UNDERSTANDING MODERN CAMELS PART 2: IT'S ALL ABOUT ASSETS

Second in a series about what regulators want in a CAMELS

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As indicated in my last blog, I thought I would take a stab at providing some real-world explanation of the CAMELS rating system. The last blog dealt with the Capital component of the CAMELS rating system. This one will be my best effort at Asset Quality.

Foundation to CAMELS

As noted in the prior blog, the CAMELS composite rating is not an arithmetic formula driven by component ratings. In fact, the Asset Quality rating, as a practical matter, drives all the other ratings.

This entails what I have referred to over the last three years as the "asset quality snowball."

The first flakes of the asset quality snowball begin with an examiner's visit to the bank and the examiner's disagreement with the bank's classifications of certain assets, for whatever reason. Once a disagreement is noted, it is followed by the examiner's request--or demand--that the allowance for loan and lease losses be increased.

Once that occurs, because the increase in the allowance for loan and lease losses is an expense, the earnings go south. As earnings have been decimated (often), the bank is no longer augmenting capital, i.e. the "C" component, and management, who has operated the bank brilliantly for 20 years, is now a bunch of know-nothings.

So, as a practical matter, in the real world, the Asset Quality rating drives the rest of the show. As the asset quality snowball goes downhill, so do all the other ratings and the composite rating. According to regulatory guidelines, the Asset Quality rating reflects the quantity of existing and potential credit risks associated with the loan and investment portfolios, other real estate owned, and other assets, as well as off-balance sheet transactions. It also reflects the ability of management to identify, measure, monitor, and control credit risk. Also reflected in Asset Quality rating is the evaluation of the loan loss reserve.

By the numbers

Asset Quality is rated between 1 and 5. A 1 rating on Asset Quality reflects "strong asset quality and credit administration." A 5 rating on Asset Quality reflects "critically deficient asset quality or credit administration." In between those two ratings are 2, 3, and 4 which reflect "Satisfactory," "Less Than Satisfactory," and "Deficient" asset quality and credit administration, respectively.

Seems kind of like an A, B, C, D and F grades to me.

In the real world these days, if the bank's level of asset classifications related to its capital account is north of about 40%, then the regulators get agitated and start tossing around enforcement actions.

Once it gets north of about 60% to 65%, those actions are normally formal/public enforcement actions, as opposed to the informal/unenforceable variety, such as a Memorandum of Understanding or a Board Resolution.

Asset Quality is the engine that drives the train, and the primary determinant of the composite rating because of its impact on all the other components.

Next, the ever-confusing Management component.

About the Author

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