



COMMONWEALTH OF PENNSYLVANIA  
DEPARTMENT OF BANKING  
333 MARKET STREET, 16TH FLOOR  
HARRISBURG, PENNSYLVANIA 17101-2290

RICHARD C. RISHEL  
SECRETARY OF BANKING

TELEPHONE  
717-787-6991

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TO: ALL CHIEF EXECUTIVE OFFICERS OF PENNSYLVANIA STATE-CHARTERED  
BANKS, BANK AND TRUST COMPANIES, SAVINGS BANKS, AND SAVINGS  
AND LOAN ASSOCIATIONS

The federal regulatory agencies have adopted a revised Uniform Financial Institutions Rating System which has been known as CAMEL, an acronym of the five components it evaluates. Copies of the new component and composite descriptions have been sent to your institution by your principal federal regulator. The revised system, which will be known as CAMELS and will be phased into Department of Banking ("Department") examination reports commenced after January 1, 1997, recognizes changes which have occurred in the financial services industry and in supervisory policies since 1979 when the CAMEL system was first implemented. The principal changes are increased emphasis on risk management processes in the component and composite definitions and the addition of a sixth component to the rating system. The new "S" component addresses sensitivity to market risk, which for most Pennsylvania state-chartered institutions will reflect exposures to changes in interest rates. Since examiners have been long considering the factors now explicitly addressed in the new descriptions, we do not expect there will be a significant impact on the conduct or result of examinations. However, because the Department generally supports the underlying premise of risk-focused supervision and the evaluation of the effectiveness of risk management in financial institutions, we have, ourselves, in recent months modified certain examination procedures to reflect what we feel is an approach that fits the profile of the state-chartered institutions we supervise. The purpose of this letter is to outline the principles underlying our examination philosophy, the changes we have instituted and those which you can expect in 1997.

There is no "one size fits all" approach; a risk profile of each institution must be determined. The risk profile of the institution should play a principal role in the examiner's determination of what areas of risks will be looked at and the amount and depth of procedures that will be used.

Since early 1996, our examiners have been encouraged to commence and prepare for an examination offsite by reviewing prior examination reports, call reports and other available data. Our intent is for the lead examiner to formulate an examination plan that will permit a focus on areas that pose the greatest risk to the institution or on weaknesses cited at prior examinations, so as to conduct as efficient an examination as possible once the onsite work begins. Offsite planning also permits the examiners to determine a transaction testing (loan file review) sample appropriate for the size, complexity and financial condition of the institution.

**Examination and supervision should focus on materiality and on supervision with minimum waste and intrusion.**

Our goal is to provide as much notice of pending examinations as possible to management to enable them to prepare for our arrival. We hope to lengthen further this notice in 1997, and to request that the information which in the past has been made available the day examiners arrive in the bank, be provided at the time examination planning begins. We expect this to increase overall examination efficiency and to reduce the time examiners spend in the institution.

A further change we have begun to implement is our trust department examination procedure for certain institutions. We have heretofore prepared a separate examination report for all bank trust departments. As scheduling permits, we plan to examine concurrently trust and commercial operations and to combine the results into one examination report for banks whose trust activities are not a significant part of total operations.

Examination and supervisory processes are deficient if they focus only on an institution's financial condition at a point in time and ignore the importance of sound management processes to identify, measure, monitor and control risks in new products, and in economic, demographic, competitive and other factors.

Many of our institutions are small and in sound financial condition which points to a risk profile which permits minimum transaction testing and a review of core examination principles. They are also noncomplex in that the risks that most of them assume reflect traditional types of banking activities -- small business and consumer lending, provision of payment services, and deposit taking, as opposed to trading, underwriting, and use of complex derivatives in hedging programs. While we will not require such institutions to have elaborate risk management systems in order to receive satisfactory ratings, they are expected to have effective internal controls, and appropriate policies for credit and interest rate risk management. There should also be evidence that management periodically objectively reviews other potential risks the institution faces, as noted above. Further expectations of examiners in the area of risk management should depend on the size, complexity, and risk profile of the institution.

We will be looking at other ways to improve examination quality and efficiency in 1997 and hope to have your cooperation as we implement new practices. To have your input into our efforts, we have revised our post examination questionnaire and hope that you and your staff will be frank in your evaluation as to how we do our job.

Sincerely,

*Richard C. Asher*

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