2100.0.1 FOREIGN OPERATIONS OF U.S. BANKING ORGANIZATIONS

U.S. banking organizations may conduct a wide range of overseas activities. The Federal Reserve has broad discretionary powers to regulate the foreign activities of member banks and bank holding companies (BHCs) so that, in financing U.S. trade and investments abroad, these U.S. banking organizations can be competitive with institutions of the host country without compromising the safety and soundness of their U.S. operations.

Some of the Federal Reserve's responsibilities over the international operations of member banks (national and state member banks) and BHCs include

- authorizing the establishment of foreign branches of national banks and state member banks and regulating the scope of their activities;
- chartering and regulating the activities of Edge Act and agreement corporations, which are specialized institutions used for international and foreign business;
- authorizing foreign investments of member banks, Edge Act and agreement corporations, and BHCs and regulating the activities of foreign firms acquired by such investors; and
- establishing supervisory policy and practices regarding foreign lending by state member banks.

The Federal Reserve examines the international operations of state member banks, Edge Act and agreement corporations, and BHCs principally at the U.S. head offices of these organizations. When appropriate, the Federal Reserve conducts examinations at the foreign operations of a U.S. banking organization in order to review the accuracy of financial and operational information maintained at the head office as well as to test the organization's adherence to safe and sound banking practices and to evaluate its efforts to implement corrective measures. Examinations abroad are conducted in cooperation with the responsible host-country supervisor.

2100.0.2 EDGE ACT AND AGREEMENT CORPORATIONS

Edge Act and agreement corporations are U.S. financial institutions that carry out international banking and financing operations, some of which the parent banks themselves are not permitted to undertake under existing laws. These corporations may act as holding companies, provide international banking services, and finance industrial and financial projects abroad, among other activities.

Sections 25 and 25A of the Federal Reserve Act grant Edge Act and agreement corporations authority to engage in international banking and foreign financial transactions. The Board's Regulation K (12 CFR 211.6) also outlines the permissible activities of Edge and agreement corporations in the United States. Among other activities, these corporations may (1) make foreign investments that are broader than those permissible for member banks, and (2) conduct a deposit and loan business in states, including those where the parent of the Edge or agreement corporation does not conduct such banking activities, provided that the business is strictly related to international or foreign business. Foreign banks may own Edge Act and agreement corporations. These corporations are examined by the Federal Reserve annually.[1]

2100.0.3 SUPERVISION OF FOREIGN BANKING ORGANIZATIONS OPERATING IN THE UNITED STATES

Although foreign banks have been operating in the United States for more than a century, before 1978 the U.S. branches and agencies of these banks were not subject to supervision or regulation by any federal banking agency. The International Banking Act of 1978 (IBA) created a federal regulatory structure for the activities of foreign banks with U.S. branches and agencies. The IBA also established a policy of "national treatment" for foreign banks operating in the United States to promote competitive equality between them and domestic institutions. This policy generally gives foreign banking organizations operating in the United States the same powers as U.S. banking organizations and subjects them to the same restrictions and obligations that apply to the domestic operations of U.S. banking organizations.

1. 12 CFR 211.13(b). See also SR letter 90-21, "Rating System for International Examinations."

The Foreign Bank Supervision Enhancement Act of 1991 (FBSEA) increased the responsibility and the authority of the Federal Reserve to regularly examine the U.S. operations of foreign banks. Under the FBSEA, U.S. branches and agencies of foreign banks must be examined on-site at least once every 12 months, although this period may be extended to 18 months if the branch or agency meets certain criteria.[2] Supervisory actions resulting from examinations may be taken by the Federal Reserve alone or in conjunction with other agencies. Representative offices of these institutions are also subject to examination by the Federal Reserve.[3]

The Federal Reserve coordinates the supervisory program for the U.S. operations of foreign banking organizations with other federal and state banking agencies. Since a foreign banking organization may have both federally chartered and state-chartered offices in the United States, the Federal Reserve plays a key role in assessing the condition of the organization's entire U.S. operations and the foreign banking organization's ability to support its U.S. operations.

In 2014, the Federal Reserve Board approved a final rule required by section 165 of the Dodd-Frank Act (which also requires enhanced prudential standards for large U.S. BHCs) to strengthen supervision and regulation of foreign banking organizations.[4] The final rule recognized that the U.S. operations of foreign banking organizations had become increasingly complex, interconnected, and concentrated, and established a number of enhanced prudential standards for foreign banking organizations to help increase the resiliency of their operations. The requirements of the final rule will bolster the capital and liquidity positions of the U.S. operations of foreign banking organizations and promote a level playing field among all banking firms operating in the United States. A foreign banking organization with U.S. non-branch assets of $50 billion or more is required to establish an intermediate holding company over its U.S. subsidiaries, which will facilitate consistent supervision and regulation of the U.S. operations of the foreign bank.[5] The foreign-owned U.S. intermediate holding company is generally subject to the same risk-based and leverage capital standards applicable to U.S. BHCs. The intermediate holding companies are also subject to the Federal Reserve's rules pertaining to regular capital plans and stress testing.

2. 12 CFR 211.26(c).
3. 12 CFR 211.26(a)2.

4. See 79 Fed. Reg. 17,240 (March 27, 2014) and the Federal Reserve Board's Regulation YY (12 CFR part 252); and Dodd-Frank Act, Pub. L. No. 111-203, July 21, 2010; 124 Stat. 1376.

5. The Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRRCPA) increases the $50 billion asset threshold in section 165 in two stages. Immediately on the date of enactment, bank holding companies with total consolidated assets of less than $100 billion were no longer subject to section 165.6. Eighteen months after the date of enactment, the threshold is raised to $250 billion. EGRRCPA also provides that the Board may apply any enhanced prudential standard to bank holding companies between $100 billion and $250 billion in total consolidated assets. See the Board's July 6, 2018, "Statement regarding the impact of the Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRRCPA)."

2120.0.1 INTRODUCTION

On January 17, 1978, the three federal bank supervisory agencies issued a joint policy statement to address their concern with regard to the potential for improper payments by banks and bank holding companies in violation of the Foreign Corrupt Practices Act and the Federal Election Campaign Act.

While not widespread, the federal bank supervisory agencies were concerned that such practices could reflect adversely on the banking system and constitute unsafe and unsound banking practices in addition to their possible illegality.

The potential devices for making political payments in violation of the law could include compensatory bonuses to employees, designated expense accounts, fees or salaries paid to officers, and preferential interest rate loans. In addition, political contributions could be made by providing equipment and services without charge to candidates for office. Refer to F.R.R.S. at 3–447.1 and 4–875.

2120.0.2 SUMMARY OF THE FEDERAL ELECTION CAMPAIGN ACT

The Federal Election Campaign Act (FECA), enacted in 1971, was designed to curb potential abuses in the area of federal election financing. In general, FECA regulates the making of campaign contributions and expenditures in connection with primary and general elections to federal offices. Since 1907, federal law has prohibited national banks from making contributions in connection with political elections. FECA does not specifically address the making of contributions and expenditures by banks or other corporations to advocate positions on issues that are the subjects of public referenda. As originally enacted, FECA required disclosure of contributions received or expenditures made; however, amendments to the law in 1974 and 1976 imposed additional limitations on contributions and expenditures as well. The 1974 amendments also established the Federal Election Commission (Commission) to administer FECA's provisions. The Commission is responsible for adopting rules to carry out FECA, for rendering advisory opinions, and for enforcing the Act. The Commission was reorganized as a result of the FECA Amendments of 1976, and it has issued regulations interpreting the statute (11 C.F.R.).

2120.0.3 BANKS AND THE FECA

National banks and other federally chartered corporations are specifically prohibited from making contributions or expenditures in connection with *any* election; other corporations, including banks and bank holding companies, may not make contributions or expenditures in connection with *federal* elections. However, corporations may establish and solicit contributions to ''separate segregated funds'' to be used for political purposes; these are discussed in greater detail below.

State member banks and bank holding companies may make contributions or expenditures that are consistent with state and local law in connection with state or local elections. Because many states have laws that prohibit or limit political contributions or expenditures by banks, familiarization with applicable state and local laws is a necessity. According to the joint policy statement of the three banking agencies, a political contribution must meet not only the requirement of legality but also the standards of safety and soundness. Thus, a contribution or expenditure, among other things, must be recorded properly on the bank's books, may not be excessive relative to the bank's size and condition, and may not involve self-dealing.

Banks may make loans to political candidates provided the loans satisfy the requirements set out below.

2120.0.4 CONTRIBUTIONS AND EXPENDITURES

The words ''contribution'' and ''expenditure'' are defined broadly by FECA and the Commission's regulations to include any loan, advance, deposit, purchase, payment, distribution, subscription or gift of money or anything of value which is made for the purpose of influencing the nomination or election of any person to federal office. The payment by a third party of compensation for personal services rendered without charge to a candidate or political committee is also treated as a contribution by FECA, although the term does *not* include the value of personal services provided by an individual without compensation on a volunteer basis.

Although loans are included in the definitions of contribution and expenditure under FECA, a specific exemption is provided for bank loans made in the ordinary course of business and in accordance with applicable banking laws and regulations. The Commission's regulations provide, further, that in order for extensions of credit to a candidate, political committee or other person in connection with a federal election to be treated as a loan and not a contribution, they must be on terms substantially similar to those made to non-political debtors and be similar in risk and amount. The regulations also provide that a debt may be forgiven only if the creditor has treated it in a commercially reasonable manner, including making efforts to collect the debt which are similar to the efforts it would make with a non-political debtor. In considering whether a particular transaction is a contribution or a loan, it is expected that a factor would be the extent to which the creditor may have departed from its customary credit risk analysis.

FECA and the implementing regulation permit certain limited payments to candidates or their political committees. For example, payment of compensation to a regular employee who is providing a candidate or political committee with legal or accounting services which are solely for the purpose of compliance with the provisions of the FECA is exempt from the definitions of contribution and expenditure. The Commission's regulations also permit occasional use of a corporation's facilities by its shareholders and employees for volunteer political activity; however, reimbursement to the corporation is required for the normal rental charge for anything more than occasional or incidental use.

2120.0.5 SEPARATE SEGREGATED FUNDS AND POLITICAL COMMITTEES

FECA allows the establishment and administration by corporations of "separate segregated funds" to be utilized for political purposes. While corporate monies may not be used to make political contributions or expenditures, corporations may bear the costs of establishing and administering these separate segregated funds, including payment of rent for office space, utilities, supplies and salaries. These costs need not be disclosed under FECA. Commission regulations also permit a corporation to exercise control over its separate segregated fund.

In practice, most corporate segregated funds are administered by a group of corporate personnel, which, if the fund receives any contributions or makes any expenditures during a calendar year, constitutes a "political committee," as defined by FECA. As such, it is required to file a statement of organization with the Commission, to keep detailed records of contributions and expenditures, and to file with the Commission reports identifying contributions in excess of $200 and candidates who are recipients of contributions from the fund.

Solicitation of contributions to corporate segregated funds by political committees must be accomplished within the precise limits established by FECA. All solicitations directed to corporate employees must satisfy the following requirements: (1) the contribution must be entirely voluntary; (2) the employee must be informed of the political purposes of the fund at the time of the solicitation; and (3) the employee must be informed of his right to refuse to contribute without reprisal. Beyond those basic requirements, FECA distinguishes between "executive and administrative" personnel and other employees. The former and their families may be solicited any number of times, while the latter and their families may only be solicited through a maximum of two written solicitations per year, and these solicitations must be addressed to the employees at their homes. Solicitations may also be directed to corporate stockholders and their families in the same manner as to executive and administrative personnel.

Although a corporation, or a corporation and its subsidiaries, may form several political committees, for purposes of determining the statutory limitations on contributions and expenditures, all committees established by a corporation and its subsidiaries are treated as one. Thus, the total amount which all political committees of a corporation and its subsidiaries may make to a single candidate is $5,000 in any federal election (provided that the committees are qualified multicandidate committees under FECA).

2120.0.6 INSPECTION OBJECTIVES

1. To determine if the company has made improper or illegal payments in violation of either of these statutes, and regardless of legality, and whether they constitute an unsafe and unsound banking practice.

2. To determine if controls have been established to prevent unproper payments in violation of these statutes.

2120.0.7 INSPECTION PROCEDURES

1. Determine whether the company and its nonbank subsidiaries have a policy prohibiting improper or illegal payments, bribes, kickbacks, or loans covered by either the Foreign Corrupt Practices Act or the Federal Election Campaign Act.

2. Determine how the policy, if any, has been communicated to officers, employees, or agents of the organization.

3. Review any investigation or study performed by, or on behalf of, the board of directors that evaluates policy or operations associated with the advancement of funds in possible violation of the statutes mentioned above. In addition, ascertain whether the organization has been investigated by any other government agency in connection with possible violations of the statutes and, if this is the case, review available materials associated with the investigation.

4. Review and analyze any internal or external audit program employed by the organization to determine whether the internal and external auditors have established appropriate routines to identify improper or illegal payments under the statutes. In connection with the evaluation of the adequacy of any audit program, the examiner should:

a. Determine whether the auditor is aware of the provisions of the Foreign Corrupt Practices Act and the Federal Election Campaign Act and whether audit programs are in place which check for compliance with these laws;

b. Review such programs and the results of any audits; and

c. Determine whether the program directs the auditor to be alert to unusual entries or charges which might indicate that improper or illegal payments have been made to persons or organizations covered by the statutes.

5. Analyze the general level of internal control to determine whether there is sufficient protection against improper or illegal payments being irregularly recorded on the organization's books.

6. Both the examiner and assistants should be alert in the course of their usual inspection procedures for any transactions, or the use of organization services or equipment, which might indicate a violation of the statutes. Examination personnel should pay particular attention to:

a. Commercial and other loans (including participations), which may have been made in connection with a political campaign, to assure that any such loans were made in the ordinary course of business in accordance with applicable laws.

b. Income and expense ledger accounts for unusual entries including unusual debit entries (reductions) in income accounts or unusual credit entries (reductions) in expense accounts, significant deviations from the normal amount of recurring entries, and significant entries from an unusual source, such as a journal entry.

Procedure 7, following here, should only be undertaken in cases in which the examiner believes that there is some sufficient evidence indicating that improper or illegal payments have occurred. Such evidence would justify the implementation of these additional procedures.

7. Verification of audit programs and internal controls.

a. Randomly select charged-off loan files and determine whether any charged-off loans were made to (i) foreign government officials or other persons or organizations covered by the Foreign Corrupt Practices Act, or (ii) persons or organizations covered under the Federal Election Campaign Act.

b. For those significant income and expense accounts on which verification procedures have not been performed: (i) prepare an analysis of the account for the period since the last examination, preferably by month, and note any unusual fluctuations for which explanations should be obtained, and (ii) obtain an explanation for significant fluctuations or any unusual items through discussions with organization personnel and review of supporting documents.

2120.0.8 APPARENT VIOLATIONS OF THE STATUTES

Where violations of law or unsafe and unsound banking practices result from improper payments, the Federal Reserve System should exercise its full legal authority, including cease-and-desist proceedings and referral to the appropriate law enforcement agency for further action, to ensure that such practices are terminated. In appropriate circumstances, the fact that such payments have been made may reflect so adversely on an organization's management as to be a relevant factor in connection with the consideration of applications submitted by the organization.

In addition, the Reserve Bank should forward any information on apparent violations of the Federal Election Campaign Act to the Federal Election Commission. The Federal Election Commission is authorized to enforce FECA. The Commission may be prompted to investigate possible illegal payments by either a sworn statement submitted by an individual alleging a violation of the law, or on its own initiative based on information it has obtained in the course of carrying out its supervisory responsibilities. When the Commission determines that there is probable cause to believe a violation has occurred or is about to occur, it endeavors to enter into a conciliation agreement with the violator. If, however, it finds probable cause to believe that a willful violation has occurred or is about to occur, it may refer the matter directly to the Department of Justice for possible criminal prosecution, without having first attempted conciliation.

If informal means of conciliation fail, the Commission may begin civil proceedings to obtain relief. Should the Commission prevail, a maximum penalty of a fine equal to the greater of $10,000 or 200 percent of the amount of the illegal payment may be imposed. Knowing and willful violations involving over $1,000 may subject the violator to a fine, up to the greater of $25,000 or 300 percent of the illegal payment, and imprisonment for up to one year.

2120.0.9 ADVISORY OPINIONS

Any person, including a bank or a corporation, may request an advisory opinion concerning the application of FECA or of the Commission's regulations to a specific transaction or activity in which that person wishes to engage. The Commission must render such advisory opinion within 60 days from receipt of a complete request. Banks or bank employees wishing to engage in activity which may be regulated by FECA are encouraged to request advisory opinions from the Commission.

Techniques, practices, and tools for credit-risk management evolve with the challenges that firms face in their business-lending activities. For larger firms, the number and geographic dispersion of their borrowers make it increasingly difficult for such firms to manage their loan portfolios simply by remaining closely attuned to the performance of each borrower. As a result, one increasingly important component of the systems for controlling credit risk at larger firms is the identification of gradations in credit risk among their commercial loans, and the assignment of internal credit-risk ratings to loans that correspond to these gradations. The use of an internal rating process is appropriate and important for sound risk management at large firms. See SR-98-25, "Sound Credit Risk Management and the Use of Internal Credit Risk Ratings at Large Banking Organizations."

Effective internal rating systems support sophisticated credit-risk management. Supervisors and examiners, both in their inspections and other contacts with firms, should emphasize the importance of development and implementation of effective internal credit-rating systems and the critical role such systems should play in a firm's credit-risk-management process.

Internal rating systems are used at large firms for a range of purposes. At one end of this range, they are primarily used to determine approval requirements and identify problem loans. At the other end, the internal rating systems are an integral element of credit-portfolio monitoring and management, capital allocation, the pricing of credit, profitability analysis, and the detailed analysis to support the allowance. Internal rating systems being used for these latter purposes should be significantly richer and more robust than systems used for the purposes such as approval requirements and identifying problem loans.

A sound risk-management process should adequately illuminate the risks being taken to enable management to initiate and apply appropriate controls that balance risks against returns. Furthermore, the process should provide information as to the firm's overall appetite for risk, considering the uncertainties faced by lenders and the long-term viability of the firm. Accordingly, large firms should have strong risk-rating systems that address the range of lending activity and provide timely and accurate information for the firm's management to monitor, manage, and control credit risk. The rating system should also consider (1) the overall composition of the various portfolios by loan type, terms, and tenure, (2) an assessment of the risk exposure and credit concentrations to a particular type of loan, borrower, market, or industry and (3) information on risk profiles of individual borrowers. Moreover, such rating systems have an important role in (1) establishing an appropriate level for the allowance, (2) conducting internal analyses of loan and relationship profitability, (3) assessing capital adequacy, and possibly (4) administering performance-based compensation.[1]

Examiners should evaluate the adequacy of internal credit-risk-rating systems, including ongoing development efforts, when assessing both asset quality and the overall strength of a firm's risk management. In doing so, examiners should be cognizant that an internal risk-identification and -monitoring system should be consistent with the nature, size, and complexity of the firm's activities.

2122.0.1 APPLICATION TO LARGE HOLDING COMPANIES

The guidance provided in this section should be considered in scoping supervisory activities at "large" bank holding companies and savings and loan holding companies (collectively referred to as "firms" or "large firms").[2] In this context, those firms with significant involvement in relevant secondary-market credit activities, such as securitization of business loans or credit derivatives, should have more elaborate and formal approaches for managing the risks associated with these activities.[3] Structured and sophisticated arrangements for managing credit risk are more appropriate for larger firms than for smaller and less complex institutions. In performing their evaluation, examiners should also consider whether other elements of the risk-management process might compensate for any specific weaknesses attributable to an inadequate rating system.

1. See the Board's Regulation Q (12 CFR part 217) for more information on capital requirements.

2. See SR-14-9, "Incorporation of Federal Reserve Policies into the Savings and Loan Holding Company Supervision Program," for more information.

3. Secondary-market credit activities generally include loan syndications, loan sales and participations, credit derivatives, and asset securitizations, as well as the provision of credit enhancements and liquidity facilities to such transactions. Such activities are described further in section 2129.05.

In addition, examiners should review a firm's internal management information system reports to determine whether the portion of loans in lower-quality pass grades has grown significantly over time, and whether any such change might have negative implications for the adequacy of a firm's risk management or capital. Examiners should also consider whether a significant migration to higher-risk pass grades, or an overall large proportion of loans in a higher-risk pass grade, could have negative implications for the firm's asset-quality, including the adequacy of the allowance. Examiners should evaluate trends in categories associated with problem assets.

Examiners should discuss these issues, including a firm's plans to enhance existing credit-rating systems, with management. Inspection comments on the adequacy of risk-rating systems and the credit quality of the pass portfolio should be incorporated within the inspection report, noting deficiencies where appropriate.

2122.0.2 SOUND PRACTICES IN FUNCTION AND DESIGN OF INTERNAL RATING SYSTEMS

A consistent and meaningful internal risk-rating system is useful for differentiating the degree of credit risk in loans and other sources of credit exposure. Although assigning such risk ratings necessarily involves subjective judgment and experience, a properly designed rating system will allow this judgment to be applied in a structured and consistent manner.

Credit-risk ratings are designed to reflect the quality of a loan or other credit exposure, and thus, explicitly or implicitly, the loss characteristics of that loan or exposure. In many instances, large firms link ratings' definitions to one or more measurable outcomes such as the probability of a borrower's default or expected loss, which couples the probability of default with some estimate of the amount of loss to be incurred in the event that a default occurs. In addition, credit-risk ratings may reflect the likelihood or severity of loss as well as the variability of loss over time, particularly as this relates to the effect of the business cycle. Linkage to these measurable outcomes gives greater clarity to risk-rating analysis and allows for more consistent evaluation of performance against relevant benchmarks.

A firm may distinguish the risks associated with the borrowing entity (essentially default risk) from the risks stemming from a particular transaction or structure (more oriented to loss in event of default). In documenting its credit-administration procedures, a firm should clearly identify whether risk ratings reflect the risk of the borrower or the risk of the specific transaction. In this regard, a firm may assign both a borrower and facility rating, based on an analysis of the loan's obligor and the structure and terms of the particular loan (that is, collateral or guarantees) which may strengthen or weaken the quality of the loan.

An effective rating scale should distinguish gradations of risk within a firm's portfolio so that there is clear linkage to loan quality (and/or loss characteristics), rather than just to levels of administrative attention.[4] Therefore, the rating system should be designed to address the range of risks typically encountered in the underlying businesses in the firm's loan portfolio. One reflection of this degree of meaning is that there should be a fairly wide distribution of a portfolio's outstanding loans or exposures across the rating grades, unless the loan portfolio is genuinely homogeneous. Many rating systems include grades intended solely to capture credits needing heightened administrative attention, such as so-called "watch" grades. Prompt and systematic tracking of credits requiring such attention is an essential element of risk management. However, to the extent such loans vary in the risk characteristics, isolating these loans in a single grade may detract from the rating system's ability to indicate risk. Therefore, a firm may use separate or auxiliary indicators to monitor risks in these loans.

Risk-rating systems that only identify loans that are classified for supervisory purposes or that require additional monitoring (that is, "watch" loans) generally are not sufficiently comprehensive in distinguishing risks. Such systems contribute little or nothing to evaluating the majority of loans in the portfolio—that is, loans for which no specific difficulties are present or foreseen. In some cases, these firms might also establish one or two risk grades for loans with limited perceived risk, such as those collateralized by cash or liquid securities. A conse-

4. See SR-20-13, "Interagency Guidance on Credit Risk Review Systems," for more information. Internal risk-rating systems and/or supporting documentation should be sufficient to enable examiners to reconcile the totals for the various internal risk ratings under the institution's system to the federal banking agencies' categories for those loans graded below "pass" (that includes special mention, substandard, doubtful, or loss).

quence of the ineffective rating systems described above is that the bulk of the loan portfolio falls into one or two remaining broad risk grades—representing “pass” loans that are neither extremely low risk nor current or emerging problem credits—even though such grades may encompass many different levels of underlying credit risk.

2122.0.3 SOUND PRACTICES IN ASSIGNING AND VALIDATING INTERNAL RISK RATINGS

Objective ratings criteria as well as experience and judgment are critical both in making the credit decision and in assigning internal risk grades. Firms should develop clear and explicit criteria for each risk grade in their credit policies to promote consistency in assigning and reviewing grades. Criteria should be specified, even when addressing subjective or qualitative considerations, that allow for consistent assignment of risk grades to transactions with similar risk characteristics. Such criteria should include guidance both on the factors that should be considered in assigning a grade and how these factors should be weighed in arriving at a final grade.

Establishing clear rating criteria can promote consistency in assessing the financial condition of the borrower and other objective indicators of a transaction’s risk. One vehicle for enhancing the degree of consistency and accuracy is the use of “guidance” or “target” financial ratios or other objective indicators of the borrower’s financial performance as a point of comparison when assigning grades. Firms may also provide explicit linkages between internal grades and credit ratings issued by external parties as a reference point, for example, senior public debt ratings issued by one or more major ratings agencies. The use of default probability models, bankruptcy scoring, or other analytical tools can also be useful as supporting analysis. However, firms employing such techniques should identify the probability of default that is “typical” of each grade. The borrower’s primary industry may also be considered, both in terms of establishing the broad characteristics of borrowers in an industry (for example, degree of vulnerability to economic cycles or long-term favorable or unfavorable trends in the industry) as well as a borrower’s market share or competitive position in the industry.

In addition to quantitative indicators and tools, credit policies and ratings definitions should also cite qualitative factors that are incorporated into the assignment of a loan’s rating. This might include (1) the strength and experience of the borrower’s management, (2) the quality of financial information provided, and (3) the access of the borrower to alternative sources of funding. Addressing qualitative considerations in a structured and consistent manner when assigning a risk rating often requires experience and business judgment. Nonetheless, adequate consideration of these factors is important to assessing the risk of a transaction appropriately. In this regard, firms may choose to cite significant and specific points of comparison for qualitative factors in describing how such considerations can affect the rating (for example, whether a borrower’s financial statements have been audited or merely compiled by its accountants, or whether collateral has been independently valued).

Some formalization of the rating process can be helpful in promoting accuracy and consistency. For example, the use of a ‘‘risk-ratings analysis form’’ can be utilized to (1) provide structure for identifying and addressing the relevant qualitative and quantitative elements for determining internal risk grades, and (2) document a loan’s rating and the analysis or discussion of key quantitative and qualitative information utilized in assigning the rating.

Risk ratings should be reviewed, if not assigned, by independent credit-risk management or loan-review personnel both at the time the transaction is consummated and periodically over the life of the loan.[5] Such independent reviewers should reflect a level of experience and business judgment that is comparable to that of the line staff responsible for assigning and reviewing initial risk grades. An effective independent review should assess whether risk-rating changes (and particularly downgrades) have been timely and appropriate. Independent reviews of individual ratings support the discipline of the rating assignments by allowing management to evaluate the performance of those individuals assigning and reviewing risk ratings. If a firm relies on outside consultants, auditors, or other third parties to perform all or part of this review role, such individuals should have appropriate credit assessment experience and have a clear understanding of the firm’s policies and its risk-rating process.

Finally, firms should track performance or effectiveness of grades over time to gauge the

5. See section 2010.10 regarding internal loan review.

adequacy of its internal rating system. This may encompass the migration, consistency, and default/loss characteristics of assigned risk grades. Such tracking also allows for ex post analysis of the loss characteristics of loans in each risk grade.

Because ratings are typically applied to different types of loans—for example, to both commercial real estate and commercial loans—it is important that each grade retains the same meaning to the firm (in terms of overall risk) across the exposure types. Such comparability allows management to treat loans in high-risk grades as a potential concentration of credit risk and to manage them accordingly. It also allows management to monitor the overall degree of risk, and changes in the risk makeup, of the portfolio. Such consistency further permits risk grades to become a reliable input into portfolio credit-risk models.[6]

2122.0.4 APPLICATION OF INTERNAL RISK RATINGS TO INTERNAL MANAGEMENT AND ANALYSIS

As noted earlier, robust internal credit-rating systems are an important element in several key areas of the risk-management process. A firm should periodically assess and modify its system to confirm that credit ratings provide accurate and consistent indications of risk and are sufficiently granular to distinguish the degree of risk, especially for riskier assets. Described below are examples of risk management and analysis approaches for internal risk-rating systems.

2122.0.4.1 Limits and Approval Requirements

Many large firms have different approval requirements and thresholds for each internal grade, allowing less scrutiny and greater latitude in decision making for loans with a lower grade. While this appears reasonable, firms should also consider whether the level of intensity in approval process (or the degree to which limits are higher) is supported by the degree of a loan's risk and uncertainty associated with the future performance of the loan. If not, lower approval requirements may provide incentives to rate loans too favorably with resulting underassessment of a loan's risk.

2122.0.4.2 Reporting to Management on Credit-Risk Profile of the Portfolio

Reports that analyze the overall credit risk in a firm's loan portfolios should include information on the profile of actual outstanding balances, exposures, or both by internal risk grade.[7] Further, to aid a firm to evaluate its risk appetite, the information should address concentrations in particular industries or borrower types. Portfolio analysis may range from aggregating loans by risk grade to risk modeling the potential behavior of a loan portfolio. Such analysis should consider the interaction between loans by type of credit and industry of borrowers. Gradations of risk reflect only one among many dimensions of portfolio risk, along with potential industry concentrations, exposure to an unfavorable turn in the business cycle, geographical concentrations, and other factors.

2122.0.4.3 Allowance

The makeup of the loan portfolio and the loss characteristics of each grade—including individual pass grades—should be considered, along with other factors, in determining the adequacy of an institution's allowance.

2122.0.4.4 Pricing and Profitability

To remain competitive, a firm will consider the appropriateness of loan pricing, particularly with regard to any single transaction or group of transactions. One way that some firms choose to enhance the discipline in their overall pricing practices across their portfolio is by incorporating risk-rating-specific loss factors in the determination of the minimum profitability requirements (that is, "hurdle rates"). Following this practice may render such firms less likely to price loans well below the level indicated by the long-term risk of the transaction.

6. See SR 11-7, "Guidance on Model Risk Management."

7. See section 2010.2 regarding a holding company's supervision of its subsidiaries and loan administration.