



ON THE RADAR SCREEN

A Publication on Current Risks Faced by Western Banking Institutions

Federal Reserve Bank of San Francisco
February 2005

SPECIAL EDITION

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*Rather than wait for our usual Spring edition of **On the Radar Screen**, we decided to issue this special edition highlighting the Federal Reserve's new bank holding company rating system - a system sporting a rather unwieldy acronym of "RFI/C(D)." And, since our primary mission is to discuss banking risks, we note that housing prices in some areas have been accelerating at a rapid and perhaps unsustainable pace, so conservative underwriting assumptions are encouraged.*

Fed Audio Conference

**Intro to the New
BHC Rating System
(w/ Q & A)**

**February 24, 2005
2:00—3:00 pm**

Register / More information:
<http://www.frbsf.org/banking/events>

New BHC Rating System: RFI/C(D)

As many readers know, a new Federal Reserve rating system for bank holding companies (BHCs) was implemented as of the first of this year. Although the terminology has changed, the new RFI/C(D) rating system is really an enhancement rather than a significant departure from the previous BOPEC approach. The new BHC rating system incorporates factors that examiners routinely have considered for many years in evaluating a BHC's condition, while also taking a more forward looking perspective with regard to risk management and financial factors. As a result, the implementation of the new rating system should not have a significant effect on the conduct of inspections and **should not impose additional regulatory burden on supervised institutions**. For more details, visit the BHC rating system website at: <http://stlouisfed.org/col/courses/bhc/rating/index.cfm>.

The components of the new rating system are intended to emphasize risk management (R), to introduce a more comprehensive and adaptable framework for analyzing and rating financial condition (F); and to provide a framework for assessing and rating the potential impact (I) of the parent holding company and its nondepository subsidiaries on the subsidiary depository institution(s). The final two letters, C and D, reflect the overall composite assessment of the BHC and the depository institution(s) respectively.

- BHCs with assets >= \$1 Billion
(and other complex BHCs):**
- R - Risk Management
 - F - Financial Condition
 - I - Impact
 - C - Composite
 - D - Depository Institution(s)
- BHCs (noncomplex) with assets < \$1 Billion:**
- R - Risk Management
 - C - Composite

Ratings for the composite and components are still based on a "1 to 5" numeric scale. The "1" rating will continue to be the highest rating, indicative of the strongest performance and practices and the least degree of supervisory concern, while a "5" rating remains the lowest rating, reflecting the weakest performance and highest degree of supervisory concern.

While complex BHCs and BHCs with \$1 billion or more in total assets will receive full RFI/C(D) ratings, a simplified version will be applied to noncomplex BHCs with assets under \$1 billion. When these institutions are examined, they will be assigned a risk management component rating (R) and composite rating (C). This represents very little change from the

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current rating system. As with the current system, the new composite rating largely reflects the primary regulator’s composite rating of the subsidiary bank(s), and the R rating largely reflects the primary regulator’s assessment of management (the M rating from the CAMELS rating system).

A conference call to present the new rating system is planned for February 24, 2005 from 2:00—3:00pm. For more information on this audio conference and to register, go to <http://www.frbsf.org/banking/events>.

Resources:

- SR Letter 04-18: <http://www.federalreserve.gov/BoardDocs/SRLetters/2004/sr0418.HTM>
- Press Release: <http://www.federalreserve.gov/boarddocs/press/bcreg/2004/20041201/>
- New BHC rating system website: <http://stlouisfed.org/col/courses/bhc/rating/index.cfm>

Additionally, bank holding companies can contact their designated Federal Reserve Central Point of Contact for questions on the new rating system.

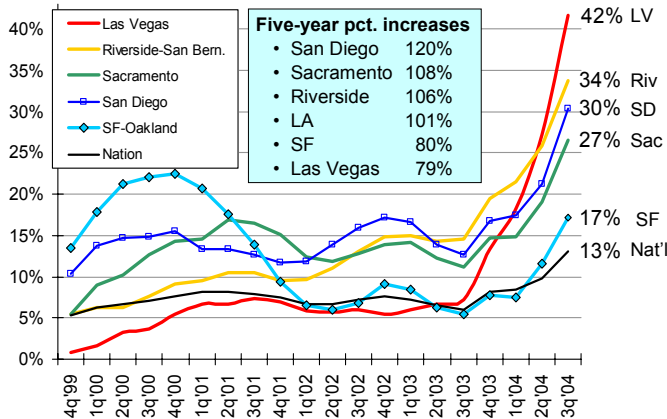
Housing Prices Go Through the Roof!!!

Housing price appreciation has been astronomical in many metropolitan areas of the west. Areas like Las Vegas and much of California have seen median prices rise 25% to 40% in one year alone (through September of 2004), and this follows several years where price gains have often been 4 to 8 times the rate of inflation. Housing demand has been very high, driven by historically low interest rates. Extremely low adjustable rate mortgage rates have enabled many people to become first-time homeowners, despite the high home prices. The increasing availability of interest-only mortgages and fairly liberal underwriting practices has made home purchasing even easier. These same factors, though, provide for growing risks for borrowers and lenders. Home prices could retract in some markets over the next year or two, particularly where prices have

accelerated most rapidly and new housing supply is not significantly constrained. First-time homeowners and others who purchase at or near peak housing prices and those financing with ARMs that can reprice in the near-term are at greatest risk. Already, ARM rates have started to rise in recent weeks, causing mortgage application volume to soften. If and when long-term rates rise, housing demand likely will further decline, putting pressure on prices.

Over the past five years, 15 MSAs nationwide have seen their median home prices more than double, and 13 of these are in California (San Diego, Santa Barbara, Salinas, Napa, and San Luis Obispo are all up by more than 110%). No measure of relevant economic activity (e.g. personal income, population growth, rent levels, etc.) has grown anywhere close to home price appreciation rates, leading many to suggest that prices in some areas may be susceptible to a correction. Given these factors, lenders are encouraged to ensure cautious loan underwriting practices.

Median home price annual changes



Source: Office of Federal Housing Oversight

The primary purpose of this report is to communicate banking risk issues to internal staff of the FRBSF Division of Banking Supervision and Regulation, and to provide a publication that FRBSF staff can share with supervised banking institutions and others to further the two-way exchange of information. It is made available to the public at <http://www.frbsf.org/publications/banking/>

Opinions expressed herein do not necessarily reflect the views of the management of the Federal Reserve Bank of San Francisco or of the Board of Governors of the Federal Reserve System.

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