# THE EARNINGS IN CAMELS

by Steve Brown

Camels are interesting animals. They can live up to 50Ys, have 2 sets of eyelashes (to protect against the sand) and do not store water in their humps (blood and fatty tissue actually create the hump). In addition to camels, banks are also interesting to us and as we all know in particular, earnings are much more interesting to shareholders and directors alike. Earnings are critically important to a bank because they not only fund dividends, but they also allow banks to remain competitive, maintain capital levels, grow and engage in new activities. The lower the earnings, the less flexibility a bank has, so earnings are important.

When assessing earnings under CAMELS, regulators look at several factors that include: level, trend and stability - are earnings fluctuating, what is the cause of the fluctuation, what is the impact on future earnings; quality/sources of earnings - can the source of earnings be relied upon or are they nonrecurring; capital augmentation - are earnings boosting capital or do they come from risky ventures; exposure to market risk - do earnings fluctuate significantly due to changing interest rates; and support for the ALLL - how much are earnings impacted by the allowance for loan losses.

Some key data points we have found examiners will take into account include: net income, net interest income, earnings before provisions and extraordinary items (core earnings), noninterest income, overhead expenses and ALLL. In this environment, even banks with strong historical earnings performance have been impacted by deterioration in the loan portfolio, rising overhead expenses, greater provisioning and other factors. Earnings are in short supply for most banks in the country, so examiners are taking a closer look at the root causes, contingency planning and future expectations.

Regulators assign a CAMELS rating to earnings based not only on the quantity and trend of earnings, but also factors that may affect the sustainability or quality of earnings. Inadequate risk management, high levels of market risk, loan losses, low levels of ALLL, and other factors all come into play during this evaluation process. Bankers should also understand that examiners will heavily discount extraordinary gains, nonrecurring events and favorable tax effects for the same reasons.

When assessing earnings, regulators will evaluate factors that include: level of earnings; trends and stability; ability to provide for adequate capital through retained earnings; quality/sources of earnings; level of expenses in relation to operations; adequacy of budgeting systems and forecasting processes; robustness of management information systems in general; adequacy of ALLL and exposure to market risks.

A CAMELS rating of "2" indicates the bank has earnings that are satisfactory and sufficient to support operations, while maintaining adequate capital and allowance levels (after consideration is given to asset quality, growth and other factors). A rating of "3" reflects a bank that needs to improve earnings, as they may not fully support operations or provide for the accretion of capital and ALLL (in relation to the institution's overall condition, growth and other factors affecting the quality, quantity, and trend of earnings).

As with banking, camels sometimes behave differently than one expects. A robust plan that protects earnings will help bankers pass examinations, leaving the choice of the right camel to cross the desert the more difficult decision. Earnings are tough to find these days (particularly with random FDIC special assessments), but this sandstorm cannot last forever so hang in there and keep moving forward.

# BANK NEWS

**Beige Book**

The Fed reported that the recession's pace has begun to ease for most of the US, though labor markets are extremely soft with overall employment to continue dropping.

**Small Biz Credit Cards**

The National Small Business Association said a survey of business owners finds 40% have had their credit card limits cut by banks, while 63% have seen their interest rates rise. This is worrisome when you consider 44% of small businesses indicate credit cards were a "major source" of financing over the past 12 months.

**Student Banking**

PNC has unrolled a program targeting students and their parents, linking 3 accounts for the purpose of long term savings, short term savings and essentially a checking account. Through the campaign, students can also ask parents for reimbursements. A Canadian credit union pulled in over 2k new members and $2.9mm in deposits from a campaign designed for those under 25Y.

**Lending**

In the 2Q, loan volumes at the 15 largest US banks fell 2.8% as caution continued. Actual volumes on new loans were far less, as over half of loans in April and May stemmed from LOC renewals and refinancing on mortgages according to WSJ. On the supply side, banks are reserving capital cushions against rising loan losses. As for demand, consumers are cutting spending and businesses are holding off on development plans.