

# Monetary Trends



## The Condition of Banks: What Are Examiners Finding?

Bank supervisory agencies use on-site examinations to measure the condition of banks. Federal law requires these agencies to examine each bank at least once every 18 months. Most of these examinations assess six aspects of a bank's operations: capital protection (C), asset quality (A), management competence (M), earnings strength (E), liquidity risk (L), and sensitivity to market risk (S). According to this CAMELS system, a bank receives a rating of 1 (best) through 5 (worst) on each of these six aspects as well as a composite rating. Composite CAMELS ratings of 1 or 2 indicate that supervisors consider a bank to be in sound condition. Supervisors use a CAMELS 3 rating for banks that exhibit some degree of concern in one or more areas; a rating of 4 or 5 indicates more serious problems.

While the CAMELS ratings assigned to individual banks are confidential, comparison of CAMELS ratings across all banks over time may provide useful information about the condition of U.S. banks as a whole. The percentage of banks rated below CAMELS 1 or 2 was substantially higher during 1991 (a recession year) than during recent recessionary quarters. In the first quarter of 1991, 17.8 percent of banks had CAMELS ratings of 3 and 10.1 percent had ratings of 4 or 5. In the first quarter of 2002, in contrast, 6.2 percent of banks had CAMELS ratings of 3 and 1.5 percent had ratings of 4 or 5.

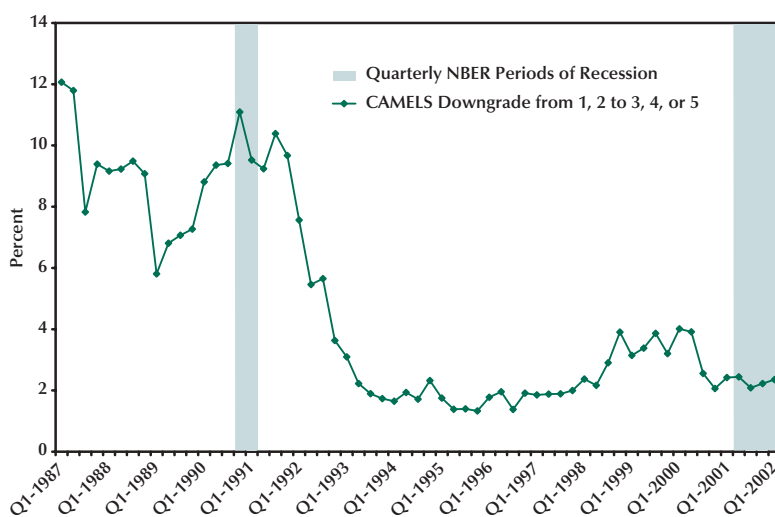
The CAMELS rating of a bank at a given point in time reflects the results of an examination conducted sometime during the prior 18 months. The figure indicates the extent to which examiners identified problems during exams conducted in each quarter since 1987. For each quarter, the denominator of the ratio plotted in the figure is the number of banks that entered the quarter with a CAMELS 1 or 2 rating and were subject to

examinations begun during that quarter. The numerator is the number of these banks that received CAMELS ratings of 3, 4, or 5 on those examinations begun during that quarter. The shaded areas are recession periods.

CAMELS ratings downgrades from 1 or 2 to a 3, 4, or 5 have been much less frequent since March 2001, the peak of the last expansion, than during the late 1980s and early 1990s. The percentage of banks downgraded in a quarter rose to just over 10 percent during the recession of the early 1990s, peaking at about 11 percent in the fourth quarter of 1990. In contrast, the downgrade percentage was just above 2 percent during 2001 and the first quarter of 2002. By this indicator, most banks continue to be in sound condition. The conclusion is unchanged if we weight the banks examined in each quarter according to their assets. Thus, the percentage of banks currently rated below CAMELS 2 is low by standards of recent years—and especially low by standards of the prior recession period.

—R. Alton Gilbert and Sarosh R. Khan

**CAMELS Downgrades**



SOURCE: Federal Reserve System.

