

Earnings are rated according to level, trend, and composition. Examiners compare a bank's annual return on assets with industry-wide benchmarks to determine quantitatively the bank's earnings rating. Since this measure may not necessarily present a wholly reliable picture of the bank's profitability, the quantitative evaluation is supplemented by a quality or composition analysis of net income. Net income attributed to inadequate loan loss provisions, for example, or significant nonrecurring revenues such as large securities gains and substantial tax credits may modify the overall earnings rating.

Liquidity. Banks must have the capacity to meet unexpected deposit withdrawals and to fulfill loan demand. A sudden change in interest rates could cause funding problems—especially for financially weak institutions. Liquidity needs vary significantly among banks, depending on many factors, including deposit volatility, volume of interest-sensitive funds, effectiveness of management's asset-liability strategies and policies, frequency and level of borrowing, access to money markets or other sources of ready cash, in addition to volume and expected use of credit commitments.

Conclusion

Obviously, the CAMEL rating is only a summary of a bank's financial condition at a given point in time. Such a rating cannot necessarily identify which banks are likely to fail. Even banks that are rated as satisfactory could become insolvent over time under significantly adverse circumstances. The CAMEL rating system, nevertheless, enables the various bank regulators to communicate with each other in the same terms and provides a framework for detailed analysis of a particular bank's financial condition.

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economic commentary

Closely Watched Banks

by Paul R. Watro

The soundness of commercial banks is a primary concern of banking regulators, investors, depositors, and the public at large. The number of financially troubled banks in the United States has increased significantly over the past two years. As of year-end 1983, 631 banks were on the Federal Deposit Insurance Corporation's list of problem banks, up from 369 at year-end 1982 and 223 at year-end 1981.¹ The number of banks that actually failed also rose to post-Depression highs in the last two years. High interest rates, poor economic conditions, and deregulation have, in fact contributed to below-average performance and financial difficulties for many banks.

This trend is only part of the picture, however. The number of troubled and failed banks, although rising, is still small compared with the number (over 14,000) of banks operating successfully throughout the United States. Nearly all of these banks are federally insured, which means that depositors with balances of up to \$100,000 are insured for the entire principal of their deposit even if the bank were to fail. Only a handful of bank depositors have suffered financial loss because of bank failure since the establishment of Federal Deposit Insurance in 1933. The dollar amount of these deposits represents only about 1 percent of the total deposits held by commercial banks that failed.² The Federal Deposit Insurance Corporation (FDIC) is one of three federal supervisory agencies responsible for maintaining the safety and soundness of the banking system and ensuring that banks serve the financial needs of the public.

The FDIC supervises over 8,500 insured state-chartered banks that are not members of the Federal Reserve System (FRS). The FRS regulates more than 1,000 banks that are state-chartered members,

while exercising direct supervisory authority over 5,000 bank holding companies with more than 7,000 banking subsidiaries. In addition, the Office of the Comptroller of the Currency (OCC) regulates over 4,500 national banks. State banking agencies oversee all state-chartered banks, and have sole responsibility for examining the less than 500 commercial banks that are not federally insured.

In the past, the three federal banking agencies did not use the same technical procedures for evaluating the financial condition of banks. The disparities among evaluation procedures emerged during the congressional hearings following the Franklin National Bank failure in 1974. In 1978 the three federal banking agencies adopted a more uniform rating system. While the actual ratings for individual banks and the list of banks in trouble are not available to the public, the criteria for determining whether a bank is financially sound are not confidential. This *Economic Commentary* explains and clarifies the bank rating system used by federal supervisory agencies.

1. While the list of problem banks includes both commercial and mutual savings banks, this article focuses on the supervision of commercial banks.

2. Federal Deposit Insurance Corporation, 1982 Annual Report.

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What the Ratings Mean

Composite rating	1	2	3	4	5
Financial condition	Sound in almost every respect	Fundamentally sound but might have minor problems that are correctable in the normal course of business	Weak in several areas, severity ranges from moderate to unsatisfactory	Unsatisfactory	Extremely weak
Supervisory response	Very little monitoring	Limited monitoring	More than normal amount of monitoring	Close monitoring	Constant monitoring

On a Scale of 1 to 5 . . .

The supervisory agencies monitor, examine, and ultimately rate insured banks. Bank monitoring is a continuous process. The agencies calculate an array of financial ratios based on reports of a bank's condition and income. This information is organized according to factors such as size and location, a method that ensures a bank will be compared with its peers. Such comparisons are provided to the banks, state bank regulators, and the public. Banks that deviate from the norm are screened for further analysis, a step that sometimes leads to special supervisory action and more frequent examinations.

Usually, banks are examined on-site once a year. These unannounced examinations may occur as often as twice a year, or as seldom as once every 18 months, depending on the condition of the bank. Each bank examined receives an overall supervisory rating of 1 through 5, with 1 being the best (see box). The overall rating is based on five separate but somewhat interdependent performance criteria, collectively called CAMEL.

The acronym stands for *capital adequacy, asset quality, management and administration, earnings, and liquidity*. Each factor is assigned an individual rating of 1 to 5, and the overall or composite rating generally represents a simple average of these factors. For example, a rating of Capital-2, Asset Quality-3, Management-2, Earnings-2, and Liquidity-1, and a composite rating of 2 indicates that the institution is fundamentally sound despite having only fair asset quality. This rating would be expressed as:

$$\frac{2-3-2-2-1}{5} = 2$$

Contrast this generally satisfactory rating with a rating of Capital-4, Asset Quality-4, Management-2, Earnings-5, Liquidity-3, and a composite rating of 4. This rating reveals that the bank has a critical problem with earnings and overall condition that is less than satisfactory. Such a rating warrants close supervisory attention and

financial monitoring. Some circumstances may move examiners to adjust the simple average rating to reflect the interrelationships among various aspects of the bank's operations. For example, if bank liquidity is extremely poor, yet all other factors are rated a 1 or 2, a composite rating of 2 may not be appropriate as the bank verges on insolvency. Also, the five performance criteria do not rule out consideration of other factors relevant to the overall condition and soundness of a particular bank.

Banks rated less than 2 receive more than normal supervisory attention. Corrective actions range from discussions with management to cease-and-desist orders. All banks rated 4 or 5 are placed on the FDIC's problem bank list. As the insurer of bank deposits, the FDIC includes on its problem list national banks and state member and nonmember insured banks. Banks rated 3 are closely supervised by the OCC and the FRS, but do not appear on the FDIC's problem list. These institutions appear to have problems less severe than those rated 4 or 5.

The Elements of a Rating

Capital adequacy. Bank capital serves as a cushion and absorbs temporary and unexpected losses, thus promoting confidence in the banking system. In appraising capital adequacy, the agencies have established quantitative guidelines based on capital-to-assets ratios. The capital needs of an individual bank, however, vary according to current asset quality, prospects for growth, and capacity to generate capital internally. Access to capital markets, deposit and liability composition, and the presence and financial strength of the bank owner, such as a bank holding company, are also considered. The actual capital-to-asset ratios of banks have declined in the past 50 years, but this trend appears to be consistent with other developments in the economy and banking industry, which have led to greater stability. In addition, greater deposit stability, increased bank liquidity, and improved management techniques have generally reduced the amount of capital that banks need. Only when a bank suffers losses can the true test of capital adequacy take place. In this case, the capital base becomes critical, particularly if losses are large and sustained.

Asset quality. This criterion is crucial to a bank's soundness. Banks hold most of their assets in loans and securities, which carry an interest rate risk and usually a credit risk, except for U.S. government securities. Large loan or security losses may cause insolvency, especially given that banks are highly leveraged institutions—that is, equity capital represents only about 5 percent to 10 percent of assets. Moreover, rapid and significant changes in interest rates could have substantial effects on the market value of loans and investments.

In rating asset quality, the primary criteria is the ratio of weighted classified assets to total capital. Classified assets, which have a higher-than-normal degree of risk, fall into a loss, doubtful, or substandard category according to how likely they are to incur an actual loss. As a rule, examiners generally expect that 100 percent of those assets classified as loss will eventually result in actual losses, compared with 50 percent classified as doubtful and 20 percent classified as substandard.³ To obtain the weighted classified assets, examiners multiply the dollar volume in each category by the associated percentage and add the figures together. The total of weighted classified assets is then divided by total capital.

Another measure of asset quality is the delinquent loan rate. Loans traditionally constitute the largest portion of a bank's assets and carry the greatest degree of risk. The number of delinquent loans (usually those with payments past-due more than 30 days) as a percentage of total loans is another indicator of a bank's asset quality.

Management. In view of the many changes taking place in the banking industry, management has become an increasingly important element of financial soundness. Like other businesses, banks are recruiting and maintaining top-notch managers. Management can take advantage of opportunities available to banks through technological developments and relaxed regulation. Bank management and administration are evaluated objectively and subjectively; technical competence, self-dealing, administrative skill, and compliance with regulations and statutes are scrutinized. The ability of management to plan for and respond to change is also considered in an assessment of management.

Earnings. Without earnings, capital would be difficult to augment and liquidity could be nonexistent. They are the bedrock of financial soundness. Earnings are also necessary to expand operations and meet the increasing demand for financial services.

3. Of course, actual loss experiences may vary, even within the same asset category, depending upon the circumstances.