Management Evaluations: Taking the “M” in CAMELS Seriously

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The “M” in CAMELS

- *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.*

Uniform Financial Institutions Ratings System
1996

A California Lament from 20 Years Ago

- *“Our present management rating system is deficient in many areas…*
- *the reluctance of the examiners to make a decision on the competence of management and the board left us with actually no rating…*
- *the criticisms lodged in the confidential section of the report are hardly ever carried forward to the page one because it is probably felt that they don’t have enough ‘feel’ for what management and the board is supposed to do. Most of management is rated average whether good or bad.”*

Memorandum from Chief Bank Examiner Harold Doyle
to Superintendant of Banks James E. Gilleran
July 27, 1990

The Traditional Emphasis

- *A bank's performance with respect to asset quality and diversification, capital adequacy, earnings performance and trends, liquidity and funds management, and sensitivity to fluctuations in market interest rates is, to a very significant extent, a result of decisions made by the bank's directors and officers. <u>Consequently, findings and conclusions in regard to the other five elements of the CAMELS rating system are often major determinants of the management rating</u>.*

Uniform Financial Institutions Ratings System

Revised 1996

A Better Emphasis

1. Does the bank have effective board oversight and corporate governance practices, policies and procedures?

2. Does the bank have an effective framework for risk management consistent with its size, complexity, structure and risk profile?

3. How well do the board, management and control functions execute against this framework?

1. Evaluate Corporate Governance

- Corporate governance involves the manner in which the business and affairs of a bank are governed by its board and management:
  - Setting strategy and objectives;
  - Determining risk tolerances;
  - Protecting the interests of depositors, other recognized stakeholders while meeting shareholder obligations;
  - Operating the bank in a safe and sound manner, with integrity and in compliance with applicable laws and regulations.

Board Responsibilities

- *The board has overall responsibility for the bank, including overseeing the implementation of the bank's strategic objectives, risk strategy, corporate governance and corporate values. The board is also responsible for providing oversight of senior management.*

Principles for Enhancing Corporate Governance
Basle Committee on Banking Supervision
March 2010

Key Elements of Effective Governance

- Board members and management have the expertise and integrity to fulfill their roles.
- Board and management have effective processes and committee structures to set objectives and achieve them.
- Information presented to the board is complete, accurate and presented in an understandable manner.
- Board has established processes to properly oversee and evaluate management and control functions and assess its own effectiveness.
- Internal audit function conducts independent, risk-based and effective audits.
- Board has knowledge of and controls over all potential conflicts of interest at board and management levels.

Common Governance Weaknesses

- Board lacks experienced, capable financial professionals with knowledge of regulations/guidance.
- Board is dysfunction (e.g., factional, distrustful, dominated by an individual or small group, unengaged, unprepared, etc.)
- Board is too trusting of the CEO & management. Dominant CEO controls the bank.
- Lack of formalized processes for management evaluations – both management structures and executive competencies. Board relies excessively on regulatory assessments of management.
- Lack of independence of the risk management functions.
- Weak or inactive risk committee structures at board and management levels.

2. Evaluate Risk Management Framework

- How effectively does the bank:
  - Identifying key risks;
  - Measure exposures to these risks;
  - Monitor risk exposures on an ongoing basis;
  - Control or mitigate risk exposures through effective processes that work as intended and through capital and liquidity resources that are appropriate for the risks; and
  - Report to the board on these items.

Key Elements of Effective Risk Management

- Independent risk management function with adequate stature, authority, board access and resources.
- MIS and analytical capabilities to perform stress tests/scenario analyses for all key exposures.
- Risk mitigation strategies, contingency plans and adequate capital and liquidity resources that are informed by such analyses.
- Capability to understand and effective adapt to changes in the economic, financial and competitive environment.
- Compensation systems that are effectively aligned with prudent risk taking.

Common Weakness in the Risk Framework

- Emphasis is on ROE without adequate consideration of risk factors. Board does not articulate risk appetite or set risk limits in a meaningful/measurable way.
- Comp plans that incent growth or short-run returns.
- Risk management function lacks leadership or support from the Board/CEO and/or lacks independence from revenue generating officers and units.
- Inadequate resources. Poor MIS. Inadequate analytical capabilities for stress testing/scenario analysis.
- Failure to recognize and control interrelated risks.
- Audit functions not independent of management.

3. Assess Execution Against Risk Framework

- Are all risk factors appropriately identified, assessed and controlled?
- Are credit concentrations properly identified and mitigated?
- Are underwriting principles sound and sensitive to market conditions?
- Is there a realistic liquidity plan for dealing with a range of potential disruptions to normal liquidity sources?
- Has the board provided proper oversight of management?
- Are internal audit, compliance and control functions effective?

Common Weaknesses in Risk Management Execution

- Failure to stay within prescribed policy limits. Exceptions to risk limits granted to meet competition.
- Inadequate communication flows.
- Ineffective oversight and controls.
- Inadequate credit underwriting standards/credit administration function.
- Excessive reliance on third parties' risk assessments (e.g., credit rating agencies, lead bank for loan participations).
- Failure to implement audit recommendations.
- Lack of accountability.

Overcoming the Hurdles to a More Effective "M" Rating Process

- Qualitative assessments are inherently less defensible, making the "M" rating more contentious.
- Is this why regulators have gravitated toward assessing M based on a bank's condition?
- A clearly articulated methodology is essential.
- Guidance exists, but probably needs updating.
- "Key Elements" and "Common Weaknesses" are a good place to start.

- *Examiner fortitude and support from the top is essential!*