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February 27, 2020

Mr. Robert E. Feldman  
Executive Secretary  
Attention: Comments  
Federal Deposit Insurance Corporation  
550 17<sup>th</sup> Street NW  
Washington, DC 20429

Ann E. Misback, Secretary  
Board of Governors of the Federal Reserve System  
20<sup>th</sup> Street and Constitution Avenue, NW  
Washington, DC 20551

Re: Request for Information on Application of the Uniform Financial Institutions Rating System (Docket No. OP-1681); (RIN 3064-ZA08)

Dear Mr. Feldman and Ms. Misback:

The Independent Community Bankers of America (ICBA)<sup>1</sup> appreciates the opportunity to respond to a request for information from the FDIC and the Federal Reserve regarding the consistency of ratings assigned by the banking agencies under the Uniform Financial Institutions Rating System (UFIRS), commonly referred to as the CAMELS ratings.

### **Background Information**

The Federal Deposit Insurance Act generally requires the appropriate federal banking agency for an insured depository institution to conduct a full-scope, on-site examination at least once every 12 months.<sup>2</sup> At the conclusion of an examination, examination staff develop findings and conclusions which serve as the primary basis for assessing the condition of an insured depository

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<sup>1</sup> *The Independent Community Bankers of America® creates and promotes an environment where community banks flourish. With more than 52,000 locations nationwide, community banks constitute 99 percent of all banks, employ more than 760,000 Americans and are the only physical banking presence in one in five U.S. counties. Holding more than \$4.9 trillion in assets, \$3.9 trillion in deposits, and \$3.4 trillion in loans to consumers, small businesses and the agricultural community, community banks channel local deposits into the Main Streets and neighborhoods they serve, spurring job creation, fostering innovation and fueling their customers' dreams in communities throughout America. For more information, visit ICBA's website at [www.icba.org](http://www.icba.org).*

<sup>2</sup> *Well capitalized and well managed insured depository institutions with total assets less than \$3 billion qualify for an 18-month exam cycle.*

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institution under the UFIRS. The UFIRS is commonly called the CAMELS rating system, which is an acronym of the six evaluation components: Capital, Asset Quality, Management, Earnings, Liquidity, and Sensitivity to Market Risk. In addition, the CAMELS rating system contains an overall composite rating.

The UFIRS describes each rating component and includes a list of factors that examiners evaluate when assigning a rating to the institution. Examiners assign CAMELS components and composite rates on a scale of “1” to “5” with a rating of “1” being the highest rating and “5” the lowest. Each component rating contains risk management considerations that focus on the ability of management to respond to changing circumstances and are an important factor in evaluating a financial institutions overall risk profile and the level of supervisory attention warranted. Examiners rate each institution individually based on their assessment of how each institution’s risk profile fits the CAMELS definitions.

The banking agencies typically communicate the CAMELS ratings to an institution through a formal, written report of examination. The CAMELS ratings and the report of examination are property of the agencies and are provided to the institution’s board of directors and management for their confidential use. The agencies prohibit disclosure of an institution’s CAMELS rating or report of examination in any manner without the primary federal regulator’s permission except in limited circumstances specified in the law.

For community banks, CAMELS ratings can have several supervisory implications. The banking agencies will increase supervisory activities, which may include targeted examinations between regularly scheduled examination, if an institution’s CAMELS ratings are less than satisfactory. If a community bank wants to merge with another institution or open a new branch, generally, it must be in satisfactory condition as shown by its CAMELS ratings before it can obtain regulatory approval for the expansion.

With respect to community banks with total assets less than \$3 billion, only well capitalized institutions with outstanding or good CAMELS composite ratings can qualify for an 18-month exam cycle. The CAMELS composite rating and its weighted average of CAMELS component ratings are important determinants of a community bank’s assessment rate so that any downgrade can have a direct financial impact on the bank.

Furthermore, composite and component ratings assigned under CAMELS are significant indicators of the need for heightened supervisory attention including enforcement actions. The UFIRS states that with respect to an institution with a “4” composite rating, close supervisory attention is required which often means a formal enforcement action is necessary to address the problem.

### **ICBA’s Comments**

ICBA surveyed its leadership bankers to determine how the CAMELS rating system is working for community banks. **Most of the bankers who participated in the survey (79%) thought that the supervisory work performed during an exam cycle aligned with the components of the CAMELS system and were generally satisfied with how their banks were rated.**

Furthermore, bankers said the examiners were assigning composite and component ratings in a manner consistent with the CAMELS rating system and were satisfied with their exams as well as with their ratings. **When asked if they would be in favor of scrapping the CAMELS system altogether, 86% of participants said “no.”**

### **Lack of Consistency and Too Much Subjectivity**

**However, many community bankers still expressed some dissatisfaction with the CAMELS system even though they generally thought the system worked or did not want to see it radically changed. A frequent criticism was that the system was too subjective and that it lacked consistency.** For instance, one banker said that “since the component ratings aren’t based on consistent variables, there is opportunity for the ratings to be inconsistently applied.” Another banker noted that his bank kept getting different ratings and the examiner’s response was always “different examiners look at things differently.” In another instance, the banker said that “things that have been compliant for three successive exams become violations based on subjective interpretation. When it is pointed out that it was considered compliant in prior exams, the examiner’s response is—it doesn’t matter.” In another instance, a banker said:

*“There isn’t consistency between the agencies. We have been a multi-bank holding company and saw exam results from the state and two different federal agencies. There are many differences between these agencies when they are supposed to be using the same set of criteria.”*

Several bankers noted that because of the subjectivity of the ratings, some components carry a greater weight than others, distorting the entire ratings system. For example, one banker said:

*“The CAMELS system is too subjective. In some cases, regardless of how well an area is managed, the examiners give a lower rating because of another category. If asset quality is downgraded, then the IRR and management get downgraded because of asset quality. Each grade is not evaluated on its own merits.”*

In another instance, a banker said that “we have seen the examiners adjust individual components to achieve the resulting composite they want.” And still another banker said:

*“The only rating that matters in any significant way is asset quality and it drives the management rating whether management or an economic downturn caused the issues to the bank. Poor asset quality, poor management by default. The liquidity and sensitivity ratings are also highly based on the asset quality rating. I am familiar with a bank that has a tremendous on-balance sheet liquidity and a strong liquidity management system, but a “1” rating isn’t possible unless the asset quality rating is also a “1.” The same can be said for sensitivity. I understand that the components have some effect on one another, but the system is all about asset quality. Period.”*

Bankers also noted that examiners are rating the Capital component inconsistently. For example, one banker noted that:

*“We have had experience with the Capital portion of the rating. Our Bank's tier 1 leverage capital is currently at 14.6% and our ALLL has been deemed adequate based on our risk by the examiners, but because we have an elevated level of classified assets, we do not get a ”1” in Capital. Even when we show that if all of our classified assets were charged off in full (resulting in -0- classified assets) our capital ratio would be in excess of 10%.”*

Some bankers were also critical of the Management component because it was too subjective. One even accused the examiners of assigning the Management component based on the bank’s cooperation with the examiners and not on any real measurable metrics.

Several bankers recommended that the UFIRS component measures be more objective. One banker said:

*“There appears to be a lot of discretion available to examiners in how they assign component ratings and there isn't a uniform way in which they are determined. Sometimes the component ratings appear to be awarded based on financial metrics (i.e., liquidity ratio, etc.) while other times it is subjective. In my opinion, the Management component should be the only rating that is more subjective while the other components should be based on financial metrics that can ensure transparency and consistency among various financial institutions.”*

Several bankers also noted that the CAMELS ratings system is still not tailored to the risk and size of the institution. For instance, one community banker said:

*“It is essential that community banks are treated differently than larger banks and should be given credit for meeting the local needs of the customer base.”*

Another banker said that concentrations, loan file exceptions and IT should be given less weight for small banks due to the smaller less sophisticated customer base and the heavy reliance on outside service providers for IT.

### **Recommendations for Improving the CAMELS Rating System**

Based on the survey results and conversations with community bankers, the banking agencies could improve the CAMELS rating system by making each component of the system more objective and basing each component score more on financial metrics. For instance, since UFIRS was adopted in 1979 prior to the adoption of FDICIA, the Basel III framework, and the Community Bank Leverage Ratio, the Capital component should be significantly rewritten to incorporate a wide range of objective capital adequacy measures that have been incorporated into banking regulation since that time. We believe that if a community bank complies with all applicable minimum regulatory capital requirements, including risk-based and leverage capital requirements under the Basel III capital rules or complies with the new Community Bank Leverage Ratio, then it should receive a Capital component score of “1” absent any issues with concentration risk or the bank’s ability to meet any debt obligations.

As for the Management component, we have been concerned that this has become too subjective and that the banking regulators are using it as a way to penalize a bank for other reasons such as

a poor CRA rating, an AML violation, or for the taking on an excessive level of “reputational risk.” The Management rating should be an objective assessment of management’s ability to keep the bank’s financial condition sound. It should not be used as another mechanism to penalize the bank for a consumer compliance problem or for some other reason.

Furthermore, we believe the entire exam process as well as the CAMELS Rating system would be improved and would be more consistently applied if there was an effective appeals process implemented. ICBA supports legislation that would reform the way bankers may seek a review of an agency decision or action resulting from an exam including classification of a loan, an exam rating, or the adequacy of loan loss reserve provision. Currently, bankers can seek review of these actions or decisions internally or through the ombudsman’s office. However, these appeals are usually not successful. Furthermore, community bankers often choose not to appeal out of fear of retaliation. ICBA supports legislation that would allow bankers to appeal to an independent council or ombudsman office that would prohibit any sort of retaliation against the bank for exercising its right of appeal.

## **Conclusion**

Based on our survey of ICBA leadership, community bankers were generally satisfied with the CAMELS Rating System and did not want to radically change it. However, they were still many who thought it could be improved by making it less subjective and more consistently applied. ICBA recommends that the banking agencies amend UFIRS to make some of the components to the CAMELS system more objective by basing the component scores more on financial metrics. We also support legislation to implement an effective appeal process for bankers.

ICBA appreciates the opportunity to respond to this RFI from the FDIC and the Federal Reserve regarding the CAMELS ratings. If you have any questions or would like additional information, please do not hesitate to contact me at (202) 821-4431 or [Chris.Cole@icba.org](mailto:Chris.Cole@icba.org).

Sincerely,  
/s/Christopher Cole

Christopher Cole  
Executive Vice President and Senior Regulatory Counsel