ratings bar to be more complex, the most important of which are consolidation within the banking industry, the increased complexity of financial products, and the expanded scope of permissible non-banking activities. As a consequence of these trends, the Federal Reserve has concluded that the more traditional, straight-forward legal entity silo approach exam needs to be replaced by a more horizontal and deeper examination approach that takes into consideration views from across the entire organization.<sup>28</sup>

The components of the new reviewing procedure are represented by the acronym RFI/C(D). Under the new rating system, each parent holding company, whether a BHC or FHC, is assigned a composite rating (C).<sup>29</sup> This rating is determined by the organization's "managerial and financial condition," as well as the potential risk it poses to the subsidiary depository institutions.<sup>30</sup> The revised rating system includes three primary components, namely risk management (R), financial condition (F), and the potential impact "of non-depository entities on the depository subsidiary (I)."<sup>31</sup> While the parent holding company is expected to continue providing financial stability to the subsidiary depository institutions, the impact rating will evaluate the risk of non-depository entities having a negative impact on the subsidiary depository institution(s).<sup>32</sup> Further, the depository institution's (D) evaluation, as determined by its primary regulator, acts as the final component of the revised system.<sup>33</sup>

## II. RISK MANAGEMENT FACTOR (R)

The risk management component (R) reflects the effectiveness of the board and senior management at managing organizational risk.<sup>34</sup> Effective risk management involves identifying potential risks, measuring their severity and potential effect, monitoring changes and controlling the organization's

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<sup>28</sup> See generally, Alvarez, *supra* note 9.

<sup>29</sup> Bank Holding Company Rating System, 69 Fed. Reg. 70,444, 70,446 (Dec. 6, 2004).

<sup>30</sup> *Id.*

<sup>31</sup> *Id.*

<sup>32</sup> *Id.*

<sup>33</sup> *Id.*

<sup>34</sup> *Id.*

exposure.<sup>35</sup> In conducting examinations, the Board considers the complexity of the organization and what risks are inherent in its activities.<sup>36</sup> Also, the control environment is an important aspect of this rating.<sup>37</sup>

The risk management component is comprised of the ratings for each of four subcomponents, namely: (1) board and senior management oversight; (2) policies, procedures, and limits; (3) risk monitoring and management information systems; and (4) internal controls.<sup>38</sup> In the request for comment on the new rating system, the Board indicated that it would consider an additional subcomponent rating the adequacy of disclosures for holding companies adopting the risk based capital ratings approach of Basel II.<sup>39</sup> These subcomponents are based on the 1995 Supervisory Letter and have been applied by Federal Reserve System Examiners in assessing risk in the Parent Holding Company or Financial Services Holding Company since 1996.<sup>40</sup>

### A. Board and Senior Management Oversight

The board and senior management oversight component evaluates how the board of directors and senior management run the organization and how well they understand and manage its activities and attendant risks.<sup>41</sup> The Board perceives the board of directors' role as ensuring that management is effectively managing risk.<sup>42</sup> In light of this responsibility, the board of directors should participate in establishing organizational policies and be involved in the approval of all business strategies.<sup>43</sup> The board should also supervise senior management to ensure the organization's activities are being properly monitored and controlled.<sup>44</sup> While directors cannot be expected to

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<sup>35</sup> *Id.*

<sup>36</sup> *Id.*

<sup>37</sup> *Id.*

<sup>38</sup> *Id.*

<sup>39</sup> *Id.*, See also Bank Holding Company Rating System, 69 Fed. Reg. 43,996, 43,998 (July 23, 2004).

<sup>40</sup> Rating the Adequacy of Risk Management Processes and Internal Controls at State Member Banks and Bank Holding Companies, Board of Governors of the Federal Reserve System, SR 95-51 (Nov. 14, 1995).

<sup>41</sup> See *Id.*; See also Bank Holding Company Rating System, 69 Fed. Reg. 70,444, 70,447 (Dec. 6, 2004).

<sup>42</sup> *Id.*

<sup>43</sup> See *id.*

<sup>44</sup> *Id.*

understand all the details of their institution's activities, they need to be aware of the risks inherent to the environment in which their organization operates.<sup>45</sup> This includes reviewing risk reports presented in a meaningful form and discussing organizational risk with auditors or other external experts.<sup>46</sup> With an adequate understanding of the organization's risks, the board can establish policies regarding acceptable levels of exposure and ensure appropriate procedures and controls are adopted by management.<sup>47</sup> To the extent that the organization's activities are more traditional, the directors can fulfill their duties without the knowledge of sophisticated financial products and capital markets required of directors of larger organizations.<sup>48</sup>

Senior management has a duty to limit the organization's exposure to risk when implementing business strategies.<sup>49</sup> Management is also responsible for maintaining regulatory compliance in both the short term and long term.<sup>50</sup> This requires knowledge of and involvement in all activities of the organization.<sup>51</sup> Additionally, management must ensure appropriate internal control systems are designed and placed in operation along with clearly established lines of authority.<sup>52</sup> To ensure compliance with the control systems, senior management should emphasize the importance of internal controls and create an environment where high ethical standards are fostered and encouraged.<sup>53</sup>

In deciding whether an institution follows appropriate policies and practices, examiners considers the following:

- i. The extent to which the board and senior management have identified and have a clear understanding and working knowledge of the types of risks inherent in the institution's activities and make appropriate efforts to remain informed about these risks as financial markets, risk

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<sup>45</sup> *Id.*

<sup>46</sup> *Id.*

<sup>47</sup> *Id.*

<sup>48</sup> *Id.*

<sup>49</sup> *Id.*

<sup>50</sup> *Id.*

<sup>51</sup> *Id.*

<sup>52</sup> *Id.*

<sup>53</sup> *Id.*

management practices, and the institution's activities evolve;<sup>54</sup>

ii. If the board has reviewed and approved appropriate policies to limit risks inherent in the institution's lending, investing, trading, trust, fiduciary and other significant activities or products;<sup>55</sup>

iii. The extent to which the board and management are familiar with and are using adequate record keeping and reporting systems to measure and monitor the major sources of risk to the organization;<sup>56</sup>

iv. If the board periodically reviews and approves risk exposure limits to conform with any changes in the institution's strategies, addresses new products, and reacts to changes in market conditions;<sup>57</sup>

v. If management ensures that its lines of business are managed and staffed by personnel with knowledge, "experience, and expertise consistent with the nature and scope" of the banking organization's activities;<sup>58</sup>

vi. Whether management ensures that the depth of staff resources is sufficient to operate and manage soundly the institution's activities and whether its employees have the "integrity, ethical values, and competence that are consistent with a prudent management philosophy and operating style;"<sup>59</sup>

vii. If management at all levels provides adequate supervision of the day-to-day activities of officers and employees, "including supervision of the senior officers and the heads of business lines;"<sup>60</sup>

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<sup>54</sup> *Id.* at 70,451.

<sup>55</sup> *Id.*

<sup>56</sup> *Id.*

<sup>57</sup> *Id.*

<sup>58</sup> *Id.*

<sup>59</sup> *Id.*

<sup>60</sup> *Id.*

viii. If management is able to respond to risks that may arise from changes in the competitive environment or from innovations in markets in which the organization is active;<sup>61</sup>

ix. Whether management, before embarking on new activities or introducing products new to the institution, identifies and reviews all risks associated with the activity or product and ensures that the infrastructure and internal controls necessary to manage the related risks are in place.<sup>62</sup>

### **B. Policies, Procedures and Limits**

The second factor that reflects the effectiveness of the organization's risk management and controls is adequate policies, procedures and limits. The risk management policies and procedures should address the risks inherent to that organization and its activities.<sup>63</sup> The organization's policies and detailed procedures provide guidance to the operational areas that execute established strategies on a daily basis.<sup>64</sup> These policies and procedures should place restrictions on certain activities to ensure the organization is not exposed to unnecessarily high levels of risk.<sup>65</sup> Management should regularly update the policies and procedures in light of changing conditions to ensure they continue to address material risks to the organization.<sup>66</sup>

Examiners will consider the following conditions when evaluating policies, procedures and limits:

i. The extent to which the institution's policies, procedures, and limits provide for adequate "identification, measurement, monitoring, and control of the risks posed by all significant activities, including lending, investing, trading, trust, and fiduciary activities;"<sup>67</sup>

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<sup>61</sup> *Id.*

<sup>62</sup> *Id.*

<sup>63</sup> *Id.* at 70,447.

<sup>64</sup> *See id.*

<sup>65</sup> *Id.*

<sup>66</sup> *Id.*

<sup>67</sup> *Id.* at 70,452.

ii. Whether the policies, procedures, and limits are consistent with management's experience level, the institution's stated goals and objectives, and the overall financial strength of the organization;<sup>68</sup>

iii. If the policies "clearly delineate accountability and lines of authority across the institution's activities;"<sup>69</sup>

iv. Whether the policies provide for the review of activities new to the financial institution to ensure that the infrastructures necessary to "identify, monitor, and control risks associated with an activity are in place before the activity is initiated."<sup>70</sup>

### **C. Risk Monitoring and Management Information Systems**

In order to adequately monitor risk, the organization needs to identify and measure all significant risks to which it is exposed.<sup>71</sup> This requires an effective information system that can provide timely information to the board of directors, senior management, and line managers regarding financial and operational performance as well as organizational risk exposure.<sup>72</sup> The complexity of the organization determines the sophistication of the information systems required.<sup>73</sup> Larger organizations will require more advanced information systems capable of aggregating risk across multiple subsidiary entities and reporting in a timely manner. Regardless of the organization's size, the information system should present the board and senior management with a clear picture of the risks the organization faces.<sup>74</sup>

Examiners should consider the following conditions in evaluating risk monitoring and information systems:

i. If the institution's risk monitoring practices and reports

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<sup>68</sup> *Id.*

<sup>69</sup> *Id.*

<sup>70</sup> *Id.*

<sup>71</sup> *Id.* at 70,447.

<sup>72</sup> *Id.*

<sup>73</sup> *Id.*

<sup>74</sup> *Id.*

address all of its material risks;<sup>75</sup>

- ii. Whether “key assumptions, data sources, and procedures used in measuring and monitoring risk are appropriate, thoroughly documented, and frequently tested for reliability;”<sup>76</sup>
- iii. If reports and other forms of communication are consistent with the banking organization's activities, are “structured to monitor exposures and compliance with established limits, goals, or objectives,” and as appropriate, “compare actual versus expected performance;”<sup>77</sup>
- iv. Whether reports to management or to the institution's directors are “accurate and timely” and contain sufficient information for decision-makers to identify any “adverse trends and to thoroughly evaluate the level of risk faced by the institution.”<sup>78</sup>

#### **D. Adequacy of Internal Controls**

The final component of the risk management rating is the adequacy of internal controls. It is important for management to create an effective system of internal controls.<sup>79</sup> Appropriate segregation of duties is a key aspect of a properly designed internal control system.<sup>80</sup> Improper segregation of duties is considered “an unsafe and unsound practice and [may] possibly lead to serious losses or otherwise compromise the financial integrity of the institution.”<sup>81</sup> The board considers internal controls highly important and may take enforcement action against organizations whose internal control systems are found lacking.<sup>82</sup>

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<sup>75</sup> *Id.*

<sup>76</sup> *Id.*

<sup>77</sup> *Id.*

<sup>78</sup> *Id.* at 70,452.

<sup>79</sup> *Id.* at 70,447.

<sup>80</sup> *Id.*

<sup>81</sup> *Id.*

<sup>82</sup> *Id.*

Well designed internal control systems aid compliance with laws and internal policies.<sup>83</sup> Internal controls should be tested regularly by internal auditors who report directly to the audit committee of the board (or the full board if no such committee exists).<sup>84</sup> In the case of smaller institutions, which often do not have a full audit function, people other than internal audit personnel may conduct the review.<sup>85</sup> These reviews should be conducted by personnel who are not involved in the function under review.<sup>86</sup> The Federal Reserve's examiners take the position that an audit department's independence may be compromised to the extent the audit department has responsibilities outside the audit function, such as responsibility for management of a corporation's ethics. All results of internal audits or reviews and management's responses to those results need to be properly documented.<sup>87</sup> Furthermore, the internal control system must stipulate that negative audit results should be communicated to the audit committee or board directly.<sup>88</sup>

Examiners will consider whether the following conditions exist when evaluating internal control systems:

- i. The system of internal controls is appropriate to the type and level of risks posed by the nature and scope of the organization's activities;<sup>89</sup>
- ii. The institution's organizational structure establishes clear lines of authority and responsibility for monitoring adherence to policies, procedures, and limits;<sup>90</sup>
- iii. If reporting lines provide sufficient independence of the control areas from the business lines and adequate separation of duties throughout the organization--such as

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<sup>83</sup> *Id.*

<sup>84</sup> *Id.*

<sup>85</sup> *Id.*

<sup>86</sup> *Id.*

<sup>87</sup> Bank Holding Company Rating System, 69 Fed. Reg. 70,444, 70,453 (Dec. 6, 2004); *see also* Rating the Adequacy of Risk Management Processes and Internal Controls at State Member Banks and Bank Holding Companies, Board of Governors of the Federal Reserve System, SR 95-51 (Nov. 14, 1995).

<sup>88</sup> *Id.*

<sup>89</sup> *Id.*

<sup>90</sup> *Id.*

those relating to trading, custodial, and back-office activities;<sup>91</sup>

iv. If official organizational structures reflect actual operating practices;<sup>92</sup>

v. Whether financial, operational, and regulatory reports are reliable, accurate, and timely and wherever applicable exceptions are noted and promptly investigated;<sup>93</sup>

vi. If adequate procedures exist for ensuring compliance with applicable laws and regulations;<sup>94</sup>

vii. If internal audit or other control review practices provide for independence and objectivity;<sup>95</sup>

viii. Whether internal controls and information systems are adequately tested and reviewed; whether the coverage, procedures, findings, and responses to audits and review tests are adequately documented; whether identified material weaknesses are given appropriate and timely high level attention; and whether management's actions to address material weaknesses are objectively verified and reviewed.<sup>96</sup>

ix. Whether the institution's audit committee or board of directors reviews the effectiveness of internal audits and other control review activities on a regular basis.<sup>97</sup>

The overall risk management rating represents the examiner's views of the adequacy of an organization's risk management system, including both quantitative and qualitative factors.<sup>98</sup> The adequacy of the risk management process is an important part of the management rating.<sup>99</sup> This is especially true in

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<sup>91</sup> *Id.*

<sup>92</sup> *Id.*

<sup>93</sup> *Id.*

<sup>94</sup> *Id.*

<sup>95</sup> *Id.*

<sup>96</sup> *Id.*

<sup>97</sup> *Id.*

<sup>98</sup> *Id.*

<sup>99</sup> *Id.*

large organizations that require more sophisticated procedures.<sup>100</sup> The overall risk management score is of significance in determining whether or not the management rating of an institution is the final management score, thus in determining whether an entity is “well managed,” one must consider the company’s risk component since it embodies that management rating.<sup>101</sup> The Board’s recent supervisory letter<sup>102</sup> states that the Board uses the R Component Rating as a major factor in determining the management rating of the holding company for the purposes of designating well-managed BHCs.<sup>103</sup>

### III. IMPACT RATING

Another component of the new rating system is the impact rating (I). This rating measures the risk or the likelihood that the non-depository entities will have a negative effect on the subsidiary depository institutions.<sup>104</sup> The range of possible ratings include: (1) a low likelihood of a significant impact, (2) a limited likelihood, (3) a moderate likelihood, (4) a considerable likelihood, or (5) a high likelihood.<sup>105</sup> The impact component is an assessment of the risk management practices and financial conditions of the non-depository entities.<sup>106</sup> The examiners will apply benchmarks and analysis relevant to the non-depository businesses. Likewise, if these non-depository subsidiaries are functionally regulated, the examination staff will consider the rating given and the analysis done by the functional regulators.<sup>107</sup> Moreover, the Examiners must consider whether and to what degree problems in the non-depository subsidiaries might negatively affect the depository institution.<sup>108</sup>

Non-depository subsidiaries may be excluded from the analysis if they are relatively insignificant;<sup>109</sup> however, if the non-

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<sup>100</sup> *Id.*

<sup>101</sup> Bank Holding Company Rating System, 69 Fed. Reg. 70,444, 70,444-5 (Dec. 6, 2004).

<sup>102</sup> Bank Holding Company Rating System, Board of Governors of the Federal Reserve System, SR 04-18 (Dec. 6, 2004).

<sup>103</sup> *Id.*, Bank Holding Company Rating System, 69 Fed. Reg. 70,444, 70,444 (Dec. 6, 2004).

<sup>104</sup> *Id.* at 70,447.

<sup>105</sup> *Id.*

<sup>106</sup> *Id.*

<sup>107</sup> *Id.*

<sup>108</sup> *Id.*

<sup>109</sup> *Id.* at 70,448.

depository subsidiaries' assets exceed 5% of the holdings company's consolidated capital or \$10 million, they must be included.<sup>110</sup> This analysis should focus on weaknesses that have the ability to affect the subsidiary depository institutions.<sup>111</sup> As to how the institution quantitatively manages its risk, the examiners look much more closely at the risk management process, the audit function, and corporate governance.

In addition, directors need to take into consideration supervisory letter 99-18 in which examiners are directed to assess the capital adequacy of the organization in relation to its risk.<sup>112</sup> In 1988, the Basel I capital rules were adopted and applied to banking organizations worldwide and provided that a flat eight percent capital charge would be imposed against the risk-sensitive assets on a bank's balance sheet.<sup>113</sup> Because it was felt by the banking industry and bank regulators that a more risk-sensitive capital approach had become necessary, a new set of bank capital rules has been proposed and called the Basel II capital rules.<sup>114</sup> A potential consequence of the Basel II process is the addition of disclosure adequacy to the risk management component. Once the Basel II framework is implemented in the U.S., the Federal Reserve may begin to assess the adequacy of disclosures made by holding companies regarding risk exposures, risk assessments, and capital adequacy.<sup>115</sup> If that happens, it is possible that Federal banking regulators will require more detailed disclosures.

If a problem at a depository institution would otherwise be concealed by a high overall rating, the problem will be highlighted by attaching the problem modifier "P" to the depository institution rating.<sup>116</sup> The Federal Reserve is now looking to evaluate institutions not only within the traditional context of financial

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<sup>110</sup> *Id.* at 70,447.

<sup>111</sup> *Id.*

<sup>112</sup> Assessing Capital Adequacy in Relation to Risk at Large Banking Organizations and Others with Complex Risk Profiles, Board of Governors of the Federal Reserve System, SR 99-18 (July 1, 1999).

<sup>113</sup> See Basel Committee on Banking Supervision, Bank for International Settlements, International Convergence of Capital Measurement and Capital Standards at 14 (1988), <http://www.bis.org/publ/bcbs04A.pdf>.

<sup>114</sup> See Basel Committee on Banking Supervision, Bank for International Settlements, Consultative Document: The New Basel Capital Accord (2001), <http://www.bis.org/publ/bcbsca03.pdf>.

<sup>115</sup> Bank Holding Company Rating System, 69 Fed. Reg. 70,444, 70,447 (Dec. 6, 2004).

<sup>116</sup> *Id.*

condition, earnings and capital, but also using a more qualitative rather than quantitative approach in assessing management controls' independence of the audit function and corporate governance. This change in approach will likely lead to a more difficult exam process.

The Federal Reserve Board announced this change in approach in Supervisory Letter SR 04-18.<sup>117</sup> Though its implications are significant, the announcement was made with little fanfare. A more public demonstration of the significance of risk management under the new rating regime was made on March 16, 2005, when the Board issued an order approving an application by Citigroup to acquire a Texas Bank with \$3.5 billion in assets.<sup>118</sup> The Board went further, however, by discussing Citigroup's compliance problems and the steps it felt were necessary for Citigroup to take in order to put its house in order.<sup>119</sup> The order can be seen as a message to the entire banking industry and others regarding the emphasis on risk management inherent in the new rating system.<sup>120</sup> The Board said in the order that it expects Citigroup's management to "devote the necessary attention to implementing [a compliance improvement] plan fully and effectively and . . . not [to] undertake significant expansion during the implementation period."<sup>121</sup> In effect, the Board announced that until Citigroup improves its compliance and risk management systems, the Board will not approve any significant expansions. This letter is reminiscent of the "go slow" policy of the 1970's when the Federal Reserve refused to approve a \$1.0 million overseas acquisition by a major U.S. banking organization.<sup>122</sup> It is possible that a number of other major organizations with compliance issues have heard similar views expressed by their examiners. This could slow any significant acquisition trend among those organizations until the Federal Reserve feels that management has implemented an effective risk management process. There are a number of lessons to be drawn from the Citicorp order:

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<sup>117</sup> Bank Holding Company Rating System, Board of Governors of the Federal Reserve System, SR 04-18 (Dec. 6, 2004).

<sup>118</sup> Citigroup, Inc., Order Approving the Acquisition of a Bank, Federal Reserve Board of Governors, (Mar. 16, 2005) [hereinafter Citigroup Order].

<sup>119</sup> *Id.*, at 6-12.

<sup>120</sup> *Id.*

<sup>121</sup> *Id.* at 11.

<sup>122</sup> See generally Wayne D. Angell, *Bank Capital: Lessons From the Past and Thoughts for the Future*, 27 WAKE FOREST L. REV. 603, 608 (1992) (explaining that pursuant the "go slow" policy, the Fed used denial of bank holding company expansion applications as a tool for enforcing capital ratios).

1. In considering Citigroup's managerial resources, the Board included the assessments of foreign regulators of Citigroup's management and Citigroup's record with supervisory authorities outside the U.S.<sup>123</sup>
2. The Board also examined and considered confidential supervisory information beyond examination reports.<sup>124</sup>
3. The Board reiterated the significance it places on the ability of an organization to identify, measure, monitor and control its risk.<sup>125</sup> The order goes on to lay out the four key areas in an evaluation of risk management operations (which we've already identified); board and senior management oversight; policies, procedures and limits; risk-monitoring and management-information systems and internal controls and audit procedures.<sup>126</sup>
4. The Board indicated that it would continue to monitor the status of investigations into Citigroup's activities being conducted in the U.S., Europe, and Japan and consult with the relevant authorities.<sup>127</sup>
5. Citigroup acknowledged deficiencies with its compliance operations and internal controls. It stated that it has taken steps to remedy these deficiencies.<sup>128</sup>
6. The Board noted that Citigroup was proactive in addressing concerns raised during the investigation.<sup>129</sup>
7. The Board noted that Citigroup is spending more money on compliance risk management programs and has taken steps to strengthen compliance risk management.<sup>130</sup>

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<sup>123</sup> Citigroup Order, *supra* note 119, at 6, 8.

<sup>124</sup> *Id.* at 7.

<sup>125</sup> *Id.* at 7.

<sup>126</sup> *Id.* at 7-8.

<sup>127</sup> *Id.* at 8.

<sup>128</sup> *Id.* at 9.

<sup>129</sup> *Id.*

<sup>130</sup> *Id.*

8. The Board noted that Citigroup now has a stronger and more independent compliance structure; compliance personnel can now report directly to the independent compliance function.<sup>131</sup>
9. Citigroup expanded “its audit coverage of the compliance function.”<sup>132</sup>
10. Citigroup modified its performance appraisal process to provide greater incentives for compliance. This is an important area of inquiry for examiners, but there is a danger that they might seek to inject themselves into the overall appraisal process, which is outside their realm of expertise.<sup>133</sup>
11. Citigroup adopted an ethics awareness program involving senior executives that was integrated into orientation and annual training sessions.<sup>134</sup>
12. Citigroup met with regulators throughout the world to identify concerns regarding Citigroup’s corporate governance and compliance.<sup>135</sup>
13. The Board concluded that the “considerations relating to the managerial resources of Citigroup, FAB, and their subsidiaries are consistent with approval” of the acquisition.<sup>136</sup>

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<sup>131</sup> *Id.*

<sup>132</sup> *Id.*, at 10 (implying that the Audit Department needed to be clearly independent of its compliance function); *see also* Alvarez *supra* note 9 at 3 (“The internal audit function should perform independent reviews of the effectiveness of the compliance function. These reviews should examine the quality of information in compliance reports, the adequacy of training programs, whether deficiencies are promptly corrected, and how compliance risk management is implemented by product managers.”).

<sup>133</sup> *Id.*

<sup>134</sup> *Id.*

<sup>135</sup> *Id.*

<sup>136</sup> *Id.* at 10-11.

#### IV. CONCLUSION

The Board's new rating system for BHCs and FHCs is more qualitative and less objective than the previous standards were under the BOPEC system. This observation carries broad implications. The relaxed regulatory expansion procedures provided by Gramm-Leach-Bliley allow for expanded product offerings and acquisitions without regulatory delays that might disadvantage a holding company competing with any other bidder for an acquisition.<sup>137</sup> Another effect of the new rating system is the difficulty it imposes on the ability to question and challenge examiners due to the qualitative nature of the assessments. Nevertheless, this new risk rating system is beneficial in that it requires a comprehensive review of the entire organization, as opposed to an entity by entity review that should ultimately result in a stronger and less risky financial services system.

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<sup>137</sup>See generally BANK HOLDING COMPANY COMPLIANCE MANUAL §§ 1.01(4), 9.05 (Matthew Bender Company, Inc.) (2005).

