

# Does the CAMELS bank ratings system follow a procyclical pattern?

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## **Abstract**

The financial crisis which erupted in 2007-8 has illustrated the disruptive effects of procyclicality. The phenomenon of procyclicality refers to the mutually reinforcing interactions between the financial system and the real economy that tend to amplify business cycle fluctuations. In this study, we empirically investigate the sensitivity of the CAMELS ratings system, which is used by the U.S. authorities to monitor the conditions in the banking market, to the fluctuations of the economic cycle. Our results suggest that the overall state of the U.S. economy and bank regulatory ratings are positively linked to each other: CAMELS increase during economic upturns and decrease during downturns. This is to say that the performance and risk-taking behaviour of banks is rated higher when the conditions in the economy are favourable and lower when the economic environment is weak. Along these lines, we document a positive relationship between CAMELS and the conditions in financial markets. This very important and rather unknown source of procyclicality should be taken into serious consideration by authorities.

*Keywords:* CAMELS ratings; procyclicality, financial crisis.

*JEL classification:* C13; C20; C50 ; D02; G21; G28

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