Composite Rating and Supervisory Actions

Now that you have a fairly good understanding of each CAMELS component and the rating process, it's time to talk about the overall composite rating that examiners assign to your bank. It's important to know that the composite rating is not the arithmetic average of the component ratings. Some components are given more weight than others, depending on how critical they are to the overall health of the bank. For example, the management component is factored in very heavily, because weaknesses in management oversight can affect every aspect of the bank. Also, examiners typically place more emphasis on asset quality when assigning a composite rating. This is because of the "domino" effect that asset problems can have on your bank. For instance, problem loans can directly impact earnings through lost interest income, higher collection expenses, and higher provisions for loan losses. Furthermore, additional capital may be necessary for the bank's increased risk profile.

Let's review the ratings we assigned to the CAMELS components at First State Bank.

Capital – 3
Assets – 3
Management – 3
Earnings – 3
Liquidity – 2
Sensitivity – 2

Now take a look at the following composite rating definitions and see which one is most appropriate for First State Bank.

Composite Rating

Composite 1 - Financial institutions in this group are sound in every respect and generally have components rated "1" or "2". Any weaknesses are minor and can be handled in a routine manner by the board of directors and management. These financial institutions are the most capable of withstanding the vagaries of business conditions and are resistant to outside influences such as economic instability in their trade area. These financial institutions are in substantial compliance with laws and regulations. As a result, these financial institutions exhibit the strongest performance and risk management practices relative to the institution's size, complexity, and risk profile, and give no cause for supervisory concern.

Composite 2 - Financial institutions in this group are fundamentally sound. For a financial institution to receive this rating, generally no component rating should be more severe than "3". Only moderate weaknesses are present and are well within the board of directors' and management's capabilities and willingness to correct. These financial institutions are stable and are capable of withstanding business fluctuations. These financial institutions are in substantial compliance with laws and regulations. Overall risk management practices are satisfactory relative to the institution's size, complexity, and risk profile. There are no material supervisory concerns and, as a result, the supervisory response is informal and limited.

Composite 3 - Financial institutions in this group exhibit some degree of supervisory concern in one or more of the component areas. These financial institutions exhibit a combination of weaknesses that may range from moderate to severe; however, the magnitude of the deficiencies generally will not cause a component to be rated more severely than “4”. Management may lack the ability or willingness to effectively address weaknesses within appropriate time frames. Financial institutions in this group generally are less capable of withstanding business fluctuations and are more vulnerable to outside influences than those institutions rated a composite “1” or “2”. Additionally, these financial institutions may be in significant noncompliance with laws and regulations. Risk management practices may be less than satisfactory relative to the institution's size, complexity, and risk profile. These financial institutions require more than normal supervision, which may include formal or informal enforcement actions. Failure appears unlikely, however, given the overall strength and financial capacity of these institutions.

Composite 4 - Financial institutions in this group generally exhibit unsafe and unsound practices or conditions. There are serious financial or managerial deficiencies that result in unsatisfactory performance. The problems range from severe to critically deficient. The weaknesses and problems are not being satisfactorily addressed or resolved by the board of directors and management. Financial institutions in this group generally are not capable of withstanding business fluctuations. There may be significant noncompliance with laws and regulations. Risk management practices are generally unacceptable relative to the institution's size, complexity, and risk profile. Close supervisory attention is required, which means, in most cases, formal enforcement action is necessary to address the problems. Institutions in this group pose a risk to the deposit insurance fund. Failure is a distinct possibility if the problems and weaknesses are not satisfactorily addressed and resolved.

Composite 5 - Financial institutions in this group exhibit extremely unsafe and unsound practices or conditions; exhibit a critically deficient performance; often contain inadequate risk management practices relative to the institution's size, complexity, and risk profile; and are of the greatest supervisory concern. The volume and severity of problems are beyond management's ability or willingness to control or correct. Immediate outside financial or other assistance is needed in order for the financial institution to be viable. Ongoing supervisory attention is necessary. Institutions in this group pose a significant risk to the deposit insurance fund and failure is highly probable.

What is the most appropriate composite rating for First State Bank?

1. Strong (link to Composite Rating answer)
2. Satisfactory (link to Composite Rating answer)
3. Less than satisfactory (link to Composite Rating answer)

4. Unsatisfactory (link to Composite Rating answer)
5. Critically deficient (link to Composite Rating answer)

[Answer] Examiners assigned the bank a composite rating of “3”. The rating reflects less-than satisfactory risk management practices in most of the CAMELS components. It also reflects the bank’s elevated risk profile caused by inadequate management and board oversight, leading to deterioration in the loan portfolio. You may have assigned a “4” rating, which is not uncommon for directors going through this course. The problems in this bank are certainly of a serious nature but probably not yet severe enough to warrant a composite “4” since the problems appear to be relatively new to this bank. The examiners will likely address these deficiencies with some type of enforcement action.

Now let’s move on to the enforcement actions module.