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Don't Blame Camels for Human Failures

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In "It's Time to Kill Camels" (June 3), Richard J. Parsons declares that the Camels regulatory rating scheme is "unreliable, unpredictable and outright misleading"and needs to be killed. I'll leave it to PETA to comment on the propriety of the sentence, but as someone who has been involved in bank regulation since, well, before the advent of Camels, I'd like to suggest a stay of execution until we have a little better grasp of the problem.

It is certainly true that the Camels ratings – which assess Capital adequacy, Assets, Management capability, Earnings, Liquidity and Sensitivity to market risk – often failed to predict the failure of banks through several down cycles in the economy. It is equally true that in most cases, examiners noted the potential problems and commented on them. It is not quite so clear whether the failures were attributable to intrinsic flaws in the Uniform Financial Institutions Rating System. In fact, my experience suggests a combination of problems likely were to blame.

Parsons correctly observes that an effective regulatory scheme needs to be "forward-looking." However, his assertion that Camels ratings are "backward-looking" is not strictly speaking true. In fact, Camels ratings are intended to be forward-looking, though the examiners' conclusions and recommendations are supposed to be informed by past performance, as well as current circumstances and conditions, all within the context of an understanding of the direction the banks and the markets and economy in which they operate, are moving. Indeed, early in the Great Recession, the FDIC produced a very good training video intended to remind them of the need for forward-looking supervision.

There are certainly faults in the Camels system, but in my experience they have been rooted in how the ratings are used. Examiners or their supervisors are inconsistent in their understanding or application of the ratings definitions. Extended periods of economic prosperity and strong bank performance sow complacency. Regulators tend to let economic fluctuations sway the examiners' interpretations of the ratings definitions. And like most human beings, examiners are demonstrably better at predicting the past than the future.

With regard to the latter, regulators began to see the looming bubble in commercial real estate, and the risks of concentrations, but failed to get the attention of bankers in time to avert an economic catastrophe. Remember the huge controversy over whether proposed concentration limits for CRE and acquisition, development and construction loans ought to be "guidelines"or regulations? Among those who saw the bubble forming, few could have predicted the depth, breadth and velocity of the problem, with property values – that is to say, collateral values – plunging by as much as half in some markets, virtually overnight. If they had, what banker would have believed them? It would have been extremely difficult for regulators to have taken the punch bowl away in 2006, just when the party was at its height. And this is exactly the problem bankers, regulators and the nation will need to come to grips with before memories fade and the next bubble forms.

None of this is to say that a better regulatory mousetrap can't be devised. It is to suggest that we need to be cautious about scrapping the old one without fully understanding why we think it failed. Any human endeavor is prone to failure, as any system is subject to improvement.

Much of the current regulatory focus seems to be fixed on computer modeling. I have serious concerns about the direction this is taking, as even computers must extrapolate past data and performance ratios, fueled by assumptions with the same limitations, into future markets that may well behave differently than those through which we have passed. My own thinking is that while such modeling is useful, we need to temper it with the understanding that "management" is a uniquely human function not yet within the ken of computer logic. And as has always been the case, it is the quality, intelligence, integrity and adaptability of management that determines how well banks manage through good times and bad.

It ain't all the Camels' fault.

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