INTRODUCTION

OTS uses the CAMELS rating system to evaluate an institution's overall condition and performance by assessing six rating components. The six components are Capital Adequacy, Asset Quality, Management, Earnings, Liquidity, and Sensitivity to Market Risk. OTS then assigns each institution a composite rating based on the examiner's assessment of its overall condition and level of supervisory concern. The rating system was revised in December 1996. The four federal banking agencies updated the rating definitions and addressed changes in the financial services industry and in supervisory policies and procedures that occurred since the rating system was first adopted in 1979. The Office of Thrift Supervision (OTS) adopted the revised Uniform Financial Institutions Rating System (UFIRS) effective for all safety and soundness examinations with start dates after January 31, 1997.

Aggregate rating information enables the public and Congress to assess the condition of the savings and loan industry. Because each of the banking regulatory agencies adopted this uniform rating system, Congress can readily compare composite rating data for all types of insured financial institutions.

Changes to UFIRS

The revised rating system places additional emphasis on management's effectiveness in identifying, measuring, monitoring and controlling risk. The interagency group made two principal enhancements to update the rating system while retaining its basic framework. First, the evaluation of interest rate and other non-credit financial risks was moved from the Liquidity and other components to a new sixth component called "Sensitivity to Market Risk." Thus, the revised rating system acronym is CAMELS. The new "S" component rating addresses the degree that changes in interest rates, commodity prices, and equity prices could adversely affect the institution's earnings or economic capital. The new component, while broad in scope, only focuses on those elements that are relevant to the thrift being examined. For example, foreign exchange and price risks may not be relevant to some thrifts and thus their "S" component rating will primarily focus on interest rate risk.

Another noteworthy change is that the definitions for composite 1-, 2-, and 3-rated institutions establish more explicit guidance for the component ratings:

- For composite 1-rated institutions, all components should generally be rated 1 or 2.
- For composite 2-rated institutions, component ratings should normally be no worse than 3.
- For composite 3-rated institutions, none of the component ratings should be worse than 4.

Such guidance, while not an absolute requirement, is more specific than previous CAMEL rating guidance. The revised UFIRS statement is the definitive statement on safety and soundness ratings. (See Appendix A.) The remainder of this handbook section expands on, or highlights certain parts of the policy statement as it applies to thrift institutions.

Composite Ratings

The composite rating is a qualitative assessment by the agency of the institution's condition and the agency's overall level of supervisory concern. Although the composite rating assigned to the thrift should normally have a close relationship to the individual CAMELS component ratings, you should not derive the composite rating merely by computing an arithmetic average of the component ratings. Such a simplistic, mechanical approach will not reflect the true condition of the savings association; nor will it indicate the appropriate supervisory actions.

You should include in the Examination Conclusions and Comments page of the report of examination (ROE) the following items:

- A discussion of the institution's composite rating.
- A reference to (not a repetition of) the applicable rating definition.
- A description of the institution's particular circumstances that affected the rating as defined.

You must ensure that the report comments and work papers support the assigned ratings.

One of the principal objectives of the CAMELS rating process is to identify, through the composite rating, those thrifts that pose a risk of failure and merit more than normal supervisory attention. Thus, you should give more weight to individual CAMELS criteria that more strongly affect the condition and viability of the thrift.

The composite CAMELS rating, the CAMELS component ratings, and supporting documentation all play an important part in the regulatory process in support of any necessary enforcement action.

OTS uses an institution's composite rating as one of the factors to determine whether the institution should be designated as being in "troubled condition." Any thrift that has a composite CAMELS rating of 4 or 5, is designated in troubled condition by OTS. Other qualifiers of "troubled condition" are defined in 12 CFR § 563.555. These thrifts are subject to greater regulatory scrutiny and restrictions, such as requirements to receive prior approval before engaging in certain activities.

When examining a thrift in troubled condition, you should consult the regulatory plan, supervisory correspondence, the previous examination, and any other pertinent information to determine the operating restrictions to which a thrift is subject. You must then analyze the institution's operations and ensure that it is in compliance with all restrictions. For further information regarding operating restrictions, refer to Handbook Section 370, Enforcement Actions.

The CAMELS ratings also support OTS's differential regulation policy. The composite CAMELS rating establishes both the OTS and the Federal Deposit Insurance Corporation (FDIC) fee assessment levels and determines the levels of supervisory oversight and restrictions. This policy provides tighter restrictions for thrifts with worse composite ratings and other factors, and is evident in the following guidance:

- Regulatory Bulletin (RB) 18 series (Enforcement Policy).
- RB 3b (Growth Restrictions).
- OTS asset-based assessment regulation at 12 CFR § 502.1.
- OTS audit regulation at 12 CFR §562.4.
- OTS transactions with affiliates regulation at 12 CFR § 563.41.
- OTS capital regulations at 12 CFR § 565.4.
- OTS directors regulation at 12 CFR §§ 563.550 through 563.590.
- FDIC risk-based deposit insurance assessment regulation at 12 CFR Part 327.

Component Ratings

As the introduction states, component ratings indicate an institution's performance in the six key performance groups that are common to all institutions.

Capital Adequacy

Maintaining an adequate level of capital is a critical element for depository institutions. While meeting regulatory capital requirements is a key factor in determining capital adequacy, the institution's operations and risk position may warrant additional capital beyond the minimum regulatory requirements. You should determine whether capital is adequate in relation to the risk profile and operations of the thrift. In addition, you should evaluate capital levels in relation to future needs.

Since maintaining a sufficient level of capital is critical for an institution to maintain operations, you should appropriately weigh the importance of capital on the viability of the thrift when formulating the composite rating. You should also consider the institution's dividend payout policy and practice. You should rate an institution's capital adequacy considering all criteria cited in the UFIRS statement.

PCA Levels

Note that, in general, an institution in any of the three lower-tier Prompt Corrective Action (PCA) categories warrants a 4 or 5 Capital component rating. A capital rating of 4 is appropriate if the thrift is undercapitalized or significantly undercapitalized but asset quality, earnings, or interest rate risk problems will not cause the thrift to become critically undercapitalized in the next 12 months. Also, a capital rating of 4 may be appropriate for an institution that does not have sufficient capital based on its capital level compared with the risks present in its operations, even though the thrift may meet the minimum regulatory requirements.

An institution is presumed to warrant a 5 rating if it is "critically undercapitalized," or has significant asset quality problems, negative earning trends, or high interest rate risk exposure that will cause the thrift to become critically undercapitalized within the next 12 months.

See the Capital Chapter of this Handbook for more detailed instructions for reviewing capital adequacy.

Asset Quality

An accurate evaluation of an institution's asset quality can be one of the most important products of the examination. The asset quality rating reflects the extent of credit risk associated with the loan and investment portfolios, real estate owned, other assets, and off-balance sheet risks as well as the institution's ability to manage those risks. The evaluation of an institution's asset quality is dependent on the institution's policies and procedures relating to loan underwriting and asset procurement, the proper classification of assets, and the adequacy of the institution's valuation allowances.

The component and composite ratings demonstrate the level of supervisory concern over an institution, its activities, and its performance. When asset quality is in doubt because of excessive or inadequately controlled risk, the institution's asset quality component rating should reflect this concern. In order to attain a 1 or 2 Asset Quality component rating, an institution must fully control its credit risk. If an institution has a high exposure to credit risk, it is not sufficient to demonstrate that the loans are profitable or that the institution has not experienced significant losses in the near term. Management must demonstrate that it has identified credit risks, measured the potential exposure to loss, established systems to monitor such risk on an ongoing basis, and has adequate measures in place to limit and control those risks. Otherwise, a significant supervisory concern will exist relative to the institution's asset quality.

Management

The management rating is a reflection of the performance of the entire management team of the thrift. This includes the board of directors and all levels of management. The rating is an assessment of management's overall effectiveness.

The directors have two basic responsibilities:

- Provide for effective thrift management.
- Establish objectives and policies appropriate for their thrift.

Directors are also responsible for ensuring that management effectively implements these policies and initiates corrective action when necessary to ensure adequate management control and results.

You should base your assessment of management on a historical, current, and prospective evaluation of management's effectiveness in addressing problems the thrift encounters. Since financial performance is the primary indicator of the viability of an institution, the thrift's financial performance will strongly influence the management rating.

Often a new management team or a new key senior executive officer assumes the administrative responsibility of a thrift in troubled condition. You should not rate new management too highly based on performance projections, newly implemented policies and procedures, or management's aggressive attempts to solve those problems. The management rating should reflect the actual results of management's efforts. As such, the management component rating should be conservative until new management demonstrates the ability to actually improve the institution's condition, or at a minimum, its policies, procedures, and key operational areas. For example, new management improved loan underwriting, collections, and the Internal Asset Review (IAR) functions on a consistent basis. Unless management implements such broad improvements, the management rating should generally be no higher than a 3 for an institution with poor operating performance.

You must be keenly aware of unsafe and unsound practices such as self-dealing that results in unofficial compensation to management or directors. Self-dealing may result from actions undertaken directly by management or directors, or by their agents. Business dealings with insiders should be for the benefit of the thrift and on terms substantially the same as those with third parties. Self-dealing provides grounds for an unsatisfactory management rating.

Earnings

You must determine whether earnings are sufficient for necessary capital formation. An institution should have minimum earnings sufficient to absorb losses without impairing capital. Quality (stability) and composition (source) of earnings are important criteria. The thrift cannot rely on income that is nonrecurring, such as gains on the sale of portfolio loans, to maintain profitability. You should consider the extent to which extraordinary items, such as nonrecurring securities transactions and tax effects contribute to net income.

In some cases, thrifts are able to sustain volume and stable earnings from noninterest sources of income; for example, mortgage banking operations. In these thrifts (as well as all other thrifts), you should use professional judgment and analyze the stability and sufficiency of noninterest earnings. This includes the institution's ability to react quickly to changing economic conditions, such as a decline in mortgage originations.

You should consider the adequacy of transfers to the general and specific valuation allowances; if the thrift needs more allowances, earnings will be negatively affected.

You should also consider the institution's operating risks to determine if its earnings position is stable and sufficient. For example, if an institution's interest rate risk management is inadequate, the institution's earnings may be adversely affected by a change in market interest rates.

Liquidity

OTS measures liquidity in relation to an institution's level of liquid assets, its outside sources of funds, and the adequacy of its funds (or cash flow) management practices. Historically, most thrifts have held sufficient liquid assets. OTS-supervised thrifts generally rely upon liquidity available from secured lines of credit with the Federal Home Loan Banks (FHLBs). As long as the thrift's performance is sufficient to allow it to maintain a favorable credit standing with the FHLBs, and as long as the FHLBs also have adequate liquidity, thrifts can continue to confidently rely upon them for their liquidity needs.

Sensitivity to Market Risk

The UFIRS bases the sensitivity to market risk component rating on two dimensions:

- The institution's level of market risk.
- The quality of the institution's practices for managing market risk.

Because few thrift institutions have significant exposure to foreign exchange risk or commodity or equity price risks, OTS generally assesses interest rate risk as the only form of market risk. You must assess both dimensions and combine those assessments into a component rating.

You must base your conclusions about an institution's level of interest rate risk – the first dimension for determining the S component rating – primarily on the interest rate sensitivity of the institution's net portfolio value (NPV). You must pay primary attention to two specific measures of risk: Interest Rate Sensitivity Measure and Post-shock NPV Ratio. (See the TB 13a glossary for definitions.)

- Interest Rate Sensitivity Measure. This measure by itself, may not give cause for supervisory concern when the institution has a strong capital position. Because an institution's risk of failure is inextricably linked to capital and, hence, to its ability to absorb adverse economic shocks, an institution with a high level of economic capital, that is, NPV, may be able safely to support a high sensitivity measure.

- Post-shock NPV Ratio. This ratio is a more comprehensive gauge of risk than the sensitivity measure because it incorporates estimates of the current economic value of an institution's portfolio, in addition to the reported capital level and interest rate risk sensitivity. There are three potential causes of a low, that is, risky, post-shock NPV ratio:

  — low reported capital
  — significant unrecognized depreciation in the value of the portfolio
  — high interest rate sensitivity.

Although the first two situations may cause supervisory concern and receive attention under the portions of the examination devoted to evaluating Capital Adequacy, Asset Quality, or Earnings, they do not necessarily represent an interest rate risk problem. Only when an institution's low post-shock NPV is, in whole or in part, caused by high interest rate sensitivity is there suggestion of an interest rate risk problem.

Refer to TB 13a (Section IV, Table 1) for the guidelines to determine the level of interest rate risk. Use these risk levels as starting points in your ratings assessments; however, you have broad discretion to exercise judgment. TB 13a provides these risk levels as guidance; they are not mandatory.

OTS produces quarterly estimates of the sensitivity measure of the post-shock NPV ratio for each thrift that files TFR Schedule CMR. You can find these estimates in the Interest Rate Risk Exposure Report for the thrift.

In drawing conclusions about the quality of an institution's risk management practices – the second dimension of the S component rating – you must assess all significant facets of the institution's risk management process.

Consider the following eight factors when assessing the quality of an institution's risk management practices:

- Quality of oversight by the board and senior management.
- Prudence of board-approved IRR limits.
- Adherence to IRR limits.
- Quality of system for measuring NPV sensitivity.
- Quality of system for measuring earnings sensitivity.
- Integration of risk management with decision-making.
- Investments and derivatives including risk management policies and procedures.
- Institution's size, complexity, and risk profile.

Although TB 13a (Table 2) provides guidelines on how to combine your assessment of these two dimensions into a component rating, you must exercise judgment in assigning ratings based on the facts you encounter at each institution. TB 13a (Section IV) provides a non-exhaustive list of factors you might consider in applying the S rating guidelines to a particular institution.

Thrift Performance Evaluation and CAMELS Rating Assignments

The Uniform Thrift Performance Report (UTPR) provides percentile rankings for many measures of thrift performance as compared to peer performance. Use the Thrift Monitoring System (TMS) Group Query process to find the CAMELS composite and component ratings of other thrifts with similar key ratios. These tools are useful in comparing a thrift's performance with that of its peers to assign ratings that are consistent with thrifts having similar ratios. However, since the composite CAMELS rating is an indicator of the overall health and viability of an institution, it is important that you rate thrifts on their absolute performance rather than only against regional or state peer performance. Thrifts in some states or regions may perform better than peer averages or medians, but perform poorly in absolute terms or when compared with peer averages or medians of other regions. Peer performance in such cases would not necessarily reflect thrifts that were being operated in a safe and sound manner. Rather, those averages could reflect substandard performance. The CAMELS ratings should accurately reflect the condition of a thrift, regardless of local or regional peer performance.

An institution's performance cannot be measured solely in numbers. The mere fact that an institution meets its minimum regulatory capital, liquidity, and other regulatory requirements does not guarantee that its condition is viable. Therefore, you must use professional judgment and consider both qualitative and quantitative criteria when analyzing an institution's performance.

You should consider the following items to determine the CAMELS composite and component ratings:

- Quality of management and the board of directors.
- Quality and composition of the asset portfolio.
- Risks inherent in the business activities.
- Financial data.

Further, since financial numbers are lagging indicators of an institution's condition, you must also conduct a qualitative analysis of current and projected operations when assigning CAMELS ratings. You should weigh the analysis of quantitative and qualitative data to determine the rating for each CAMELS component.

An institution with a high level of classified assets, a decreasing trend in foreclosures and delinquencies, and adequate general valuation allowances, loan underwriting, and an IAR program may merit a higher asset quality rating than an institution with the same level of classified assets, an increasing trend in foreclosures and delinquencies, and inadequate general valuation allowances, loan underwriting, and IAR program. Qualitative criteria related to these ratios may mitigate the institution's condition and, hence, the rating. You should consider all significant criteria, both qualitative and quantitative, when assigning CAMELS ratings.

You must consider all applicable information reviewed under each CAMELS component on a scale of 1 to 5. You must then make a qualitative assessment of the information reviewed for each CAMELS component to assign the ratings.

OTS structured this Handbook and the ROE around the CAMELS components. An analysis of an institution's overall soundness cannot be made without adequate consideration of all six areas and their interrelationships. This Handbook Section briefly presents the main areas you must review in order to assign the six CAMELS component ratings and the composite rating. The remaining chapters in this Handbook provide detailed instructions for the review of each CAMELS component. You should follow the examination procedures within each of the chapters as required by the examination scope to develop the CAMELS component ratings.

Consistency in CAMELS Rating Assignments

It is essential that OTS apply CAMELS ratings on a nationally consistent basis. Inconsistencies in assigning CAMELS component or composite ratings may result in confusion and degrade the integrity of the supervisory process. When OTS consistently applies CAMELS ratings, the condition of the thrift can be compared between the previous examination and the most recent examination. Furthermore, thrifts can be compared on an intraregional and a national basis using TMS Group Query reports sorted by key ratios or imported into a spreadsheet and sorted by component ratings. To ensure consistency in the CAMELS rating process, you must have a thorough understanding of the criteria to assign the different CAMELS component and composite ratings.

Maintaining and Updating the CAMELS Ratings

It is also essential that regional offices monitor new developments for each thrift and update the ratings, as needed, so that the rating is always a current indicator of the institution's condition. (Refer to the procedures for off-site CAMELS ratings at the end of this Handbook Section.) Maintaining these ratings requires periodic monitoring with an emphasis on the criteria supporting the CAMELS ratings for the thrift. For this reason, it is imperative that you document the significant points supporting the CAMELS rating.

Deterioration or significant changes in the institution's operations or condition may indicate a need for some special supervisory attention. Supervisory attention may include a telephone inquiry or written request for additional information, a special limited examination, or a regular examination. Any changes in the criteria that support the current ratings or any new developments may require a change in the CAMELS ratings and the supervisory treatment needed.

Since ratings affect the institution's assessment and supervisory treatment, they must be kept current. Analyze and adequately document any updates to the ratings. The rating reported to a thrift must always be the most recent rating based on all sources of information.

Documentation and Support

Given the importance of the CAMELS ratings, it is critical to clearly show and support how you determined these ratings. You should review ROE ratios, UTPR schedules, and customized TMS reports and use them to concisely document and support the analysis. You may also find these reports useful in assimilating and reviewing work paper conclusions and organizing your thoughts before drafting the ROE.

Disclosure of CAMELS Ratings

Since 1988, OTS disclosed composite or overall examination ratings to each institution’s management and board of directors. Concurrent with the adoption of the new UFIRS rating system, OTS began disclosing the CAMELS component ratings with the CAMEL composite rating in the ROE. Disclosure of the CAMELS component ratings encourages a more complete and open discussion of examination findings and recommendations between examiners and thrift management. Further, disclosure of the CAMELS component ratings in addition to the composite rating provides management with a better understanding of how OTS derives the composite rating. Disclosure also enables management to better address any weaknesses in specific areas before OTS finds it necessary to downgrade the institution’s overall composite rating. Use the following rating disclosure procedures for all safety and soundness examinations, including joint and concurrent examinations, that OTS conducts.

You must disclose the assigned composite rating in accordance with OTS’s ROE instructions. Add the component rating to the top left corner of each ROE core component page. Report comments on the Examination Conclusions and Comments page and on other related schedules throughout the report should fully support the composite and component ratings assigned. The individual core page for a component rating should continue to contain a clear and thorough discussion of that component. You should support component ratings with selected use of statistics. Use language that is clear and informative, appropriate in tone, and explain your assignments, conclusions, and reasoning.

Management Discussions

You must disclose CAMELS composite and component ratings at exit conferences with senior management and, when appropriate, the board of directors. You should obtain sufficient concurrence with the ratings from regional management, so that the component ratings disclosed are final, or subject to revisions only in rare instances. If the ratings are subject to further review, you should disclose to thrift management that the ratings are not final. Each region has office procedures to implement this policy.

During the discussion with management, you should discuss the criteria you considered in assigning each component rating as well as the overall composite rating. You should indicate that you based the composite rating on a careful evaluation of the institution's managerial, operational and financial performance, and compliance with laws and regulations. You should clarify that you did not base the composite rating on an arithmetic average of the components, but on a qualitative analysis of the criteria comprising each component, the interrelationship between components, and, more importantly, the overall level of supervisory concern.

The quality of management is the single most important element in the successful operation of a thrift, and is usually the factor that is most indicative of how well the institution identifies, measures, monitors, and controls risk. For this reason, you should take sufficient time to explain to senior management and, when appropriate, to the board of directors, the criteria you considered in assigning the management component rating, and the meaning of the rating. Your written comments in support of the management rating should include an assessment of the effectiveness of existing processes to identify, measure, monitor, and control risk. Finally, you should remind management that the CAMELS composite and component ratings disclosed in the examination report remain subject to the confidentiality rules imposed by 12 CFR Part 510 of the OTS Regulations. This includes the verbal disclosures made at the conclusion of the examination.

REFERENCES

Code of Federal Regulations (12 CFR)

OTS Regulations

§502.1	Asset-based Assessments
§562.4	Audit of Savings Associations and Holding Companies
§563.41	Loans and Other Transactions With Affiliates
§563.550	Additions of Directors and Employment of Senior Executive Officers
§565.4	Capital Measures and Capital Category Definitions

FDIC Regulations

Part 327	Assessments

Office of Thrift Supervision Bulletins

RB 3b	Policy Statement on Growth for Insured Institutions
RB 18	General Enforcement Policy Series
TB 13a	Management of Interest Rate Risk, Investment Securities, and Derivative Activities
TB 69	Revised Rating System; Disclosure of Component Ratings (the UFIRS is attached)
TB 69-1	Common Questions on the Revised UFIRS (the FFIEC document is attached)

Other References

OTS Report of Examination Instructions Manual

FFIEC Press Release, "Uniform Financial Institutions Rating System," December 19, 1996

OTS Transmittal 166: Regulatory Citations to UFIRS