February 28, 2020

Via Electronic Mail

The Honorable Jerome Powell
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Board of Governors of the Federal Reserve System
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Washington, DC 20551

The Honorable Jelena McWilliams
Chairman
Federal Deposit Insurance Corporation
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Chairmen Powell and McWilliams:

Thank you for requesting public input on the Uniform Financial Institution Ratings Systems, better known by the CAMELS acronym, that governs how banks are rated by regulators. I commended you both for asking important questions regarding the adequacy, transparency, consistency, and quality of the current system's performance. Financial regulation is based on assumptions that the CAMELS system is high functioning, predictive, responsive, and timely. Given the significant regulatory mistakes in the 2000s, exposed by the Great Financial Crisis of 2007-2008, and the structural reforms undertaken to fix these problems, now is an opportune time to critically examine the CAMELS system with shared goals of increasing functionality, improving transparency, consistency, and accuracy of ratings within and across financial institutions.

The proposal in this comment is simple: make public the composite CAMELS ratings for all regulated insured depository institutions. This proposal may seem radical, given the extremely confidential nature with which existing CAMEL ratings are treated. Until 1997 bank regulators did not even disclose CAMELS ratings to the bank being rated! However, careful analysis proves that today, for the largest financial institutions in America CAMELS ratings are already made public, or more precisely negative CAMELS for only the largest institutions are made public. That select institutions ratings would be made public, only at the lowest ratings, creates a series of perverse incentives that hamper the effectiveness of the CAMELs system.

Making all institutions ratings public is one solution to level the playing field. It has many other positive ramifications, which should be actively considered, debated, and in my opinion, deployed to increase the effectiveness, transparency, consistency, and quality of our financial regulatory system. After all, shouldn't market participants have the right to know on a high-level basis, if the government believes a financial institution is on the brink of collapse? Conversely if the government believes an institution is in excellent condition, that information important. Finally, transparency of ratings will improve the quality of financial regulation by requiring regulators to defend their assessments to broader market and public.

The current CAMELS rating system is thought to be completely confidential and non-public. However, that is not the case in practice for the largest financial institutions. This is because the FDIC publishes the aggregate assets of all troubled institutions, defined on the basis of an aggregate CAMELS rating of a 4 or 5, on a quarterly basis as part of its quarterly banking profile.[1] Currently those banks have cumulative assets of $49 billion, a range that is consistent with experience during non-crisis periods.[2] This size, coupled with the number of banks with similar asset sizes under $10 billion, makes it essentially impossible to identify specific smaller institutions on the list, providing relative anonymity for smaller institutions.

The addition of any of the top ten banks would make it easily be apparent to the public which institution, based on the unique size of those institutions.[3] Once outside of the top ten institutions, the addition of a single institution would be easily narrowed to one of a small handful of institutions. Market forces might well require those not identified to restate their strength, easily identifying the institution that has been downgraded. Even further down the list it would be relatively easy to identify certain banks addition – for example, there is only one institution with assets between $80 and $90 billion. It would be difficult and unlikely to hide that institution's appearance on the list, depending on conditions of other institutions. Only below the $50 billion threshold there are enough banks that it might not be easily apparent which one.

Thus, the current system does in fact make a small subset of the largest financial institutions ratings cumulative CAMELS public, albeit in an indirect and slightly lagged basis. This creates an unlevel playing field whereby a series of incentives apply to regulators and financial institutions regarding the ramification of such a downgrade, that do not exist for the vast majority of smaller financial institutions. For example, despite all the regulatory issues surrounding the recent scandals involving Wells Fargo, at no point was Wells given an overall CAMELS rating of a 4. Whether such a rating was justified is a different question: what is known is that it was never done. And had it been done, that rating would have been clear to the public only at the release of the FDIC's next quarterly banking profile. That is neither the

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[1] "FDIC: Quarterly Banking Profile." Accessed February 21, 2020. https://www.fdic.gov/bank/analytical/qbp/2015sep/qbpnot.html.

[2] ibid

[3] Based on either the deposits or assets of the largest US domestic institutions as reported by the Federal Reserve. "FRB: Large Commercial Banks-- December 31, 2019." Accessed February 21, 2020. https://www.federalreserve.gov/releases/lbr/current/.

confidentiality that is believed to exist in the system, nor the proper timing or process for such a rating to be made public. Further, the status quo system is not consistent across institutions and is somewhat arbitrarily applied as it relates to privacy depending on the size of that institution and the size of other institutions. This underscores the need to at least recognize the problems this creates and consider alternatives.

The solution of making all CAMELS aggregate ratings public may appear an overreaction to this inconsistency. CAMELS ratings are held by regulators in substantial secrecy and the impulse of regulators has long been to overly guard this information. Before 1997 bank regulators did not even disclose CAMELS ratings to the very institutions they were rating. Substantial pushback to the requirement to share ratings included arguments that doing so would reduce supervisory effectiveness. The requirements to disclose those ratings did not reduce supervisory effectiveness (Feldman, Schmidt, and Jagtiani)[4]. It is noteworthy that none of the questions asked by the Fed and FDIC in this proposal question whether regulators should go back to the 1990s era of not sharing CAMELS ratings. In monetary policy by the Federal Open Markets Committee, great debate regarding increased transparency eventually gave way to increasing steps of transparency, which has been lauded by regulators, the market, and academics (Blinder[5] and Cukierman and Meltzer[6]). The value of transparency and the inaccuracy of the arguments against have been proven in monetary policy and it should be incumbent upon those in bank regulation to argue why it this time is different.

Many of the questions posed in this request have to do with the consistency or lack thereof in CAMELS ratings across financial institutions. Making such reports public is a useful step to creating consistency. The lack of public data to measure the application of CAMELS fosters an environment where inconsistency can flourish. It also makes it nearly impossible to check the accuracy or value of CAMELS ratings as given. One commenter wrote that they "are aware of no evidence that existed at the time, or exists currently, to support" the conclusion that the bank regulators made that "UFIRS has proven to be an effective internal supervisory tool for evaluation the soundness of financial institutions on a uniform basis and for identify those institutions requiring special attention or concern."[7]

Making CAMELs public provides regulators strong incentive regulators to make ratings more uniform. Currently, little information is publicly available regarding CAMEL ratings across

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[4] Feldman, Ron J. and Schmidt, Jason and Jagtiani, Julapa A., The Impact of Supervisory Disclosure on the Supervisory Process: Will Bank Supervisors be Less Likely to Downgrade Banks? (August 25, 2003).
[5] Alan S. Blinder, 2002. "Through the Looking Glass: Central Bank Transparency," Working Papers 116, Princeton University, Department of Economics, Center for Economic Policy Studies.
[6] Cukierman, Alex, and Allan H. Meltzer. "A Theory of Ambiguity, Credibility, and Inflation under Discretion and Asymmetric Information." Econometrica 54, no. 5 (1986): 1099-128. Accessed February 21, 2020. doi:10.2307/1912324.
[7] Baer, Greg. Comment Letter. "Re: Substantive Review & Revision of the Uniform Financial Institution Rating System." Comment Letter, January 10, 2020. https://bpi.com/wp-content/uploads/2020/01/BPI-Comment-Letter-re-CAMELS-Docket-No-OP-1681-RIN-3064-ZA08-002.pdf.

institutions and hence little public scholarship or analysis has been conducted to assess the uniformity of existing ratings. The ability to publicly take composite ratings and analyze them across institutions matched with a myriad of available data from call reports, publicly traded data for such institutions, and other data sets will help financial regulators, financial institutions, depositors, market participants, and others assess the uniformity and appropriateness of the CAMELs system.

Providing the public, investors, market participants, access to pertinent data would allow the public to provide meaningful answers to many of the questions posed in this request for comment. It is difficult, for example to answer question 9, "To what extent do the CAMELS ratings impact the issuance of enforcement actions?" without knowing the ratings of institutions subject to enforcement actions. How is anyone outside of the regulators to know the answer to this for multiple financial institutions, when institutions CAMELS ratings are not known?

Making CAMELS rating public would also increase market discipline on financial institutions. As research by Jose Lopez at the Federal Reserve Bank of San Francisco found, "Such disclosure could benefit supervisors by improving the pricing of bank securities and increasing the efficiency of the market discipline brought to bear on banks."[8] Greater market discipline is one of the primary tools to achieve optimal an optimal financial system.

CAMELS ratings have achieved the ability to be withheld from investors, despite the clear materiality of such downgrades and the legal requirement that public companies disclose 'on a rapid and current basis' material information regarding changes in a company's financial condition or operations. CAMELS fall under section (b) of 12 CFR § 4.37 prohibiting their public disclosure and providing substantial penalties on individuals who break this confidentiality. As a legal matter this appears to trump securities law requiring investor disclosure of material events. The recommendation in this proposal does not seek to overturn this legal structure. It simple would have the regulators themselves disclose the aggregate rating, and only the aggregate rating to the public with an appropriate lag. Further it would apply to all banks, as opposed to the securities laws which govern those who are accessing public markets.

It worth noting the inherent tension within the legal framework between investor rights and disclosure for market discipline and the provision of limited confidentiality to regulators. By voluntarily disclosing additional information, bank regulators will be conforming with the spirit of other portions of law. They will also be putting making their work public, allowing markets to digest and incorporate this information, as well as allowing the public to provide an important check on the quality of the CAMELS system. As noted above it is difficult if not impossible for

[8] https://www.frbsf.org/economic-research/publications/economic-letter/1999/june/using-camels-ratings-to-monitor-bank-conditions/

the external world to judge the accuracy and quality of a grading system when grades are never revealed.

The question then becomes, why keep this overall rating private, depriving the market place of important information, creating un-level playing fields, and fostering an environment where inconsistency is allowed to exist without external verification? Two main objections to making CAMELS public are concerns that it would reduce the quality of bank supervision, and increase the potential for a run on a bank that has been downgraded. The first fear was used to oppose the transparency increase of the 1990s: telling the bank its own rating. Evidence on the requirement to disclose ratings to the banks being rated shows that there was not a reduction in supervisory effectiveness (Feldman, Schmidt, and Jagtiani).

Addressing run risk, prior research by Rosengren, Peek, and Jordan at the Boston Federal Reserve analyzed the role of increased disclosure of enforcement actions within the U.S. banking context and global banking problems in past crisis before the Great Financial Crisis and found "that improving disclosure at troubled U.S. banks during the banking crisis was not destabilizing and did provide conditions for market discipline to work more effectively." [9] Similarly, Gilbert and Vaughan from the Federal Reserve Bank of Saint Louis demonstrated that enforcement actions do not trigger run risk and they argued that would be true for CAMELS:

> "Our research does have implications for the debate over publicizing CAMELS scores. As noted, supervisors have historically opposed the release of any adverse information gathered through examinations for fear of sparking costly runs. Our evidence demonstrates that the fears expressed by supervisors during the debate over disclosing formal actions were unfounded. The next logical step is to provide depositors with more contextual information about each formal action in an easy-to-understand. Then, should no runs occur, the debate could move on to the issue of CAMELS disclosure."[10]

Two important answers to the run risk concern, if that still remains, are that: 1) this issue already exists for the largest financial institutions, thereby coloring regulator's actions. Thus, maintaining the status quo de facto acknowledges a reluctance of regulators to use the full range of CAMELS only for the largest banks. Is this an example of the dreaded Too-Big-To-Fail (TBTF) problem whereby regulators protect only the largest financial institutions? If so, the best solution is consistency whereby any institution who acts in an unsafe and unsound manner, falling to a CAMELS 4 or 5 level, should be allowed to fail. This leads to point 2) the failure resolution regime created by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) is largely considered to be able to handle the idiosyncratic failure

[9] https://www.bostonfed.org/publications/research-department-working-paper/1999/the-impact-of-greater-bank-disclosure-amidst-a-banking-crisis.aspx

[10] https://s3.amazonaws.com/real.stlouisfed.org/wp/2000/2000-020.pdf

of any large financial institution. A Bipartisan Policy Center report concluded that strategy set forth by these laws "should succeed in solving a critical part of the too-big-to-fail problem." [11] Thus, if there is a concern that an institution who has gotten itself into significant trouble to merit a CAMELS 4 or 5 rating, and that rating is made public, and that triggers a run whereby the institution fails, then that failure will be well managed and not create systemic risk. If that is not the case, and regulators are afraid that such a scenario would create a systemic risk, then there is a greater problem of mass delusion as to the effectiveness of Dodd-Frank's failure regime.

If multiple large financial institutions are simultaneously in positions that justify CAMELS 4 and lower ratings, then we are probably in the midst of a financial crises. The further release of those CAMELS on a lagged basis would probably provide little marginal impact given the other activities occurring in real time on the basis of whatever panic or crises has caused this systemic problem. The FDIC's troubled institution list peaked at over $850 billion in assets in 2009[12], indicating to the public that there were large problems in large institutions. Of course, the public was already well aware given the incidents of the fall of 2008.

When to Release?

A lag between a final rating and its being made public may well be justified as described above. The lag between that rating and when it is made public should be debated and studied, with an appreciation that a lag may be appropriate, although it should not be too long. Such CAMELS could be incorporated into the FDIC's quarterly bank report, as a subset of CAMELS ratings already are. The exact delay is not as important as the commitment from financial regulators to public release. One way to start would be for regulators to make public historical ratings for institutions. Much could be learned regarding many of the questions poses by regulators in this request if the aggregate CAMELS for all financial institutions between the years 1998 and 2008 were made public. It is certainly difficult to argue that a CAMELS of an institution a decade ago, pre-financial crisis, would pose any risk to market stability. However, it would provide substantial ability to ascertain how effective and accurate CAMELS ratings were in the run-up to the financial crisis, as well as how consistent ratings were across financial regulators for similar institutions.

Personal Experience in CAMELS Inconsistencies

Absent public CAMELS data, anecdotal experience what is available to judge many of the questions posed. My first-hand experience came from witnessing the disagreements between

[11] Too Big to Fail: The Path to a Solution, A Report of the Failure Resolution Task Force of the Financial Regulatory Reform Initiative of the Bipartisan Policy Center, p. 2 (May 2013).
[12] "FDIC: FDIC Quarterly Banking Profile." Accessed February 21, 2020. https://www.fdic.gov/bank/analytical/qbp/2019sep/.

financial regulators regarding the CAMELS ratings between financial institutions and regulators. This experience made evident that CAMELS are ratings are inconsistent between financial regulators and occasionally inconsistent within a given regulator. Individual CAMELS elements are also highly subjective with significant flexibility given to examiners and less consistency and formality applied that I had thought would be the case. The aggregate rating, an understandably not well defined non-mathematical blend of the individual elements, is thus itself subject to multiple levels of inconsistency. Making public the aggregate rating would enhance pressure for consistency, while maintaining substantial examiner discretion at the elemental level.

I served on the Treasury's TARP Investment Committee where I had access to the CAMEL reports, ratings, and analysis of a subset of financial institutions: those who had applied for TARP capital and where the then four financial regulators disagreed upon the fundamental health and viability of the financial institution. Put simply, at least one of the four regulators thought the bank was not financially viable without receiving a TARP injection, and at least one thought it was. In other words, they had fundamental disagreements about what the entity's overall CAMEL rating would have been for the subset of institutions likely to receive a 3,4, or 5 according to at least one regulator.

My tenure on the Committee began in the summer of 2009 when the investment committee was reviewing mainly smaller financial institutions (generally $10 billion or less, rarely over $50 billion according to my memory). I observed many financial institutions that were similar but were treated differently by different regulators, both primary regulators and secondary regulators or non-direct regulators. All were making judgements on the basis of current data and had access to primary regulator reports. Seeing the differences between financial institutions' individual subsection CAMELS scores there was substantial variation not explainable on the basis of hard data. It appeared a combination of examiner discretion and agency culture. Further, in at least one instance, the examiner in charge substituted his judgment for the objectives of the institution, over the objectives of the bank's management and ownership, providing a negative rating that was unjustified (in my opinion). Yet, for that institution there was no recourse.

This unique experience witnessing multiple financial regulators openly debate differences of opinion on the same institution, made clear that CAMELS ratings could substantially benefit from greater consistency both across regulators and within regulators. Primary examiners wield substantial discretion. That discretion may be merited and in fact necessary given the idiosyncratic nature and differences between banks business models. Similar aggregate data profiles do not necessarily justify similar CAMELS ratings when bank specific factors are brought account. For example, high exposure to commercial real estate (CRE) is a classic red flag for potential trouble for smaller financial institutions. However, loans given to houses of worship and loans given to retail space are both classified as CRE, even if their risk profiles substantially differ. Thus, there is logic and importance in providing flexibility to examiners to modify ratings based on judgment.

Concluding Thoughts

Maximizing transparency while preserving optimal value from confidential supervisory information are twin goals in financial regulatory policy. Inherent tension between the two is a problem in determining the quantity and type of information released to the public, as well as the timing of such information. Provide too much information too soon and risks of bank runs increase. Provide too little too late and economic and market incentives fail to apply, causing inefficient and risky behavior by financial institutions.

The existing system has through an underappreciated set of differing regimes created a two-tiered regime subjecting the largest financial institutions to a different de-facto level of CAMELS publicity than smaller institution. Regulators need to acknowledge this and appreciate the distortions it creates. Compounding this is the lack of data and external information available to depositors, creditors, market participants, academics, and others to conduct meaningful research and make important economic decisions based on many of the important questions asked. From my unique but limited experience, heterogeneity in CAMELS ratings are the norm and consistency are less common than appreciated.

What was once considered radical and unwise levels of transparency with monetary policy decisions has become the norm. Similarly, a small step in making CAMELS ratings more transparent was undertaken in the late 1990s with positive impacts. The Board and Corporation are to be commended for asking these important questions and should have the courage to go where the answers take them, even if it results in substantial changes. Given the experience of the financial crisis and the substantial changes in regulation brought in its aftermath this is a wise moment to consider how increased transparency into CAMELS ratings could enhance regulation and efficiency and why such transparency should not be feared as it has been in the past.

Submitted Respectfully,

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