Banking & Finance

AN EIGHTH DISTRICT PERSPECTIVE

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CAMEL Rating — Regulators' Guide to Bank Performance

The rising number of bank failures has increased popular attention on the role of bank examinations and their impact on the safety of the banking system. By assessing the operating soundness and financial viability of the institution, a bank examination is intended to identify financial problems and recommend corrective action that, if the problems are manageable, will forestall a bank failure. In order to measure the health of an institution, examiners have relied on an evaluation system known as the CAMEL rating.

The CAMEL performance rating is based upon an evaluation of five critical dimensions of a bank's operations. This article examines each aspect of a bank's performance evaluated by these criteria and describes how an overall performance rating is determined.

The specific dimensions of the evaluation form the acronym CAMEL: **C**apital adequacy, **A**sset quality, **M**anagement/administration, **E**arnings and **L**iquidity. Each measure of performance is rated on a scale of one through five in descending order of performance quality. Thus, one represents the highest performance and five the lowest (and most critically deficient) level of operating performance.

Capital Adequacy

Bank capital is defined as the difference between a bank's assets and its liabilities. Among other functions, capital serves as a buffer against loan losses. The adequacy of a bank's capital is rated (one through five) in relation to (a) the volume of risky assets, (b) the volume of marginal and inferior-quality assets, (c) plans for growth in bank size, and (d) capital ratios relative to the bank's peer group. Examiners are concerned with whether the current level of capital could absorb shrinkage in asset value and other losses the bank may incur. Banks typically receive a lower rating if they hold a higher-than-normal degree of risky assets.

Asset Quality

The quality of a bank's asset portfolio influences earnings and shareholder wealth. The regulatory agencies rate asset quality relative to (a) the level, distribution and severity of classified assets, (b) the level and composition of nonaccrual and reduced-rate (renegotiated) assets, (c) the adequacy of loan loss reserves, and (d) demonstrated ability to administer and collect problem credit. To a large degree, the rising number of bank failures in recent years can be traced to the deterioration of an institution's asset portfolio. As a result, examiners are focusing added attention on the quality of a bank's assets.

Management/Administration

The competence of a bank's management staff is crucial to the overall operations of the bank. Management is rated with respect to (a) technical competence, leadership and administrative ability, (b) compliance with banking regulations and statutes, (c) ability to plan and respond to changing circumstances, (d) adequacy of and compliance with internal policies, and (e) demonstrated willingness to serve the legitimate banking needs of the community it serves. Examiners are responsible for determining whether the bank's management has instituted policies and operating procedures which guide the bank within accepted banking practices and in a safe and sound manner.

THE FEDERAL RESERVE BANK of ST. LOUIS

Earnings

Earnings are rated according to their level (quantity) and their composition (quality). The quantitative aspect of earnings is evaluated by analyzing the bank's return on assets (ROA) relative to peer institutions. The ROA ratio (net income as a percent of total assets) gauges how well the bank's management is employing its assets. The level of earnings is rated with respect to (a) the ability to cover losses and provide for adequate capital, (b) earnings trends, (c) peer group comparisons, (d) quality and composition of net income, and (e) the rate of growth of retained earnings. Examiners are concerned with banks that have negative earnings or earnings that, although positive, may be characterized by mounting loan losses or a downward earnings pattern.

Liquidity

Liquidity is evaluated on the basis of the bank's capacity to meet the demand for payment of its obligations promptly and to fulfill the reasonable credit needs of the community. Liquidity is rated with respect to (a) the volatility of deposits, (b) reliance on interest-sensitive funds and frequency and level of borrowing, (c) availability of assets readily convertible into cash, and (d) access to money markets or other ready sources of cash. As clearly demonstrated in recent years, a bank's liquidity position rests heavily on depositors' confidence. As a result, examiners must determine the impact of adverse changes in the bank's environment on the institution's current liquidity position.

Having determined the individual rating for each of the five performance dimensions, an overall or composite rating is calculated. As a preliminary determination of the overall rating, a simple average is calculated by summing the individual performance ratings. This averaging process assigns equal weight to each performance dimension, which may or may not be realistic, depending upon the circumstances of any given bank. Therefore, before a final composite rating is assigned, the examiner subjectively determines whether the preliminary rating provides an accurate reflection of the bank's condition. The composite rating also is based upon a scale of one through five in ascending order of supervisory concern and reflects the institution's financial condition, compliance with banking regulations and operating soundness. The five composite ratings are defined and distinguished as follows:

Composite 1—Banks in this category are sound institutions in virtually every respect; any critical findings are basically of a minor nature and can be handled in a routine manner.

Composite 2—These banks also are fundamentally sound institutions but may reflect modest weaknesses that can be corrected in the normal course of business. Although such banks are stable, this score indicates that areas of weakness could develop into conditions warranting greater concern. To the extent that the minor adjustments are handled in the normal course of business, the supervisory response is limited.

Composite 3—Banks in this category exhibit a combination of weaknesses and could easily deteriorate into serious problems if corrective action is not effective. Consequently, such banks are vulnerable to adverse business conditions and require more than normal supervision. Overall strength and financial capacity, however, still make bank failure at the present time only a remote possibility.

Composite 4—A bank in this category has an exceptional volume of asset weaknesses and, unless prompt action is taken to correct these deficiencies, the future viability of the institution could be impaired. The bank requires close supervisory attention and financial surveillance.

Composite 5—This category is reserved for banks whose volume and character of weaknesses are such as to require urgent aid from the shareholders or other sources. Such banks require immediate corrective action and constant supervisory attention. The probability of failure is high for these institutions.

—Lynn M. Barry

Banking & Finance—An Eighth District Perspective is a quarterly summary of banking & finance conditions in the area served by the Federal Reserve Bank of St. Louis. Single subscriptions are available free of charge by writing: Research and Public Information Department, Federal Reserve Bank of St. Louis, P.O. Box 442, St. Louis, Missouri 63166. Views expressed are not necessarily official positions of the Federal Reserve System.

EIGHTH DISTRICT BANKING DATA

LARGE WEEKLY REPORTING BANKS[1]

Selected Assets & Liabilities	Level III/1986 ($ millions)	Rates of Change: Current Quarter II/1986-III/1986	Current Year III/1985-III/1986	Same Periods Previous Year II/1985-III/1985	Same Periods Previous Year III/1984-III/1985
Total Loans & Leases	$16,886	14.2%	10.4%	5.2%	10.5%
Commercial Loans	5,591	−0.2	5.4	−10.5	3.7
Consumer Loans	4,035	19.3	17.8	23.2	23.0
Real Estate Loans	3,756	21.8	10.1	7.1	7.2
Loans to Financial Institutions	1083	128.1	11.0	21.0	−14.7
All Other Loans	2,422	−0.4	10.8	12.7	34.3
Total Securities	3,866	13.8	2.1	−2.7	2.5
U.S. Treasury & Agency Securities	2,280	36.4	−1.7	−2.9	−1.4
Other Securities	1,585	−11.0	8.2	−2.2	9.3
Total Deposits	19,662	6.2	6.3	−0.8	4.2
Non-Transaction Balances	11,992	2.0	3.2	−4.0	4.8
MMDAs	2,661	19.2	19.6	20.4	17.2
$100,000 CDs	3,593	−9.8	−1.1	−21.3	−3.7
Demand Deposits	5,764	10.0	10.2	−2.7	−0.7
Other Transaction Balances[2]	1,904	23.2	21.9	8.6	14.3

SMALL WEEKLY REPORTING BANKS[3]

Selected Assets & Liabilities	Level III/1986 ($ millions)	Rates of Change: Current Quarter II/1986-III/1986	Current Year III/1985-III/1986	Same Periods Previous Year II/1985-III/1985	Same Periods Previous Year III/1984-III/1985
Total Loans & Leases	$5,383	8.0%	8.0%	2.0%	7.6%
Commercial Loans	1,561	−3.7	2.1	−8.3	0.6
Consumer Loans	1,089	15.6	7.9	−2.9	8.2
Real Estate Loans	2,280	18.5	13.5	4.3	10.4
All Other Loans	453	−13.0	3.5	53.9	20.9
U.S. Treasury & Agency Securities	1,992	5.0	1.1	−3.6	1.5
Other Securities	768	11.1	11.4	8.8	2.5
Total Deposits	8,199	8.1	2.4	7.2	8.1

All data are not seasonally adjusted.

[1] A sample of commercial banks with total assets greater than $750 million. Historical data have been revised to incorporate adjustment factors that offset the cumulative effects of mergers and other changes involving weekly reporting banks during 1985. These adjustment factors, which are computed each year, are used to construct a consistent time series for which year-to-year growth rates can be calculated. Adjustment factors are available upon request from the Statistics Section of the Research and Public Information Department. Rates of change are compounded annual rates.

[2] Includes NOW, ATS and accounts permitting telephone or pre-authorized transfers.

[3] A sample of commercial banks with total assets less than $300 million as of January 1984.

EIGHTH DISTRICT BANKING DATA

Bank Performance Ratios

RATIOS	II/1986	II/1985	II/1984
Loans to Deposits			
Large Banks[4]	78.20%	80.09%	74.94%
Small Banks[5]	58.50	60.00	60.02
Loan Loss Reserves to Total Loans			
Large Banks	1.49	1.53	1.34
Small Banks	1.33	1.16	1.07
Delinquent Loans to Total Loans			
Large Banks	3.68	4.13	4.03
Small Banks	4.87	4.92	4.61
Net Loan Losses to Total Loans			
Large Banks	0.29	0.26	0.19
Small Banks	0.35	0.35	0.22

EIGHTH DISTRICT INTEREST RATES[6]

	Sept. 1986	Aug. 1986	July 1986	Year Ago Sept. 1985
NOWs	5.21%	5.26%	5.31%	6.04%
MMDAs	5.48	5.63	5.90	6.91
Time CDS				
92 — 182 days	5.71	5.89	6.19	7.44
1 — 2½ years	6.40	6.44	6.79	8.39
2½ years and over	6.77	6.81	7.15	8.84

[4] All Eighth District banks with total assets greater than $750 million. Ratios are derived from Call Reports.

[5] All Eighth District banks with total assets less than $300 million.

[6] Average interest rates paid on new deposits by a sample of Eighth District commercial banks.