A Better M for CAMELS

Greg Baer and Bill Nelson | Feb. 13, 2025

Recent events have highlighted the subjectivity, opacity and power of the bank examination process.[1] The heart of that process is the CAMELS rating regime – the 45-year-old system for rating banks that has no statutory or regulatory origin and has never been meaningfully reviewed since its adoption.

While the CAMELS system has six components,[2] the federal banking agencies have made the Management component the deciding factor in determining its composite rating and whether a bank will be subject to secret sanctions. (Similarly, in ratings at the holding company level, the Federal Reserve's regime contains three components – Capital, Liquidity and Governance & Controls – but the composite rating is determined by the lowest of the three, which is always or almost always Governance & Controls.)[3]

This note includes a look at recent history demonstrating the dysfunction in the Management rating, and earlier academic research indicating why that should have been expected. It then describes what a more informative and useful "M" could look like.

Background

While Management is a standalone component of the CAMELS regime, it is important to note that every other ratings component already includes management as a factor:

[1] See Testimony of Stephen T. Gannon before the U.S. Senate Committee on Banking, Housing and Urban Affairs (Feb. 5, 2025), available at https://www.banking.senate.gov/imo/media/doc/gannon_testimony_2-5-25.pdf. See also Scott, Stephen, "Leaked OCC 'Camels' report puts bad policy on public display (Sept. 3, 2024), *The Banker*, available at https://www.thebanker.com/content/db994e3e-405e-52ee-9684-b969327f827c.

[2] Capital, Asset Quality, Management, Earnings, Liquidity and Sensitivity to Market Risk Including Interest Rate Risk. *See, e.g.*, 62 Fed. Reg. 753 (Jan. 6, 1997), https://www.govinfo.gov/content/pkg/FR-1997-01-06/pdf/97-155.pdf. The six CAMELS components 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 1 being the best.

[3] At least two-thirds of outstanding issues (unresolved supervisory findings) have related to Governance & Controls as reported by the Federal Reserve over the past several years. *See, e.g.*, *Supervision and Regulation Report*, FRB. (Nov. 2024), https://www.federalreserve.gov/publications/files/202411-supervision-and-regulation-report.pdf; *Supervision and Regulation Report*, FRB (May 2024), https://www.federalreserve.gov/publications/files/202405-supervision-and-regulation-report.pdf; *Supervision and Regulation Report*, FRB (Nov. 2023), https://www.federalreserve.gov/publications/files/202311-supervision-and-regulation-report.pdf; *Supervision and Regulation Report*, FRB. (Nov. 2022), https://www.federalreserve.gov/publications/files/202211-supervision-and-regulation-report.pdf.

- **C**apital: "The ability of **management** to address emerging needs for additional capital" and "Prospects and plans for growth, as well as past experience in **managing** growth."
- **A**sset Quality: "The adequacy of loan and investment policies, procedures, and practices" and "The ability of **management** to properly administer its assets"
- **E**arnings: "The adequacy of the budgeting systems, forecasting processes, and **management** information systems in general."
- **L**iquidity: "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."
- **S**ensitivity to Market Risk: "The ability of **management** to identify, measure, monitor, and control exposure to market risk given the institution's size, complexity, and risk profile."

The standalone "M" is therefore notable because it evaluates management *untethered to any financial risk, and is therefore wholly subjective and variable.* It is where immaterial and non-financial issues like "reputational" risk can manifest themselves, or simply displeasure with how management is behaving.

The M in Theory and Practice

The question, then, is whether a standalone M rating adds any value to assessing the strength of the firm, or to the contrary provides a misleading impression. Both theory and fact suggest the latter.

The banking turmoil of 2023 presented a useful case study. A recent study examined the ratings that should have reflected concern as the Federal Reserve began dramatically raising interest rates: Liquidity (L) and Sensitivity to Market Risk including interest rate risk (S). The authors found that L and S downgrades accelerated at banks with high interest rate risk exposure, but only 16 percent of the quintile of banks with the highest levels of interest rate risk saw a downgrade. More significantly for present purposes, though, *there was no correlation to downgrades in the Management rating, and no correlation to downgrades in the composite rating, which is generally driven by the Management rating.* So, actual financial risk was not reflected in the Management-driven composite ratings assigned to those banks. Relatively objective and focused components of the rating system were overridden by a highly subjective and unfocused one.

Other research has shown that the bank failures in spring 2023 occurred despite an abundance of bank examiners because those examiners were focused on bank operations and management and not on financial risk.[4]

Recent research has validated these concerns beyond 2023 events. In a study of the CAMELS regime, researchers define "absolute discretion" as "…the extent to which the examiner relies on case-specific soft information as well as any biases, gut feelings, or intuition."[5] They define "directional discretion" as

[4] Jeremy Newell and Pat Parkinson, *A Failure of (Self-) Examination: A Thorough Review of SVB's Exam Reports Yields Conclusions Very Different From Those in the Fed's Self Assessment*, BANK POLICY INSTITUTE (May 8, 2023), https://bpi.com/a-failure-of-self-examination-a-thorough-review-of-svbs-exam-reports-yields-conclusions-very-different-from-those-in-the-feds-self-assessment/; *see also* U.S. GOV'T ACCOUNTABILITY OFF., GAO-23-106736, *Bank Regulation: Preliminary Review of Agency Actions Related to March 2023 Bank Failures*, at 22 (Apr. 28, 2023), https://www.gao.gov/products/gao-23-106736 (stating, "While SVB management failed to take adequate and timely steps to mitigate risks […] [GAO's] review of examination staff's acknowledgment of SVB *management* responses found the staff generally agreed that SVB's planned actions were reasonably designed to remediate the underlying supervisory issues.") (emphasis added).

[5] Sumit Agarwal et al., *Noisy Experts? Discretion in Regulation*, NBER Working Paper No. w32344, at 4 (Apr. 16, 2024, revised Nov. 16, 2024), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4794393.

the extent to which an examiner is tighter or easier on average. In the case of the composite CAMELS rating, they "…find economically large levels of and variations in absolute discretion among examiners, as well as wide variation in directional discretion."[6] As an example of the role of discretion, they document that in the majority of cases where a bank's composite CAMELS rating changes, the change owes to a change in examiners, *not* a change in "true bank quality."[7]

The same study identifies two causes for the disagreement across examiners. First, examiners place 50 percent weight, on average, on the Management component in setting the composite rating. They link this result to psychological findings that "…people place too much weight on face-to-face interactions or perceptions drawn from facial expressions…"[8] Second, examiners weigh the six components differently when determining the composite.

Much earlier research suggests why that might have been: A Federal Reserve researcher noted in 2000 that bank examiners may have "…political and other goals that temper their monitoring efforts…" and that "[p]olitical compromises also may give rise to statutory or regulatory restrictions that are unrelated to bank safety…"[9] Furthermore, examiners "…may find effective oversight to be a difficult task, given the broad range of activities in which banks and their parent holding companies engage." A knowledge and experience deficit in dealing with subject matter experts at banks – in everything from cybersecurity to corporate governance – leads to a focus on ensuring that procedures are written down and followed invariably.

The present state of bank supervision puts an exclamation point on these concerns.

> The results can be seen in the most recent Federal Reserve Supervision Report, from May 2024. *Only one third of large U.S. banks are now rated as well managed*. Note that under Federal Reserve guidance, "A 'well managed' firm has sufficient financial and operational strength and resilience to maintain safe-and-sound operations through a range of conditions, including stressful ones." Thus, one would expect that a finding that two thirds of large U.S. banks cannot maintain safe and sound operations would be a major policy and market concern, but of course it is not—because that conclusion is flatly inconsistent with the extremely strong capital and liquidity position of large U.S. banks; the external credit ratings of those banks; universal analyst opinions of those banks; and innumerable statements from Federal Reserve officials that large U.S. banks are in excellent condition. Indeed, it is even inconsistent with the Supervision Report itself, which begins by stating, "The banking system remains sound and resilient."

So how could the Federal Reserve's Report reach a conclusion that is absurd? The answer is simple: according to the Report, criticisms of Governance & Controls—non-material financial risks—represented two thirds of outstanding issues.[10]

[6] *Id.* at 4.
[7] *Id.* at 16.
[8] *Id.* at 6.
[9] Mark E. Van Der Weide & Satish M. Kini, *Subordinated Debt: A Capital Markets Approach to Bank Regulation*, 41 B.C. L. Rev. 195, 210 (2000), https://lira.bc.edu/work/sc/ee6b82c1-5f96-485c-b649-812b4bf9ccb2.
[10] Greg Baer, *The Bank Examination Problem and How to Fix It*, BANK POLICY INSTITUTE (July 17, 2024), https://bpi.com/the-bank-examination-problem-and-how-to-fix-it/.

A Better M

Back to the Future

In 1999, the Federal Reserve conducted a study using market information – in particular, spreads on subordinated debt – to support and substitute for bank examination. The study built on a large economics literature that documented the value of market information for assessing bank risk even after taking into account examination ratings. The literature reflected in part a preference among economists for allowing markets rather than government officials to guide economic activity. The Fed study concluded that sub debt spreads could be used to help determine the breadth and frequency of bank examinations and examiners could "…take account of the market signals provided by [subordinated debt] when setting banks' CAMELS ratings…"[11] One Fed researcher speculated that "[a] significant benefit of this proposal is that it would permit less frequent examinations of banks by federal regulators, while facilitating better assessments of the risk posture of institutions."[12]

There are other market signals that would provide useful information in assessing the financial soundness of a bank – and which did not exist when the CAMELS regime was adopted 45 years ago. In addition to debt spreads, they would include credit default swap spreads, ratings from the credit rating agencies and sell-side analyst opinion. These signals would be useful to senior regulators in understanding the financial condition of a given bank. Of course, there could not be a formula for combining these signals, as each would need to be evaluated in the context of a particular bank. For example, a regional bank may have wider spreads than a universal bank simply because its debt is lower in volume and trades more infrequently.[13]

Of course, only the largest banks issue market debt and attract analyst coverage, and so only for them would it be possible to redefine the "M" in CAMELS. For smaller banks, which do not pose as large a risk to the financial system, simply dropping the M and moving to a CAELS rating would be appropriate.

Conclusion

Ultimately, the question is what would tell agency principals more about the condition of a large bank, and what would be a better basis on which to focus its future examination and potentially take action to restrict a bank's activities: (1) a wholly subjective assessment of management untethered to financial risk or (2) some combination of market signals. Given both theory and practice, it is difficult to understand how anyone could claim the former.

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[11] Board of Governors of the Federal Reserve System Staff Study, "Using Subordinated Debt as an Instrument of Market Discipline," Study Group on Subordinated Notes and Debentures, Federal Reserve System (December 1999), available at https://www.federalreserve.gov/pubs/staffstudies/1990-99/ss172.pdf.
[12] Van Der Weide & Kini, *supra* note 9, at 242–43.
[13] There are methodologies for controlling for this and similar factors. See Lester, John, and Kumar, Aditi, "Do Bond Spreads Show Evidence of Too Big to Fail Effects? Evidence from 2009-2013 Among US Bank Holding Companies", Oliver Wyman, April 2014, available at https://bpi.com/wp-content/uploads/2014/04/oliver-wyman-study-do-bond-spreads-show-evidence-of-too-big-to-fail.pdf.