

Can a Bank Go to Court to Challenge its CAMELS Rating? Maybe.

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On January 19, 2017, the United States Court of Appeals for the Seventh Circuit issued a potentially game-changing opinion concerning the appeal of a federal banking regulator's assignment of a CAMELS rating. The Seventh Circuit held that a district court in Chicago should not have dismissed a complaint brought by Builders Bank, a \$100 million asset bank, challenging the Federal Deposit Insurance Corporation's ("FDIC") assignment of a CAMELS rating of 4 to Builders Bank.

Background

Builders Bank is an insured, non-member bank regulated by the FDIC. After an examination in June 2015 the FDIC assigned Builders Bank a composite rating of 4 under the Uniform Financial Institutions Rating System that measures six components: capital, asset quality, management, earnings, liquidity, and sensitivity ("CAMELS rating"). The highest rating is 1, the lowest 5. Among other supervisors uses, the CAMELS rating is a key factor in determining how much a bank must pay for deposit insurance. When the FDIC assigned a CAMELS rating of 4 to Builders Bank, the FDIC significantly raised the deposit premiums the bank pays to the FDIC.

Builders Bank contended in this suit under the Administrative Procedure Act ("APA") that its CAMELS rating should have been 3 and that the 4 rating was arbitrary and capricious. The FDIC argued that a CAMELS rating is unreviewable by federal courts because the federal agencies have absolute discretion to set appropriate levels of capital, and that discretionary actions of agencies are not reviewable under the APA. The FDIC relied on 12 U.S.C. §3907(a)(2), which states in relevant part:

Each appropriate Federal banking agency shall have the authority to establish such minimum level of capital for a banking institution as the appropriate Federal banking agency, in its

discretion, deems to be necessary or appropriate in light of the particular circumstances of the banking institution.

The district court dismissed the suit for lack of jurisdiction, ruling that the assignment of CAMELS rating is completely and solely within agency discretion by law, and that the APA does not permit courts to review such cases. The Seventh Circuit vacated the district court's order and remanded the case for further proceedings finding that the lower court might have jurisdiction over the matter given the right circumstances.

Holding

It is important to understand exactly what the Seventh Circuit said and did not say. It did not say that the FDIC's assignment of a CAMELS rating of 4 to Builders Bank was arbitrary. The Court only said that if certain additional facts were present, then the lower court had the jurisdiction to hear the complaint against the FDIC and should not have dismissed the complaint of Builders Bank for lack of jurisdiction. The Seventh Circuit instructed the lower court to explore:

- Whether the FDIC assignment of a 4 rating was a final agency action. Only final agency actions are appealable under the APA. Perhaps, the Court mused, the assignment of a CAMELS rating is not a final action. Perhaps, the Court continued, only an enforcement action under 12 U.S.C. §1818 constitutes a final action. At the same time, the Court noted the change in the Bank's deposit insurance premium might be enough for the assignment of the 4 rating to be construed as a final action.
- Whether Builders Bank had exhausted its remedies at the agency level. In order to pursue an action against the FDIC under the APA, Builders Bank had to have pursued all available remedies under agency rules. The Court wondered if the failure of Builders Bank to utilize the FDIC's voluntary internal appeals process would constitute grounds to dismiss the appeal to the federal court.

The Seventh Circuit acknowledged that the power of a federal court may be restrained pursuant to 12 U.S.C. §3907(a)(2) when a court reviews how a bank regulatory agency sets minimum capital requirements. However, the Court noted there were no similar statutory restrictions to prevent a federal court from reviewing other components of the CAMELS rating, assuming the agency action constitutes final action and the complaining bank has exhausted the agency remedies. The Court reasoned that the CAMELS rating includes much more than "capital." Specifically, the Court explained that in addition to the "capital" category, the CAMELS rating assesses "asset quality, management, earnings, liquidity, and sensitivity." In addition, the Court questioned whether 12 U.S.C. §3907(a)(2) renders the "capital" component of the CAMELS rating completely unreviewable. The Court stated that "the statute does not insulate the agency's math" in calculating the CAMELS rating, including its "capital" category.

What are the likely consequences of the Seventh Circuit's holding?

Builders Bank v. FDIC opens a crack in a door that had been thought to be not only slammed shut, but bolted as well. Under the right set of circumstances, it may be possible to challenge the findings of a bank regulator in a federal court proceeding. Hurt feelings over being rated a 2 instead of a 1 may still likely not be enough. Actual harm such as the loss caused by a higher deposit premium

might be sufficient.

Importantly, the Seventh Circuit's holding does not otherwise impact any federal agency actions regarding the federal regulatory enforcement process. Consequently, the *Builders Bank v. FDIC* opinion could serve as a catalyst and cause federal banking regulators to become more formal in their actions. Enforcement actions are subject to the administrative law process and are only subject to court appeals after the exhaustion of that administrative process. At the same time, the appeal of a composite CAMELS rating may be found as not interfering with the administrative law process. Administrative law proceedings do not affirm or override CAMELS ratings. Rather, these proceedings focus on the existence of violations of law and unsafe and unsound banking practices, and the suitable remedies for such circumstances.

Conclusion

This litigation is far from over. Nonetheless, the Seventh Circuit's holding might create an opportunity for a bank to challenge a federal banking regulator on the CAMELS rating assigned to that bank. As it now stands, banks have long thought it was impossible to get a court to hear a case that a CAMELS rating was grossly unfair even though the rating might be costing the bank hundreds of thousands or even millions of dollars in assessment fees and deposit insurance premiums.

To view the full text of Opinion, [click here](#).

*This post was written with input from **Mark C. Svalina**.*

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