THE CAPITAL IN CAMELS

by Steve Brown

Regulators follow a uniform rating system that has been in existence since 1979. While we have written about the CAMELS rating system, this entire week we devote time toward better understanding each subcomponent letter. During this time of extreme industry stress, many bankers have asked us to provide more detailed information of what regulators are looking for, in order to better prepare for the next examination. It is in that theme, that we begin with the "C" in CAMELS.

Regulators themselves tell bankers that the amount of capital needed at each bank depends on the risk profile of that bank. While there are established metrics that define "Well Capitalized," "Adequately Capitalized," etc., examiners really rate capital relative to the bank's risk profile. Just because a given bank in one's peer group has more capital than your bank does not mean it will carry a higher rating.

Some of the things regulators will analyze related to capital adequacy is quality, type and diversification of assets; underwriting standards; management quality and staffing levels; earnings available to augment capital; whether earnings are coming from core operations or from one-time events; exposures to changing interest rates (one reason they look so closely at ALCO reports); historical and planned growth; economic conditions; dividend history and projections; and bank geographic area (riskier areas under stress will usually result in a regulatory posture that more capital is better.

When assessing capital adequacy, we have found that regulators will most often look at some key ratios that include the Tier 1 Leverage Capital ratio (Tier 1 Capital/Average Assets); the Tier 1 Risk-Based Capital ("RBC") ratio (Tier 1 Capital/Risk Weighted Assets); and the Total RBC ratio (Total Capital/Risk Weighted Assets). The RBC ratios are a blunt attempt to measure capital relative to the bank's risk profile by adjusting assets and thereby account for overall portfolio risk. These ratios are just the beginning of a proper analysis, but they are tried and true and easily found in the Call Report, so they provide a good basis for comparison among banks.

Another consideration for bankers when it comes to capital relates to trends and tolerances. Banks will often get into trouble when board and management oversight is lacking; asset quality is declining; loan growth is concentrated and funded by wholesale sources; weaknesses are found in loan underwriting processes or credit administration (this is one reason we suggest bankers have loan reviews conducted every 6 months); poor monitoring and reporting; regularly exceeding limits; and unduly wide risk tolerances/policy limits (particularly in sectors that have been degrading).

When assessing capital adequacy, regulators will assess factors that include: level and quality of capital and the overall financial condition of the institution; ability of management to address emerging needs for additional capital; nature, trend, and volume of problem assets; adequacy of ALLL; balance sheet composition (including the nature and amount of intangible assets); market risk; concentration risk; nontraditional activity exposures; risks of off-balance sheet activities; quality and strength of earnings; reasonableness of dividends; access to other sources of capital; support provided by a parent holding company; prospects and plans for growth and past experience in managing growth. Each of these factors is closely analyzed by examiners, so bankers should be prepared.

Finally, composite ratings are assigned based on both qualitative factors (i.e. risk profile, portfolio shift, classifications, loan administration, etc.) and quantitative factors (i.e. Tier 1 Leverage ratio, RBC ratio, whether they have declined or are rising, etc.).

Understanding CAMELS can certainly be difficult and riding one in a sandstorm is next to impossible. That is, unless you have a good guide, lots of water and have prepared for the trip.

BANK NEWS

Housing Study

A new study by the University of Chicago finds 26% of mortgage defaults are calculated economic decisions to walk away from mortgages (strategic) due to excessive negative equity. The research also found that when negative equity hit $50k, 7% of those who considered "strategic" defaults immoral said they would walk away; when it hit $100k the number climbed to 22% and when it reached $200k, 37% said they would walk away.

Ugly Employment

The Labor Department reported that MI became the 1st state in 25Ys to see an unemployment rate above 15%, hitting 15.2% in June. Rounding out the rest of the top 5 were RI (12.4%), OR (12.2%), SC (12.1%) and NV (12%). In all, 15 states have unemployment rates of at least 10%.

Mortgage Delinquencies

In April, 3.42% of SFR loans in FNMA's portfolio were 90 days past due, up 8.6% from March and 41.3% from 2008 year end.

US Economic Projection

The latest IMF projection of the US economy indicates GDP will shrink 2.6% this year before expanding 0.8% in 2010.

Builder Stress

A study by the National Association of Home Builders finds 26% of builders say they have had contracts fall through because appraisals are coming in below the contract price.