

UNDERSTANDING MODERN CAMELS, PART 4: EARNINGS

Fourth in a series about what regulators want in a CAMELS

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Jeff Gerrish has been taking readers through a six-week look at the modern essentials of the CAMELS system. Read his takes on Capital, Assets, and Management after you read this fourth installment on Earnings.

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The Earnings component of the CAMELS rating. How important is that?

Over the last three years, many of us have not had any earnings to worry about. Only a lack of earnings to worry about.

Earnings and the asset quality snowball

Over the last three years, bank earnings, and thus the Earnings component in the CAMELS rating, have simply been hammered as a result of the previously blogged asset quality snowball effect.

As asset quality goes south, the allowance for loan and lease losses must be funded, often significantly, and as a result, earnings disappear, or more likely, go negative.

All the current reports indicate that the earnings for community banks in particular are coming back fairly strongly. This is primarily a result of the reduction of the allowance for loan and lease loss provision, i.e., the banks are not having to expense so much to cover potential loan softening and losses.

Earnings are basically a "tag-along." They are virtually totally driven, or at least have been in the last three years, by asset quality issues.

If the bank had no asset quality issues, e.g., no enormous provisions, and still had poor earnings, that would certainly be a problem. That would indicate that there is something amiss with the "core" of the bank, i.e., it cannot even earn money when not dealing with extraordinary expenses.

That is not the problem for most institutions currently.

Where the "E" stands on examiners' priority list

Do the regulators pay attention to earnings? Absolutely. As noted, however, I have always viewed the Earnings component of the CAMELS ratings as derivative of the asset quality component, for the most part.

From a regulatory standpoint, the Earnings rating, according to the regulators, "reflects not only the quantity and trend of earnings, but also factors that may affect the sustainability or quality of earnings."

The quality of earnings can be hit by excessive credit risk, provisions to the reserve, or volatility in interest rates. When looking at earnings, the regulators will also consider whether earnings have been "juiced" by extraordinary gains, non-recurring events, or some type of tax recovery.

Regulators' 7-point earnings evaluation

The regulators look at seven factors:

1. Level of earnings, including trends and stability.
2. Ability to augment capital through retained earnings.
3. Quality and source of earnings.

4. Level of expense in relation to operations.

5. Adequacy of budgeting processes and information systems.

6. Adequacy of the allowance.

7. Earnings exposure to market risk, particularly interest rate risk.

As with the other component ratings, Earnings are rated 1 to 5.

A rating of 1 indicates earnings that are "strong." A rating of 5 indicates earnings that are "critically deficient." Ratings of 2, 3, and 4 are satisfactory, needs to be improved, and deficient, respectfully.

Earnings place in the CAMELS weighting

In connection with the CAMELS rating system, the component ratings are not all weighted equally. Since earnings are "derivative," the Earnings rating is usually going to be tied, most often particularly in the last three years, to Asset Quality ratings. If the bank receives a 4 on Asset Quality, it most likely will have to super-fund its reserve and will receive a 4 or 5 on Earnings as well.

Next week we'll look at Liquidity.

About the Author

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