UNDERSTANDING MODERN CAMELS, PART 1: THE CAPITAL QUESTION

First in a series about what regulators want in a CAMELS

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One of the great mysteries of banking life, especially for community bankers, is the CAMELS rating system.

This blog deals with the "C" from the CAMELS rating system, the rating for Capital. It comes in response to recent questions from bankers about what regulators mean today. Look for a series of blogs attempting to take some of the mystery out of the CAMELS rating system.

CAMELS basics

The CAMELS system has been around for a long time, since 1979. It has been amended once. In 1997, "sensitivity to market risk" was added.

Under CAMELS, each bank is given a composite rating based on the individual ratings of Capital, Assets, Management, Earnings, Liquidity, and Sensitivity. As we all know, a 1 is good and a 5 is really bad.

When you are considering the composite rating, keep in mind that it is certainly not any kind of arithmetic average. It does have some relationship to the component ratings assigned--but in some cases, not a whole lot.

The capital rating and management rating probably have received more ink than anything else over the last couple of years.

Closing in on Capital

So, what is the deal with the capital rating?

We have heard a lot about capital in the last 36 months. The capital rating assesses whether the bank is maintaining capital at an appropriate level for its risk profile.

You know the capital regulations have not actually changed in years. Community banks are still required to maintain a 4% Tier 1 leverage ratio and a 10% total risk based ratio.

Try and operate at that 4% Tier 1 leverage ratio. The regulators will be all over you in a heartbeat. So, what is the deal?

The CAMELS rating system requires that in connection with rating capital, the regulators consider a number of things, including the following:

- Overall financial condition of the institution

- Management ability to address needs for additional capital

- Major trend and volume of problem assets

- Balance sheet composition

- Off-balance-sheet issues

- Strength of earnings

- Plans for growth

- Access to sources of capital

Objectivity? Not at work here

Is the capital rating subjective? You bet!

You could have a bank rated 1 in capital that maintains 8% Tier 1 leverage and a bank rated 4 in capital that maintains 8% Tier 1 leverage.

The rating depends on the issues noted above.

But remember, from a regulatory standpoint, more capital is always better. Less capital is always worse.

The reality (at least from my vantage point in the trenches) is that in the last few years, the entire capital ratio minimums are floating up in large part because of continued deteriorating asset quality in many institutions.

Shoot for a 2 rating on Capital!

It probably means no matter what your bank's condition, you are going to need to maintain at least a 9% Tier 1. Also, if you have the availability to put additional capital in, for example, from your holding company leveraged or otherwise, make that known to the regulators as well.

In the next blog, I will try to take some of the mystery out of the Asset Quality rating.

About the Author

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