BANK POLICY INSTITUTE

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Contact: Sean Oblack (202-589-2456)
sean.oblack@bpi.com

BPI Offers Recommendations Regarding How to Revise Rating Systems to Reflect their Current Functions and Consequences

Washington, D.C. –The Bank Policy Institute (BPI) submitted a comment letter to the Federal Reserve and Federal Deposit Insurance Corporation in response to their request for information seeking public input on a fundamental aspect of how the federal banking agencies supervise banks, the Uniform Financial Institution Rating System (UFIRS). The UFIRS is commonly known as the CAMELS ratings, an acronym of the six components it evaluates for each U.S. bank: capital adequacy, asset quality, management, earnings, liquidity and sensitivity to market risk. The Federal Financial Institutions Examination Council (FFIEC) adopted UFIRS in 1979, and though the purpose it now serves has fundamentally changed, the implementation has changed very little since inception.

"The purpose of CAMELS ratings has changed fundamentally; the consequences of poor CAMELS ratings have become significant, severe and legally binding; and a regulatory revolution has occurred in terms of establishing more objective and accurate ways to assess certain CAMELS components," wrote BPI President and CEO Greg Baer in the letter. "There have been innumerable changes to how banks are regulated since the last revision to the UFIRS that make it outdated and substandard as a measure of financial condition."

The letter details the evolution of UFIRS and demonstrates how it was designed to be a supervisory tool without formal legal consequence, but bank CAMELS ratings are now serving roles such as setting deposit insurance premiums, determining whether a bank or its parent may expand and determining whether a bank has access to credit at the Federal Reserve. The new roles for UFIRS argue for clarifying its purpose – in particular, to assess the financial condition of the bank. The letter observes that the "M" (Management) component of CAMELS has deviated from this purpose and should (if retained) going forward reflect management's ability and resources to keep the bank's financial condition strong. The letter then goes on to offer concrete recommendations for updating each of the other CAMELS ratings components as well as the overall composite rating to more clearly serve this purpose and reflect innovations in bank supervision and regulation such as stress-testing.

Finally, the letter concludes by recommending further study of the CAMELS framework to assess whether it is an effective evaluation methodology at all.

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Americans, make nearly half of the nation's small business loans, and are an engine for financial innovation and economic growth.

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