CENTRAL BANK OF LIBERIA

GUIDELINES FOR
CAMELS RATINGS
AT LIBERIAN BANKS

September 30, 2005

BANK SUPERVISION DEPARTMENT
MONROVIA, LIBERIA

Central Bank of Liberia

Bank Supervision Department Guidelines:

Application of the CAMELS Rating System in the Supervision of Liberian Banks

The Bank Supervision Department (BSD) of the Central Bank of Liberia (CBL) is responsible for monitoring the financial conditions of the commercial banks it has licensed to be part of the Liberian Banking Sector. The BSD is additionally responsible for enforcing related legislative requirements as well as regulatory policies adopted and published by the CBL.

Although much of the data required to fulfill these legal requirements can be sourced from regulatory reports submitted by the Liberian Banks, on-site examinations are needed to verify report accuracy and to gather further supervisory information.

One of the primary approaches to the assessment of and rating of commercial banks that has developed within the industry is the use of CAMELS ratings. These supervisory ratings are assigned at the end of exams, whether on-site or off-site, and are generally disclosed only to a bank's board of directors and its senior management team and to the appropriate supervisory authorities.

CAMELS ratings are commonly viewed as summary measures of the private supervisory information gathered by examiners regarding banks' overall financial conditions, although they also reflect available public information as well.

What are CAMELS ratings?

During a bank examination, whether an on-site or an off-site examination, the BSD examiners gather proprietary information, such as details on problem loans, with which to evaluate a bank's financial condition and to monitor its compliance with Liberian laws and regulatory policies. A key product of such an examination is a supervisory rating of the bank's overall condition, commonly referred to as a CAMELS rating. This' rating system has been developed within the banking industry to provide a convenient summary of bank conditions at the time of an exam.

The acronym "CAMELS" refers to the six components of a bank's condition that are assessed: Capital adequacy, Asset quality, Management, Earnings, Liquidity and a bank's Sensitivity to market risk. Ratings are assigned for each component in additional to the assignment of an overall rating of the bank's financial condition.

The ratings are assigned on a scale from 1 to 5. Banks with ratings of 1 or 2 are considered to present few, if any, supervisory concerns, while banks with ratings of 3, 4, or 5 present moderate to extreme degrees of supervisory concern.

All examination work papers and materials are confidential, including the CAMELS rating and its associated assessment documentation. A bank's CAMELS rating is disclosed by the CBL to only the bank's board of directors and its senior management and, of course to appropriate supervisory staff. CAMELS ratings are thus never released by the BSD as the public might then infer any supervisory action to be taken by the CBL because of a bank's condition as evidenced by the CAMELS rating assigned to that bank.

This Guideline is to provide the licensed banks of the Liberian Banking Sector with the details of the CAMELS rating employed by the BSD and a clear understanding of how each component is defined.

Component Ratings

Each of the component rating descriptions is divided into three sections: an introductory paragraph; a list of the principal evaluation factors that relate to that component; and a brief description of each numerical rating for that component. Some of the evaluation factors are reiterated under one or more of the other components to reinforce the interrelationship between components. The listing of evaluation factors for each component rating is in no particular order of importance.

Capital Adequacy

A financial institution is expected to maintain capital commensurate with the nature and extent of risks to the institution and the ability of management to identify, measure, monitor, and control these risks. The effect of credit, market, and other risks on the institution's financial condition should be considered when evaluating the adequacy of capital. The types and quantity of risk inherent in an institution's activities will determine the extent to which it may be necessary to maintain capital at levels above required regulatory minimums to properly reflect the potentially adverse consequences that these risks may have on the institution's capital.

Capital Adequacy - Evaluation Factors

The capital adequacy of an institution is rated based upon, but not limited to, an assessment of the following evaluation factors:

The level and quality of capital and the overall financial condition of the institution.

The ability of management to address emerging needs for additional capital.

The nature, trend, and volume of problem assets, and the ad13quacyof allowances for loan and lease losses and other valuation reserves.

Balance sheet composition, including the nature and amount of intangible assets, market risk, concentration risk, and risks associated with nontraditional activities.

Risk exposure represented by off-balance sheet activities.

The quality and strength of earnings, and the reasonableness of dividends.

Prospects and plans for growth, as well as past experience in managing growth.

Access to capital markets and other sources of capital, including support provided by a parent holding company.

Capital Adequacy Ratings

1. A rating of 1 indicates a strong capital level relative to the institution's risk profile.

2. A rating of 2 indicates a satisfactory capital level relative to the financial institution's risk profile.

3. A rating of 3 indicates a less than satisfactory level of capital that does not fully support the institution's risk profile. The rating indicates a need for improvement, even if the institution's capital level exceeds minimum regulatory and statutory requirements.

4. A rating of 4 indicates a deficient level of capital. In light of the institution's risk profile, viability of the institution may be threatened. Assistance from shareholders or other external sources of financial support may be required.

5. A rating of 5 indicates a critically deficient level of capital such that the institution's viability is threatened. Immediate assistance from shareholders or other external sources of financial support is required.

Asset Quality

The asset quality rating reflects the quantity of existing and potential credit risk associated with the loan and investment portfolios, other real estate owned, and other assets, as well as off-balance sheet transactions. The ability of management to identify, measure, monitor, and control credit risk is also reflected here. The evaluation of asset quality should consider the adequacy of the allowance for loan and lease losses and weigh the exposure to counterparty, issuer, or borrower default under actual or implied contractual agreements. All other risks that may affect the value or marketability of an institution's assets, including, but not limited to, operating, market, reputation, strategic, or compliance risks, should also be considered.

Asset Quality - Evaluation Factors

The asset quality of a financial institution is rated based upon, but not limited to, an assessment of the following evaluation factors:

The adequacy of underwriting standards, soundness of credit administration practices, and appropriateness of risk identification practices.

The level, distribution, severity, and trend of problem, classified, nonaccrual, restructured, delinquent, and nonperforming assets for both on- and off-balance sheet transactions.

The adequacy of the allowance for loan and lease losses and other asset valuation reserves.

The credit risk arising from or reduced by off-balance sheet transactions, such as unfunded commitments, credit derivatives, commercial and standby letters of credit, and lines of credit.

The diversification and quality of the loan and investment portfolios.

The extent of securities underwriting activities and exposure to counterparties in trading activities.

The existence of asset concentrations.

The adequacy of loan and investment policies, procedures, and practices.

The ability of management to properly administer its assets, including the timely identification and collection of problem assets.

The adequacy of internal controls and management information systems.

The volume and nature of credit documentation exceptions.

Asset Quality - Ratings

1. A rating of 1 indicates strong asset quality and credit administration practices. Identified weaknesses are minor in nature and risk exposure is modest in relation to capital protection and management's abilities. Asset quality in such institutions is of minimal supervisory concern.

2. A rating of 2 indicates satisfactory asset quality and credit administration practices. The level and severity of classifications and other weaknesses warrant a limited level of supervisory attention. Risk exposure is commensurate with capital protection and management's abilities.

3. A rating of 3 is assigned when asset quality or credit administration practices are less than satisfactory. Trends may be stable or indicate deterioration in asset quality or an increase in risk exposure. The level and severity of classified assets, other weaknesses, and risks require an elevated level of supervisory concern. There is generally a need to improve credit administration and risk management practices.

4. A rating of 4 is assigned to financial institutions with deficient asset quality or credit administration practices. The levels of risk and problem assets are significant, inadequately controlled, and subject the financial institution to potential losses that, if left unchecked, may threaten its viability.

5. A rating of 5 represents critically deficient asset quality or credit administration practices that present an imminent threat to the institution's viability.

Management

The capability of the board of directors and management, in their respective roles, to identify, measure, monitor, and control the risks of an institution's activities and to ensure a financial institution's safe, sound, and efficient operation in compliance with applicable laws and regulations is reflected in this rating. Generally, directors need not be actively involved in day-to-day operations; however, they must provide clear guidance regarding acceptable risk exposure levels and ensure that appropriate policies, procedures, and practices have been established. Senior management is responsible for developing and implementing policies, procedures, and practices that translate the board's goals, objectives, and risk limits into prudent operating standards.

Depending on the nature and scope of an institution's activities, management practices may need to address some or all of the following risks: credit, market, operating or transaction, reputation, strategic, compliance, legal, liquidity, and other risks. Sound management practices are demonstrated by: active oversight by the board of directors and management; competent personnel; adequate policies, processes, and controls taking into consideration the size and sophistication of the institution; maintenance of an appropriate audit program and internal control environment; and effective risk monitoring and management information systems. This rating should reflect the board's and management's ability as it applies to all aspects of banking operations as well as other financial service activities in which the institution is involved.

Management – Evaluation Factors

The capability and performance of management and the board of directors is rated based upon, but not limited to, an assessment of the following evaluation factors:

The level and quality of oversight and support of all institution activities by the board of directors and management.

The ability of the board of directors and management, in their respective roles, to plan for, and respond to, risks that may arise from changing business conditions or the initiation of new activities or products.

The adequacy of, and conformance with, appropriate internal policies and controls addressing the operations and risks of significant activities.

The accuracy, timeliness, and effectiveness of management information and risk monitoring systems appropriate for the institution's size, complexity, and risk profile. The adequacy of audits and internal controls to: promote effective operations and reliable financial al1d regulatory reporting; safeguard assets; and ensure compliance with laws, regulations, and internal policies.

Compliance with laws and regulations.

Responsiveness to recommendations from auditors and supervisory authorities.

Management depth and succession.

The extent that the board of directors and management is affected by, or susceptible to, dominant influence or concentration of authority.

Reasonableness of compensation policies and avoidance of self-dealing.

Demonstrated willingness to serve the legitimate banking needs of the community.

The overall performance of the institution and its risk profile.

Management - Ratings

1. A rating of 1 indicates strong performance by management and the board of directors and strong risk management practices relative to the institution's size, complexity, and risk profile. All significant risks are consistently and effectively identified, measured, monitored, and controlled. Management and the board have demonstrated the ability to promptly and successfully address existing and potential problems and risks.

2. A rating of 2 indicates satisfactory management and board performance and risk management practices relative to the institution's size, complexity, and risk profile. Minor weaknesses may exist, but are not material to the safety and soundness of the institution and are being addressed. In general, significant risks and problems are effectively identified, measured, monitored, and controlled.

3. A rating of 3 indicates management and board performance that need improvement or risk management practices that are less than satisfactory given the nature of the institution's activities. The capabilities of management or the board of directors may be insufficient for the type, size, or condition of the institution. Problems and significant risks may be inadequately identified, measured, monitored, or controlled.

4. A rating of 4 indicates deficient management and board performance or risk management practices that are inadequate considering the nature of an institution's activities. The level of problems and risk exposure is excessive. Problems and significant risks are inadequately identified, measured, monitored, or controlled and require immediate action by the board and management to preserve the soundness of the institution. Replacing or strengthening management or the board may be necessary.

5. A rating of 5 indicates critically deficient management and board performance or risk management practices. Management and the board of directors have not demonstrated the ability to correct problems and implement appropriate risk management practices. Problems and significant risks are inadequately identified,

measured, monitored, or controlled and now threaten the continued viability of the institution. Replacing or strengthening management or the board of directors is necessary.

Earnings

This rating reflects not only the quantity and trend of earnings, but also factors that may affect the sustainability or quality of earnings. The quantity as well as the quality of earnings can be affected by excessive or inadequately managed credit risk that may result in loan losses and require additions to the allowance for loan and lease losses, or by high levels of market risk that may unduly expose an institution's earnings to volatility in interest rates. The quality of earnings may also be diminished by undue reliance on extraordinary gains, nonrecurring events, or favorable tax effects. Future earnings may be adversely affected by an inability to forecast or control funding and operating expenses, improperly executed or ill-advised business strategies, or poorly managed or uncontrolled exposure to other risks.

Earnings - Evaluation Factors

The rating of an institution's earnings is based upon, but not limited to, an assessment of the following evaluation factors:

The level of earnings, including trends and stability.

The ability to provide for adequate capital through retained earnings.

The quality and sources of earnings.

The level of expenses in relation to operations.

The adequacy of the budgeting systems, forecasting processes, and management information systems in general.

The adequacy of provisions to maintain the allowance for loan and lease losses and other valuation allowance accounts.

The earnings exposure to market risk such as interest rate, foreign exchange, and price risks.

Earnings - Ratings

1. A rating of 1 indicates earnings that are strong. Earnings are more than sufficient to support operations and maintain adequate capital and allowance levels after consideration is given to asset quality, growth, and other factors affecting the quality, quantity, and trend of earnings.

2. A rating of 2 indicates earnings that are satisfactory. Earnings are sufficient to support operations and maintain adequate capital and allowance levels after

consideration is given to asset quality, growth, and other factors affecting the quality, quantity, and trend of earnings. Earnings that are relatively static, or even experiencing a slight decline, may receive a 2 rating provided the institution's level of earnings is adequate in view of the assessment factors listed above.

3. A rating of 3 indicates earnings that need to be improved. Earnings may not fully support operations and provide for the accretion of capital and allowance levels in relation to the institution's overall condition, growth, and other factors affecting the quality, quantity, and trend of earnings.

4. A rating of 4 indicates earnings that are deficient. Earnings are insufficient to support operations and maintain appropriate capital and allowance levels. Institutions so rated may be characterized by erratic fluctuations in net income or net interest margin, the development of significant negative trends, nominal or unsustainable earnings, intermittent losses, or a substantive drop in earnings from the previous years 5 A rating of 5 indicates earnings that are critically deficient. A financial institution with earnings rated 5 is experiencing losses that represent a distinct threat to its viability through the erosion of capital.

Liquidity

In evaluating the adequacy of a financial institution's liquidity position, consideration should be given to the current level and prospective sources of liquidity compared to funding needs, as well as to the adequacy of funds management practices relative to the institution's size, complexity, and risk profile. In general, funds management practices should ensure that an institution is able to maintain a level of liquidity sufficient to meet its financial obligations in a timely manner and to fulfill the legitimate banking needs of its community. Practices should reflect the ability of the institution to manage unplanned changes in funding sources, as well as react to changes in market conditions that affect the ability to quickly liquidate assets with minimal loss. In addition, funds management practices should ensure that liquidity is not maintained at a high cost, or through undue reliance on funding sources that may not be available in times of financial stress or adverse changes in market conditions.

Liquidity - Evaluation Factors

Liquidity is rated based upon, but not limited to, an assessment of the following evaluation factors:

The adequacy of liquidity sources compared to present and future needs and the ability of the institution to meet liquidity needs without adversely affecting its operations or condition.

The availability of assets readily convertible to cash without undue loss.

Access to money markets and other sources of funding.

The level of diversification of funding sources, both on-and off-balance sheets.

The degree of reliance on short-term, volatile sources of funds, including borrowings and brokered deposits, to fund longer term assets.

The trend and stability of deposits.

The ability to securitize and sell certain pools of assets.

The capability of management to properly identify, measure, monitor, and control the institution's liquidity position, including the effectiveness of funds management strategies, liquidity policies, management information systems, and contingency funding plans.

Liquidity - Ratings

1. A rating of 1 indicates strong liquidity levels and well-developed funds management practices. The institution has reliable access to sufficient sources of funds on favorable terms to meet present and anticipated liquidity needs.

2. A rating of 2 indicates satisfactory liquidity levels and funds management practices. The institution has access to sufficient sources of funds on acceptable terms to meet present and anticipated liquidity needs. Modest weaknesses may be evident in funds management practices.

3. A rating of 3 indicates liquidity levels or funds management practices in need of improvement. Institutions rated 3 may lack ready access to funds on reasonable terms or may evidence significant weaknesses in funds management practices.

4. A rating of 4 indicates deficient liquidity levels or inadequate funds management practices. Institutions rated 4 may not have or be able to obtain a sufficient volume of funds on reasonable terms to meet liquidity needs.

5. A rating of 5 indicates liquidity levels or funds management practices so critically deficient that the continued viability of the institution is threatened. Institutions rated 5 requires immediate external financial assistance to meet maturing obligations or other liquidity needs.

Sensitivity to Market Risk

The sensitivity to market risk component reflects the degree to which changes in interest rates, foreign exchange rates, commodity prices, or equity prices can adversely affect a financial institution’s earnings or economic capital. When evaluating this component, consideration should be given to management’s ability to identify, measure, monitor, and control market risk; the institution’s size, the nature and complexity of its activities, and the adequacy of its capital and earnings in relation to its level of market risk exposure.

Sensitivity of Market Risk – Evaluation Factors

Market risk is rated based upon, but not limited to, an assessment of the following evaluation factors:

The sensitivity of the financial institution's earnings or the economic value of its capital to adverse changes in interest rates, foreign exchanges rates, commodity prices or equity prices.

The ability of management to identify, measure, monitor, and control exposure to market risk given the institution's size, complexity, and risk profile.

The nature and complexity of interest rate exposure arising from nontrading positions.

Where appropriate, the nature and complexity of market risk exposure arising from trading and foreign operations.

Sensitivity to Market Risk - Ratings

1. A rating of 1 indicates that market risk sensitivity is well controlled and that there is minimal potential that the earnings performance or capital position will be adversely affected. Risk management practices are strong for the size, sophistication, and market risk accepted by the institution. The level of earnings and capital provide substantial support for the degree of market risk taken by the institution.

2. A rating of 2 indicates that market risk sensitivity is adequately controlled and that there is only moderate potential that the earnings performance or capital position will be adversely affected. Risk management practices are satisfactory for the size, sophistication, and market risk accepted by the institution. The level of earnings and capital provide adequate support for the degree of market risk taken by the institution.

3. A rating of 3 indicates that control of market risk sensitivity needs improvement or that there is significant potential that the earnings performance or capital position will be adversely affected. Risk management practices need to be improved given the size, sophistication, and level of market risk accepted by the institution. The level of earnings and capital may not adequately support the degree of market risk taken by the institution.

4. A rating of 4 indicates that control of market risk sensitivity is unacceptable or that there is high potential that the earnings performance or capital position will be adversely affected. Risk management practices are deficient for the size, sophistication, and level of market risk accepted by the institution. The level of earnings and capital provide inadequate support for the degree of market risk taken by the institution.

5. A rating of 5 indicates that control of market risk sensitivity is unacceptable or that the level of market risk taken by the institution is an imminent threat to its viability.

Risk management practices are wholly inadequate for the size, sophistication, and level of market risk accepted by the institution.

The Development of Composite Bank Ratings

Based on a thorough examination of each risk component of the CAMELS Model, the risk profile of a' bank can now be determined through an assessment of the individual CAMELS components set within the context of the Liberian Banking Sector and the bank's own market strategy.

Composite Ratings

Composite ratings are based on a careful evaluation of an institution's managerial, operational, financial, and compliance performance. The six key components used to assess an institution's financial condition and operations are: capital adequacy, asset quality, management capability, earnings quantity and quality, the adequacy of liquidity, and sensitivity to market risk. The rating scale ranges from 1 to 5, with a rating of 1 indicating: the strongest performance and risk management practices relative to the institution's size, complexity, and risk profile; and the level of least supervisory concern. A 5 rating indicates: the most critically deficient level of performance; inadequate risk management practices relative to the institution's size, complexity, and risk profile; and the greatest supervisory concern. The composite ratings are defined as follows:

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.