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February 28, 2020

Via Electronic Mail to:

Ms. Ann E. Misback
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington D.C. 20551

Mr. Robert E. Feldman
Executive Secretary
Attention: Comments
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington D.C. 20429

Re: Docket No. OP-1681; RIN 3064-ZA08. Response to Request for Information on
Application of the Uniform Financial Institutions Rating System

Dear Ms. Misback and Mr. Feldman:

I am writing in response to the request for information on the application of the Uniform Financial Institutions Rating System, or UFIRS, also known as the CAMELS ratings system, as noticed in a Request for Information published in the October 31, 2019, issue of the Federal Register, page 58383.

I bring to this comment letter the perspective of having served for over thirty years as an expert witness in litigation arising from the failure of various banks and thrifts. Without exception, I have served as an expert on behalf of defendants in litigation brought by the FDIC and, years ago, brought by the Federal Home Loan Bank Board on behalf of the FSLIC. In several cases, I also have served as an expert on behalf of defendants in criminal proceedings.

A key aspect of my work as an expert has been reviewing examination reports and related supervisory materials pertaining to failed depository institutions. These reviews were conducted in accordance with the provisions of confidentiality statements I signed in which I agreed to not disclose to outside parties whatever confidential information I learned while reviewing these documents. Without exception, I have honored that obligation, including in drafting this comment letter.

One aspect of the document reviews I have conducted consisted of reviewing CAMELS ratings assigned to failed institutions, prior to their failure, as well as related materials, such as enforcement orders and supervisory correspondence, such as letters sent from the examiner-in-charge and other regulators to the officers and directors of a troubled bank or thrift.

I first noted years ago and without exception in the years since then that declines in a bank's composite CAMELS ratings as well as individual components of the composite rating materially lagged the actual deteriorating condition of the institution, as measured by accounting and other data, such as increases in non-performing loans and loan charge-offs, rapid asset growth, high expense levels, unhealthy geographic risk concentrations, and other indicators of an increasing risk of failure.

Quite often, after several years of poor performance, when the bank or thrift's CAMELS components would be slowly deteriorating, with a mix of 2s and 3s and perhaps an occasional 4, the components would suddenly become 4s and 5s immediately preceding the bank or thrift's closure. In effect, the failed institution's examiners played catch-up in the CAMELS ratings they assigned to the failing institution.

Although I have not conducted a systematic review of reports on failed banks and thrifts conducted by the inspector generals of the bank regulatory agencies, my strong sense when reviewing those reports, and specifically the recitation of the history of each failed institution's CAMELS ratings, was the existence of the same phenomenon I had previously observed as an expert witness – a decided lag in the decline of the CAMELS ratings assigned to failing institutions. I recommend that FDIC staff conduct a systemic analysis for at least a sample of failed banks and thrifts since 2003 to determine the correlation, if any, between CAMELS ratings and forward-looking measures of the failed banks' financial health. My sense is that similar weaknesses are evident in institutions that end up not failing, except they either turn themselves around or they were acquired by a healthily institution.

Undoubtedly numerous reasons can be offered for the quite evident lag in CAMELS rating declines reflecting the deteriorating condition of a bank or thrift, but I believe the underlying reason for this lag has been and continues to be the inability or unwillingness of bank examiners and supervisors to identify and quantify leading indicators of banking risk. This phenomenon, of course, also is reflected in the FDIC's so-called risk-sensitive deposit insurance premiums; i.e., these premium rates invariably reflect lagging measures of banking risk rather than leading indicators of risk, which if priced properly, would deter risky banking practices in a timely manner, thereby reducing failures.

Hence, if the FDIC is going to revamp the manner in which it determines CAMELS ratings so that they properly reflect a bank's riskiness, the FDIC should do so in the context of developing risk-sensitive deposit-insurance premium formulae that properly reflect leading indicators of banking risk, such as, to cite just two examples, excessively rapid asset growth and real-estate loan concentrations in geographic areas experiencing overbuilding or weak economic conditions.

Properly priced, risk-sensitive deposit insurance premiums might then spark this question: What is the rationale for assigning a CAMELS rating to a bank if its deposit-insurance risk is properly priced? There might be a need for non-solvency-rated ratings, such as a rating reflecting compliance with anti-money-laundering regulations, but such a rating would not have to be reflective of the bank's financial condition or probability of failure.

I have appreciated the opportunity to submit this comment letter. Should FDIC and/or Federal Reserve staff so desire, I would welcome the opportunity to expand on the information and perspectives provided in this letter.

Very truly yours,

A handwritten signature in blue ink that reads "Bert Ely". The signature is fluid and cursive, with the first name "Bert" and the last name "Ely" clearly distinguishable.

Bert Ely