Executive Summary

In the context of regulation, there is no single number more important to a bank than its composite CAMELS rating. All bank directors should have a firm understanding of the meaning of CAMELS ratings and the profound impact these ratings have on the bank. This article will describe the elements of a CAMELS rating and the potential consequences of a low composite score.

As opposed to other regulatory measures (such as, for example, the OCC’s risk assessment system, which focuses on the categories, quality, and direction of prospective risk to an institution), CAMELS ratings are primarily a point-in-time assessment of its component factors.

Banks deemed to be “problem” banks are generally those with composite CAMELS ratings of 4 or 5, and those with composite ratings of 3, 4, or 5 may be subject to regulatory enforcement actions. As of June 30, 2016, the Federal Deposit Insurance Corp. (FDIC) noted 147 banking institutions—a fraction of the 884 listed in 2010—in its list of “problem” institutions out of more than 6,000 banks and thrifts. The future of these institutions continues to be uncertain at best.

In the post-Dodd-Frank environment, many banks continue to be relatively large and complex institutions tasked with an increasingly complex web of regulation at the federal and state level. Given such an environment, each bank necessarily has its own unique relationship with its prudential regulators. However, whether your bank’s primary federal regulator is the Office of the Comptroller of the Currency, the FDIC, or the Federal Reserve Board, your regulator’s overall view of the safety and soundness of your institution, regardless of its size, complexity, or scope, is summarized in your bank’s composite CAMELS rating.

Meaning of the CAMELS Score

CAMELS ratings are the result of the Uniform Financial Institutions Rating System, the internal rating system used by regulators for assessing financial institutions on a uniform basis and identifying those institutions requiring special supervisory attention.

Regulators assign CAMELS ratings both on a component and composite basis, resulting in a single CAMELS overall composite rating. When introduced in 1979, the system had five components. A sixth component—sensitivity to market risk—was added in 1996. The regulators that year also added an increased emphasis on an organization’s management of risk.

The six component areas are:

- C—Capital adequacy
- A—Asset quality
- M—Management
- E—Earnings
- L—Liquidity
- S—Sensitivity to market risk

The ratings range from 1 to 5, with 1 being the highest rating (representing the least amount of regulatory concern) and 5 being the lowest. CAMELS ratings are strictly confidential, and may not be disclosed to any party.

Component #1: Capital Adequacy

The capital adequacy component focuses upon:

- Level and quality of capital
- Overall financial condition
- Ability of management to address emerging needs for additional capital
- Nature, trend, and volume of problem assets, and the adequacy of allowances for loan and lease losses and other valuation reserves
Component #2: Asset Quality
The rating of the asset quality of a financial institution is based upon:

- Adequacy of underwriting standards, soundness of credit administration practices, and appropriateness of risk identification practices
- Level, distribution, severity, and trend of problem, classified, nonaccrual, restructured, delinquent, and nonperforming assets for both on- and off-balance sheet transactions
- Adequacy of the allowance for loan and lease losses and other asset valuation reserves
- Credit risk arising from or reduced by off-balance sheet transactions
- Diversification and quality of the loan and investment portfolios
- Extent of securities underwriting activities and exposure to counterparties in trading activities
- Existence of asset concentrations
- Adequacy of loan and investment policies, procedures, and practices
- Ability of management to properly administer its assets, including the timely identification and collection of problem assets
- Adequacy of internal controls and management information systems
- Volume and nature of credit documentation exceptions

Component #3: Management
The component rating regarding the capability and performance of management and the board of directors is rated upon:

- Level and quality of oversight and support by the board and management
- Ability of the board and management to plan for, and respond to, risks
- Adequacy and conformance with appropriate internal policies and controls
- Accuracy, timeliness, and effectiveness of management information and risk monitoring systems
- Adequacy of audits and internal controls
- Compliance with laws and regulations
- Responsiveness to recommendations from auditors and supervisory authorities
- Management depth and succession
- Extent of dominant influence or concentration of authority
- Reasonableness of compensation policies and avoidance of self-dealing
- Demonstrated willingness to serve the legitimate banking needs of the community
- Overall performance of the institution and its risk profile

Component #4: Earnings
The rating of an institution’s earnings focuses upon:

- Level of earnings, including trends and stability
- Ability to provide for adequate capital through retained earnings
- Quality and sources of earnings
- Level of expenses in relation to operations
- Adequacy of the budgeting systems, forecasting processes, and management information systems
- Adequacy of provisions to maintain the allowance for loan and lease losses and other valuation allowance accounts
- Earnings exposure to market risk such as interest rate, foreign exchange, and price risks

Component #5: Liquidity
The liquidity component rating is based upon:

- Availability of assets readily convertible to cash without undue loss
- Adequacy of liquidity sources compared to present and future needs and the ability of the institution to meet liquidity needs without adversely affecting its operations or condition
- Access to money markets and other sources of funding
- Level of diversification of funding sources, both on- and off-balance-sheet
- Degree of reliance on short-term, volatile sources of funds, including borrowings and brokered deposits, to fund longer term assets
- Trend and stability of deposits
Component #6: Sensitivity to Market Risk

The sensitivity to market risk component is based upon:

- Sensitivity of the financial institution’s earnings to adverse changes in interest rates, foreign exchange rates, commodity prices, or equity prices
- Ability of management to identify, measure, monitor, and control exposure to market risk
- Nature and complexity of interest rate risk exposure arising from non-trading positions
- Where appropriate, the nature and complexity of market risk exposure arising from trading and foreign operations

Potential Consequences of Low CAMELS Scores

An overall CAMELS score of 3, 4, or 5 can expose a financial institution to any of the informal and formal enforcement actions available to federal regulators. These regulatory tools include a menu of memorandums of understanding, consent orders, cease and desist orders, written agreements, and prompt directive action directives, imposed in an escalating manner if an institution’s CAMELS scores do not improve or continue to degrade.

Enforcement actions, in turn, will affect the bank in a variety of ways, including influencing access to capital, insurance costs, and the ability to recruit and maintain talent in your organization.

To avoid being potentially subject to enforcement measures, monitoring CAMELS scores—and fully understanding the factors that can influence their composition—should be a primary concern for every bank director.

This publication has been prepared for the general information of clients and friends of the firm. It is not intended to provide legal advice with respect to any specific matter. Under rules applicable to the professional conduct of attorneys in various jurisdictions, it may be considered attorney advertising material. Prior results do not guarantee a similar outcome.