




# Taking CAMELS for a “Test Drive”



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# Disclaimer

**The views and opinions expressed in this presentation are solely those of the speaker and do not necessarily represent those of the Federal Reserve Bank of Richmond or the Federal Reserve System.**

# Disclaimer / Reminders #2 & #3

**#2 - Your bank's CAMELS rating is Confidential, so if you know it, please do not share it.**

**#3 – This case study is fictitious any resemblance to an actual bank is purely coincidental.**

# Agenda

- Introduction
- Complete Dogwood Bank & Trust case study
- Compare & Contrast Banks Rated Composite 1, 2, 3, 4 & 5
- Dispel Common Myths about Examiners
- Q&A

# What day is it?

1

- Strong

2

- Satisfactory

3

- Less than Satisfactory

4

- Deficient

5

- Critically Deficient

# CAMELS

○Capital

○Asset Quality

○Management

○Earnings

○Liquidity

○Sensitivity to Market Risk

○Composite

○Risk Management

# Dogwood Bank & Trust - Background

- 6/30/2017 - 2
- 12/31/2019 – 3
- \$350 million in assets



# More about Dogwood

- Main office and one branch located in Dogwood, Virginia, a small, but growing bedroom community for the big city of Riverville.
- Bank expanded into another market in August 2015 by opening its 3rd office about 45 miles away in Beach City.
- Majority of Asset Quality problems were originated in Beach City office.
- Bank is currently subject to an enforcement action

Component Ratings	12/31/2019
Capital	<b>3</b>
Asset Quality	<b>3</b>
Management	<b>3</b>
Earnings	<b>5</b>
Liquidity	<b>2</b>
Sensitivity to Market Risk	<b>2</b>
<b>Composite</b>	<b>3</b>
Risk Management	<b>3</b>

# Your Assignment

- 6/30/2020 Safety and Soundness exam work has been completed
- Analyze the results and provide a rating for each CAMELS
  - Components
  - Risk management
  - Composite



# Asset Quality

- Underwriting including Growth & Quality
- Credit Risk Management & Risk Identification
- Loan Policy
- Classifications & Delinquencies
- Loan Loss Reserve (ALLL)
- Concentrations of Credit
- Investment Portfolio



# Dogwood – AQ – 12/2019 Exam

- Aggressive Construction & Land Development (CLD) lending growth, especially in Beach City
- Lax credit administration
- Weak internal credit review process
- Examiners downgraded 15 relationships
- Nine appraisal violations
- 62% of C&LD loans are classified
- ALLL methodology and level not adequate
  - Additional provision to ALLL required
- **Most problem assets are classified Substandard**

# AQ Ratios

	6/2020	12/2019
<b>Total Classifications</b>	<b>65.5</b>	<b>95.5</b>
<b>Weighted Classifications</b>	<b>14.5</b>	<b>32.5</b>
<b>Past Due Ratio</b>	<b>4.25</b>	<b>4.50</b>
<b>ALLL / Total Loans</b>	<b>2.0</b>	<b>1.5</b>

# AQ - Current Exam

- Loan personnel have been focused on identifying and addressing problem credits
- Created workout area to address problem loans.
- Improved MIS to track loan documentation exceptions. Number is reduced but are still present.
- Management has adopted more stringent underwriting standards
- Acknowledged concentration risk management needs improvement but no significant progress made
- Noted improvements in ability to identify and internally risk rate loans that have credit weaknesses; only one downgrade during this AQ review compared with 12 at previous exam.
- Improvement noted in ALLL methodology, which fundamentally conforms to regulatory guidance; downgrade resulted in minimal additional provision of \$150,000 needed at this examination

# Earnings

- Provide for Capital & ALLL
- Quality and Composition
  - Net Interest Margin
  - Noninterest Income
  - Overhead
  - Provision for Loan Losses
  - Nonrecurring Items (income or expense)
- Level and trend
- Vulnerability to market risk
- Risk Management – Budgeting Process



# Dogwood – Earnings Results

- At previous exam, ALLL methodology was deemed inappropriate and unacceptable. Management was required to add an additional \$4.8 million to the ALLL, which caused a loss for the year.
- Return on Assets (ROA) for the most recent six months has been 0.11%.
- Exposure to interest rate risk is not excessive.

# Earnings

	<b>6/30/2020 Budget</b>	<b>6/30/2020 Actual</b>	<b>12/31/2019</b>
<b>Net Income</b>	<b>\$203,000</b>	<b>\$187,500</b>	<b>\$(4,000,000)</b>
<b>Provision for Loan Losses</b>	<b>\$1,350,000</b>	<b>\$1,500,000</b>	<b>\$4,800,000</b>

	<b>2020</b>	<b>Peer</b>	<b>2019</b>	<b>2017</b>
<b>ROA</b>	<b>0.11</b>	<b>0.95</b>	<b>(1.14)</b>	<b>1.05</b>
<b>NIM</b>	<b>3.25</b>	<b>3.95</b>	<b>3.75</b>	<b>4.25</b>

# Capital

- Level
- Growth Expectations & Commitments
- Quantity & Quality of Earnings
- Reasonableness of Dividends
- Access to Capital
- Asset Quality (AQ rule of thumb)
- Strength of risk management practices





# Dogwood – Capital Ratios

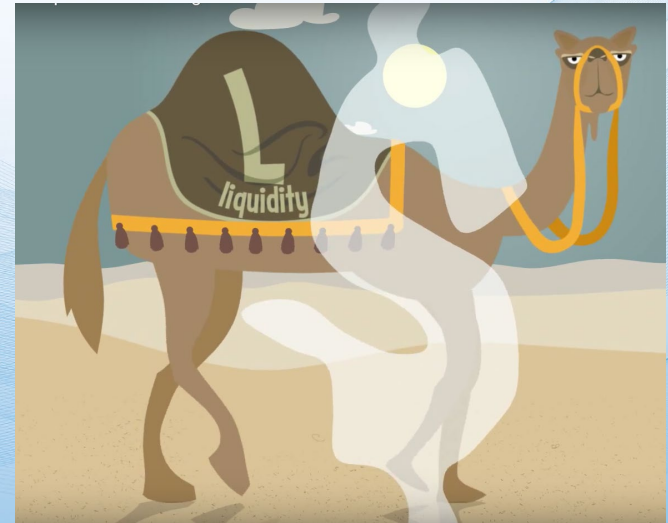
	<b>Current Exam</b>	<b>2019</b>	<b>2017</b>	<b>Well Capitalized</b>
Tier 1 Leverage	6.28%	6.25%	8.35%	5.0%
Common Equity Tier 1 Leverage	6.26%	6.22%	8.31%	6.5%
Tier 1 Risk Based Capital	9.75%	9.44%	10.85%	8.0%
Total Risk Based Capital	11.05%	10.95%	12.65%	10.0%

# Dogwood – Capital Results

- At previous examination, capital ratios declined rapidly to 6.2% (tier one leverage) and 10.9% (total risk-based capital), just above the minimums for Well Capitalized.
- At this exam, ratios are 6.2% and 11.0% respectively.
- Reluctant to raise capital due to family concerns over dilution, but family is discussing additional investment.

# Liquidity

- Adequacy of sources
- Ability to meet needs
- Stability of deposits
- Reliance on “non core” funding
- Liquid Assets
- Loans & Commitments
- Access
- Risk Management & Monitoring
- Contingency Planning

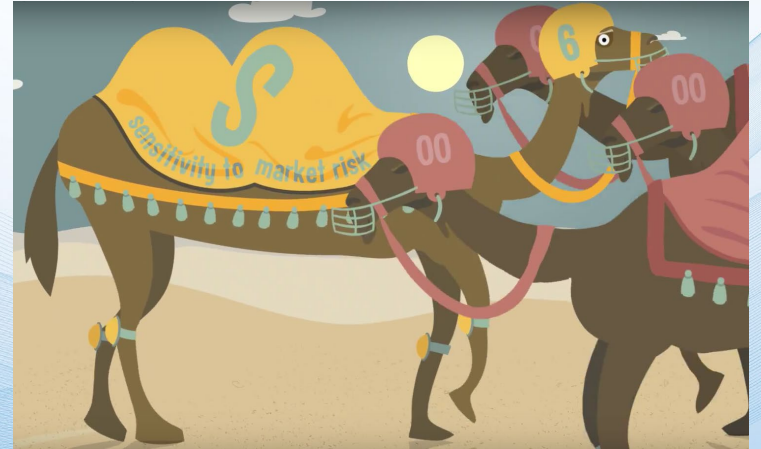


# Dogwood – Liquidity Results

- Bank has sufficient short-term assets and access to funding sources to meet expected funding needs in near term.
- Forward looking cash flow analysis is adequate.
- Deposit base is relatively stable and diversified; reliance on brokered funds is slightly higher than average.

# Sensitivity to Market Risk

- Primarily Interest Rate Risk for community banks
- How sensitive are earnings and capital to changes in interest rates?
- Ability to identify, measure, monitor, and control interest rate risk

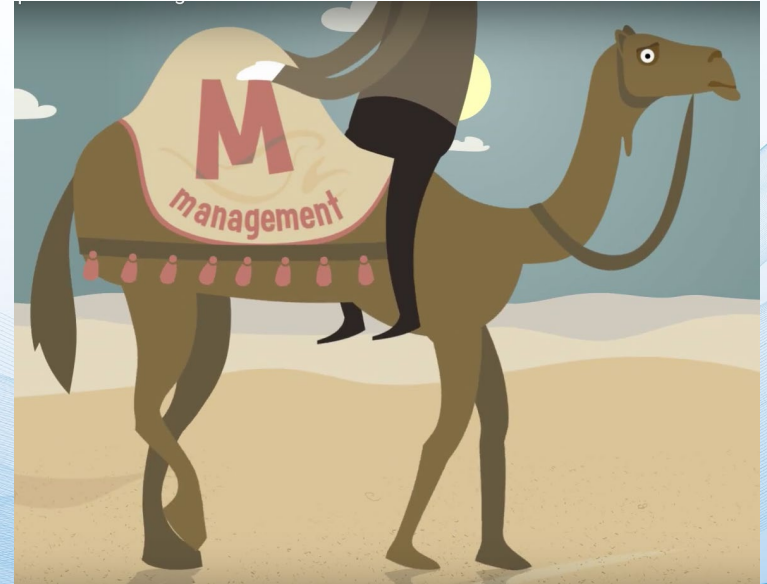


# Dogwood – Sensitivity to Market Risk

- Level of risk is within tolerance range
- Bank utilizes acceptable models to determine risk, and as a result, monitoring of risk is considered adequate.
- Policy is adequate in light of noncomplex balance sheet structure.

# Management

- Quality of Board and Senior Management Oversight
- Corporate Governance
- Strategic Planning & Ability to Adapt
- Management Depth & Succession
- Compliance with Laws and Regulations
- Overall Performance & Risk Profile
- Adequacy of Risk Management Processes
  - (Risk Management Rating)



# Risk Management

- Effective Risk Management
- Identify – Measure – Monitor – Control
  - Active board and senior management oversight
  - Adequate policies, procedures, and limits
  - Adequate risk management, monitoring, and MIS
  - Comprehensive internal controls and audits

Credit

Market

Liquidity

Operational

Compliance

Legal



# Dogwood – Previous Exam

## Management / Risk Management

- President Waters controlled virtually all aspects of the operation.
- Previously considered satisfactory; responsive to examiners recommendations
- Failed to recognize changes in the economy and related credit risks and did not develop an overall plan to address the rapid increase in classifications.
- Policies generally adequate (with the exception of the loan policy) but were not regularly being enforced.
- Management is operating outside of policy guidelines in the loan area and board awareness or approval of policy exceptions is not evident.
- Somewhat frequent use of renewals and extensions masked the true risk profile of the loan portfolio, which resulted in a portion of the increase in the ALLL provision.
- Fledgling Internal Audit department

# Dogwood – Current Exam Management / Risk Management

- President continues to be heavily involved in day-to-day operations.
- Board has taken a more active role in management of bank
- Hired experienced Credit Risk Officer (CRO) who has led improvements previously outlined in AQ / credit risk management
- Board is provided monthly updates from CRO and Internal Auditor regarding problem loans, ALLL methodology, and other areas with weaknesses outlined in exams
- Strategic planning has been minimal but management stated Board intends to limit growth and focus on reducing risk in real estate portfolio and conduct an economic analysis of the bank's markets
- Several previous recommendations such as loan exception tracking report have been implemented.
- Subcommittee established to review and update all bank policies over the next four quarters.

**Component Ratings****6/30/2020****12/31/2019****Capital****3****Asset Quality****3****Management****3****Earnings****5****Liquidity****2****Sensitivity to Market Risk****2****Composite****3****Risk Management****3**

# Composite Snapshots

1



2



3



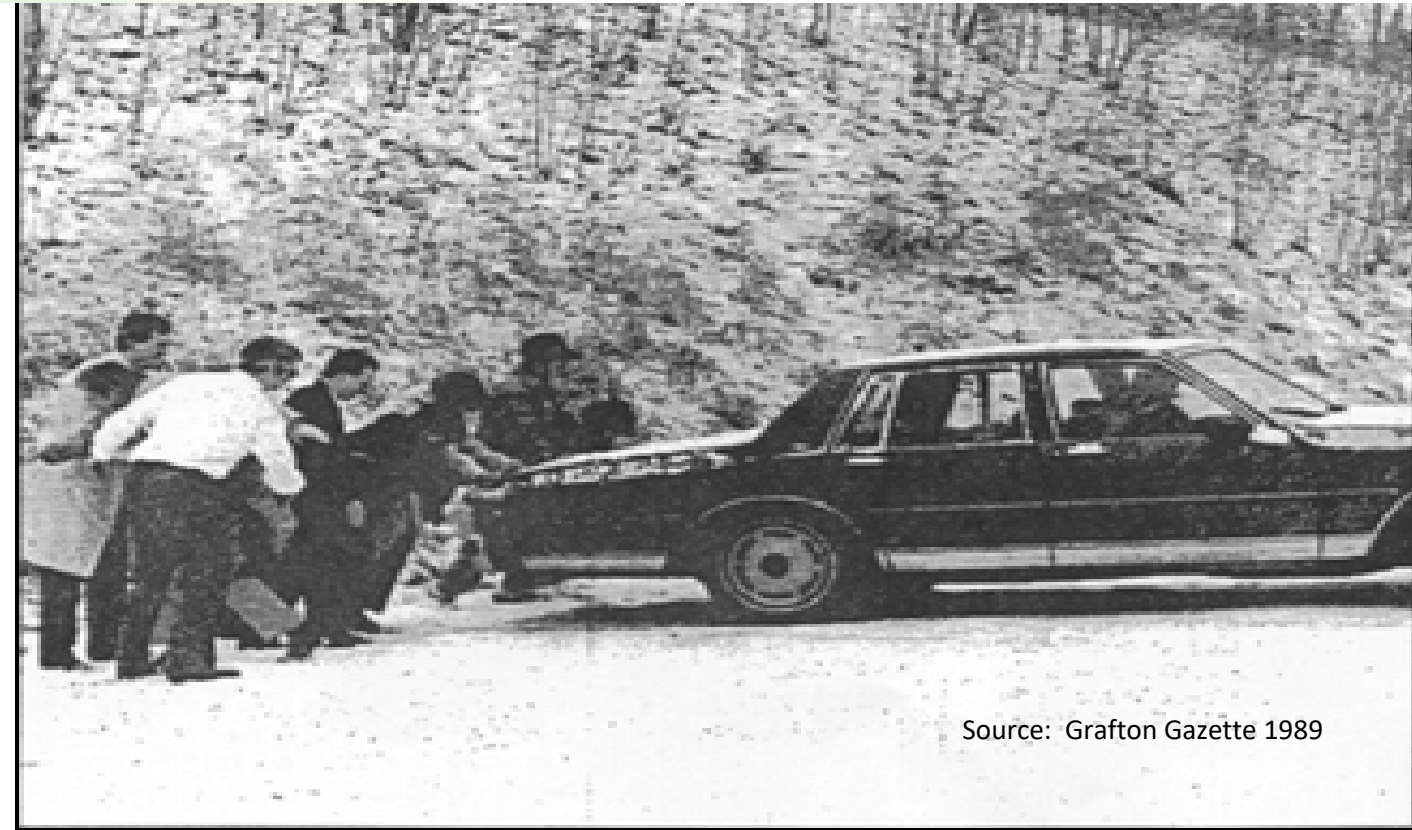
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# Glamorous Life of a Bank Examiner



Source: Grafton Gazette 1989



# Questions?



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