CAMELS RATINGS

USAID-Funded Economic Governance II Project

Presented To: CBI Bank Supervision Examiners

Date:2006-10-29

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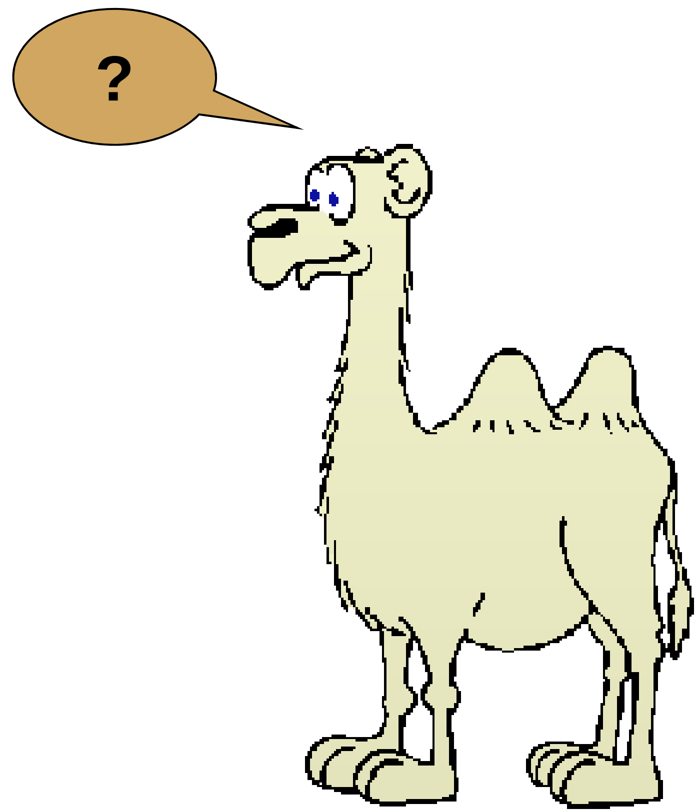
Overview

Learning objectives

- Review the key components of CAMELS ratings. Understand their meaning and their application to commercial banks. There are six elements:
  - **C**apital adequacy
  - **A**sset quality
  - **M**anagement
  - **E**arnings
  - **L**iquidity
  - **S**ensitivity to market



Purpose of CAMELS ratings

The purpose of CAMELS ratings is to determine a bank's overall condition and to identify its strengths and weaknesses:

- Financial
- Operational
- Managerial

Rating System

Each bank is assigned a uniform composite rating based on six elements. The system provides a general framework for evaluating the banks.

It is a standardized method which allows the assessment of the quality of banks according to standard criteria providing a meaningful rating.

CBI does not take into consideration the Sensitivity to Market Risks.

Rating Provisions

Each element is assigned a numerical rating based on five key components:

- 1 Strong performance, sound management, no cause for supervisory concern
- 2 Fundamentally sound, compliance with regulations, stable, limited supervisory needs
- 3 Weaknesses in one or more components, unsatisfactory practices, weak performance but limited concern for failure
- 4 Serious financial and managerial deficiencies and unsound practices. Need close supervision and remedial action
- 5 Extremely unsafe practices and conditions, deficiencies beyond management control. Failure is highly probable and outside financial assistance needed

Based on the ratings of each element, a composite rating of 1 through 5 is assigned to the bank. All the factors reflected in the key components ratings are considered in assigning the composite rating.

Capital Adequacy

Rating factors

Capital is rated based on the following considerations:

- Nature and volume of problem assets in relation to total capital and adequacy of LLR and other reserves
- Balance sheet structure including off balance sheet items, market and concentration risk
- Nature of business activities and risks to the bank
- Asset and capital growth experience and prospects
- Earnings performance and distribution of dividends
- Capital requirements and compliance with regulatory requirements
- Access to capital markets and sources of capital
- Ability of management to deal with above factors

Capital rating 1

Rating "1" is characterized by:

- Capital levels and ratios exceed all regulatory requirements
- Strong earnings performance
- Well managed and controlled growth
- Competent management able to analyze the risks associated with the activities in determining appropriate capital levels
- Reasonable dividends and ability to raise new capital
- Low volume of problem assets

Capital rating 2

Rating “2” is characterized by similar criteria as “1”, but experiences weaknesses is one or more of the factors. For example:

- Capital and solvency ratios exceed regulatory requirements, but:
  - Problem assets relatively high
  - Management inability to maintain sufficient capital to support risks

Capital rating 3

Rating”3”indicates that the bank complies with capital adequacy and solvency regulatory requirements, but has major weaknesses in in one or more factors:

- High level of problem assets in excess of 25% of total capital
- Bank fails to comply with regulatory regulations
- Poor earnings
- Inability to raise new capital to meet regulatory requirements and correct deficiencies
- It requires regulatory oversight to ensure management and shareholders address the issues of concern

Capital rating 4

Rating "4" means that the bank is experiencing severe problems resulting in inadequate capital to support risks associated with the business and operations:

- High level of problems generating losses in all area of activities
- Problem loans in excess of 50% of total capital
- Insufficient capital
- Non compliance with regulatory requirements
- Management needs to take immediate action to correct deficiencies to avoid going into bankruptcy

Capital rating 5

Rating"5" indicates that the bank is insolvent:

- Strong regulatory oversight is needed to mitigate the loss to depositors and creditors
- Very slight possibility that actions from management will prevent the demise of the bank
- Only shareholders may be able to prevent the failure

ASSET QUALITY

Asset represents all the assets of the bank, current and fixed, loan portfolio, investments and real estate owned as well as off balance sheet transactions

Rating factors

Asset quality is based on the following considerations:

- Volume of problem of all assets
- Volume of overdue or rescheduled loans
- Ability of management to administer all the assets of the bank and to collect problem loans
- Large concentrations of loans and insiders loans, diversification of investments
- Loan portfolio management, written policies, procedures internal control, Management Information System
- Loan Loss Reserves in relation to problem credits and other assets
- Growth of loans volume in relation to the bank's capacity

Asset quality rating 1

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Asset quality rating “1” is characterized by:

- Ratio of troubled assets to capital is less than 2% or 3%
- Past due and extended loans kept under control by a specific unit, in accordance with the law
- Concentrations of credits and loans to insiders provide minimal risk
- Efficient loan portfolio management, close monitoring of problem loans
- Adequate Loan Loss Reserves in accordance with CBI’s regulations
- Non credit assets pose no loss threat

Asset quality rating 2

Asset quality rating "2" is assigned to banks that display similar characteristics as "1", but are experiencing non significant weaknesses, and the management is able to address these issues without close regulatory oversight.

- Problem assets do not exceed 10 % of total capital, but:
  - The bank is experiencing negative trends in the level of overdue and prolonged credits and of LLR
  - There are weaknesses in the management underwriting standards and control procedures
  - Loans to insider pose some regulatory concern, but can be easily corrected
  - Return on non credit assets is low and they display more than normal risk without posing a threat of loss

Asset quality rating 3

Asset quality rating “3” indicates that a bank displays weaknesses in one or more of the “2” factors. Regulatory oversight is required to ensure that management is able to address the problems. Other characteristics are:

- Bank is experiencing high level of past due and rescheduled credits
- Inadequate LLR
- Poor underwriting standards
- Policies and procedures are not properly implemented
- Inappropriate loans to insiders
- Non credit assets display abnormal risks and may pose a threat of loss

Asset quality rating 4

Asset quality rating "4" indicates a bank with severe problems resulting in inadequate capital to support risks associated with the bank business and operations.

- High volume of loss making loans, and;
  - Level of problem credits continues to increase and could result in insolvency
  - Doubtful and loss credits exceed LLR and pose a threat to capital
  - Non-credit assets pose major threat of loss of capital and may result in bank's insolvency
- Lack of proper policies and procedures

Asset quality rating 5

Asset quality rating”5” displays a high level of problem assets credit and non-credit, that impairs the capital or results in a negative capital.

- Problem assets to capital ratio above 50%
- Slight possibility that management actions can improve the quality of the bank
- Strong regulatory oversight is needed to prevent further capital erosion and protect depositors and creditors
- Law authorize CBI to send an custodian for assessment and recommendations

Management

Management includes all key managers and the Board of Directors

Rating factors

Management is the most important element for a successful operation of a bank. Rating is based on the following factors:

- Quality of the monitoring and support of the activities by the board and management and their ability to understand and respond to the risks associated with these activities in the present environment and to plan for the future
- Financial performance of the bank with regards to the other CAMELS ratings
- Development and implementation of written policies, procedures, MIS, risk monitoring system, reporting, safeguarding of documents, contingency plan and compliance with laws and regulations controlled by a compliance officer
- Availability of internal and external audit function
- Concentration or delegation of authority
- Compensations policies, job descriptions
- Response to CBI concerns and recommendations
- Overall performance of the bank and its risk profile

Management rating 1

Management rating "1" indicates a strong and committed management showing:

- A thorough understanding of the risks associated with the bank's activities
- A strong financial performance in all areas
- Appropriate understanding and response to changing economy
- Planning, control, implementation of internal policies
- Appropriate audit function
- No evidence of self-dealing
- Strong cooperation and interaction between the Board of Directors and the management and successful delegation of authority
- Competent and trained staff at all levels
- Management's reaction to CBI concerns and recommendations

Management rating 2

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Management rating “2” has the general characteristics of “1” but possesses some deficiencies in rating factors, that can be easily corrected without regulatory supervision.

Careful consideration should be given to the financial condition of the bank.

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Management rating 3

Management rating "3" displays major weaknesses in one or more of the rating factors. It needs regulatory supervision to ensure that management and Board takes corrective actions. Among the problems are:

- Significant insider abuse
- Disregard for regulatory requirements
- Poor assessment of risks and planning
- Inappropriate reactions to economic adversities and corrective actions
- Poor financial performance
- Lack of proper written policies and procedures

Management rating 4

Management rating "4" indicates major weaknesses in several areas.

- Strong regulatory action is needed
- Board of Directors should consider replacing or strengthen management due to:
  - Insider abuse
  - Disregard for regulatory requirements
  - Lack of proper policies
  - Damaging actions
- Poor financial performance may lead to insolvency

Management rating 5

Management rating “5” requires immediate and strong supervisory actions:

- Bank displays strong weaknesses in all areas
- Poor financial performance
- Insolvency very likely
- Consider replacing management
- Board of directors to consider receivership

Earnings

All income from operations, non-traditional sources, extraordinary items

Rating factors

Earnings are rated according to the following factors:

- Sufficient earnings to cover potential losses, provide adequate capital and pay reasonable dividends
- Composition of net income. Volume and stability of the components
- Level of expenses in relation to operations
- Reliance on extraordinary items, securities transactions, high risk activities
- Non traditional or operational sources
- Adequacy of budgeting, forecasting, control MIS of income and expenses
- Adequacy of provisions
- Earnings exposure to market risks, such as interest rate variations, foreign exchange fluctuations and price risk

Earnings rating 1

Rating “1” indicates:

- Sufficient income to meet reserve requirements, provide capital growth and pay reasonable dividends to shareholders
- Strong budgeting, planning and control of income and expenses
- Positive trends in major income and expenses categories
- Minimal reliance on extraordinary items and non traditional sources of income

Earnings rating 2

Rating “2” indicates that the bank generates sufficient income to meet reserve requirements, provide capital growth and pay dividends. Nevertheless there may be some negative trends such as:

- Relying somehow on non traditional income
- Need to improve budget, planning and control process

Management should be able to deal with the problems without regulatory supervision.

Earnings rating 3

Earnings rating "3" shows that the bank has major weaknesses in several of the rating factors.

- Regulatory supervision is needed to ensure management takes appropriate measures to improve earnings performance
- Insufficient earnings retention may impair capital position

Earning rating 4

Earning rating "4" indicates bank is experiencing severe earnings problems. Net profit may be positive, but insufficient to maintain adequate reserves and capital growth

- Strong regulatory supervision is needed to prevent loss of capital
- Management must take immediate action to improve income and reduce expenses
- Certain activities may have to be suspended
- Corrective action is needed to prevent losses developing into insolvency

Earning rating 5

Earning rating "5" shows bank is experiencing major losses that may lead into insolvency.

- Immediate action is needed and strong regulatory supervision is required from CBI

Liquidity

The ability to generate cash or turn quickly short term assets into cash

Rating factors

Liquidity is rated based on the following factors:

- Sources and volume of liquid funds available to meet short term obligations
- Volatility of deposits and loan demand
- Interest rates and maturities of assets and liabilities
- Access to money market and other sources of funds
- Diversification of funding sources
- Reliance on inter-bank market for short term funding
- Management ability to plan, control and measure liquidity process. MIS.
- Contingency plan

Liquidity rating 1

Liquidity rating "1" indicates a management having a thorough understanding of the bank's balance sheet.

- Sufficient liquid assets to meet loan demand and unexpected deposit reduction
- Little reliance on inter-bank market
- Strong and sophisticated planning, control and monitoring
- Existence of an contingency plan

Liquidity rating 2

Liquidity rating “2” has the same basic characteristics as a “1” but is experiencing some weaknesses in one or more of the rating factors. These weaknesses can be corrected promptly.

- Bank meets its liquidity requirements, but management lacks proper expertise for planning, control and monitoring
- Bank experienced liquidity problems. Management reacted appropriately but failed to take action to prevent a recurring risk
- Management is unaware of negative trends
- Management did not address liquidity problems

Liquidity rating 3

Liquidity rating”3” indicates a bank has major weaknesses in several factors.

- Regulatory supervision is usually required to assure management is taking care of the problems
- Poor liquidity management resulting in frequent liquidity concerns
- Management needs to address negative trends immediately to prevent a crisis in daily obligations

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Liquidity rating 4

Liquidity rating "4" shows a bank is experiencing severe liquidity problems.

- Requires immediate attention and regulatory control
- Actions must be taken to strengthen liquidity position to meet current obligations
- Management must engage in extensive planning to deal with the situation

Liquidity rating 5

Liquidity rating"5" shows a bank requires outside financial assistance to meet current liquidity requirements to prevent failure of the bank due to the inability to meet creditors and depositors needs.

Sensitivity to Market Risks

Sensitivity to market risks is not taken into consideration by CBI at the present time

Rating factors

Market risk is based primarily on the following evaluation factors:

- Sensitivity to adverse changes in interest rates, foreign exchange rates, commodity prices, fixed assets
  - Nature of the operations of the bank
  - Trends in the foreign currencies exposure
  - Changes in the value of the fixed assets of the bank
  - Importance of real estate assets resulting from loans write off
- Ability of management to identify, measure and control the market risks given the bank exposure to these risks

Composite rating

The composite rating assigned is not an arithmetic average of the component ratings, but is based on a qualitative analysis of the factors comprising each component, the interrelationship between components, and the overall level of supervisory concern about the bank.

Composite rating 1

Banks with a composite rating of “1” are sound in all aspects, generally have components rated 1 or 2 and are in substantial compliance with laws and regulations. Any weaknesses can be handled routinely by the board of directors and management. Banks are considered stable, well managed and capable of withstanding all but the most severe economic downturns. Risk management practices are strong and minimal supervisory oversight is required to ensure the continuation and validation of the bank’s fundamental soundness. Banks rated “1” give no cause for concern.

Composite rating 2

Banks with a composite rating of 2 are fundamentally sound; generally no component is rated higher than “3”, and is in substantial compliance with laws and regulations. Only moderate weaknesses are present and well within the capabilities of the board of directors’ and management’s capability and willingness to correct. These banks are stable and can withstand most economic downturns. Overall risk management practices are satisfactory and there are not material supervisory concerns. Supervisory response for “2” rated banks should be informal and limited.

Composite rating 3

Banks rated “3” generally have weaknesses in one or more component areas that if not corrected within a reasonable time frame could result in significant solvency or liquidity concerns. Management may lack the ability or willingness to effectively address weaknesses in a timely manner and these banks generally are less capable of withstanding business fluctuation and are vulnerable to outside influences. Risk management practices may be less than satisfactory and banks in this group may be in significant noncompliance with laws and regulations. The CBI should consider the need for administrative actions which provide clear guidance to management in addressing weaknesses. Failure appears unlikely, however, given the overall strength and financial capacity of these banks.

Composite rating 4

Banks rated "4" indicate serious unsafe and unsound practices and serious financial or managerial deficiencies that result in unsatisfactory performance. The weaknesses and problems are not being satisfactorily resolved by the board of directors and management. Risk management practices are generally unacceptable and there may be significant violations with laws and regulations. Problems range from severe to critically deficient and require close supervision and specific remedial action. The overall solvency of the bank is threatened if immediate and specific supervisory action is not taken.

Composite rating 5

Banks rated "5" exhibit extremely unsafe and unsound practices or conditions, critically deficient performance and their risk management practices are inadequate. The volume and severity of problems are beyond management's ability or willingness to control or correct. Failure is highly probable and immediate outside financial or other assistance is needed and on-going supervision is necessary.