UNDERSTANDING MODERN CAMELS, PART 3: MANAGEMENT

Third in a series about what regulators want in a CAMELS

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Oh, the mystery of the Management component rating when it comes to the CAMELS!

The first two blogs in this series dealt with the Capital component rating and the Asset Quality component rating, respectively. Arguably, there is at least some objectivity associated with the rating of those two components. The Management component rating--who knows? You can't weigh intelligence and you can't measure savvy.

Does "Management" component lead its own life?

Let's say you subscribe to the notion that the regulators are attempting to adopt "forward-looking supervision," i.e., not addressing the condition of the bank today, but in the future. Or that you subscribe to the alternative theory, that the regulators view management, and hence the Management rating, in isolation from the condition of the bank.

In either case, theoretically, could there exist an extraordinarily healthy bank, e.g., Tier 1 capital ratio of 15%, classifications to capital of 20%, and return on assets of 1%, which receives a Management rating of 5 (the worst of the categories)?

Or, again theoretically, could there exist a bank that has 4% capital, classifications to capital of 250%, losses for a

lengthy period of time, and a clearly deteriorating condition, yet a Management rating of 1 (the highest rating)?

In other words, is or should management be graded independently from the condition of the bank?

Quit your dreaming, it doesn't happen

The reality today in the field is that management is not rated independently from the condition of the bank.

As noted in the Asset Quality blog, management could be exemplary. The bank's leadership could have shepherded the bank to record profitability and asset quality over the last 22 of 25 years. Yet in the last three years, the bank has suffered through the economic disaster that befell the nation, and all of a sudden, management is, at best, incompetent in the eyes of the regulators, and if the bank is a CAMELS 5, Management must be a 5.

Something is not quite right here.

"M" also means "D"

For those of you reading this commentary who are directors or trustees, do not be too smug. The Management component also addresses not only the capability of full-time management but also the board of directors.

According to the regulators, management is going to be tested on their ability to "identify, measure, monitor and control the risk of the institution and ensure a financial institution's safe, sound and efficient operation in compliance with applicable laws and regulations."

Well, board member, that incorporates your job description too.

In connection with this rating, the ability of the board of directors to establish acceptable risk exposure levels and of management practices in connection with credit, market, operating, transaction, reputation, strategic, compliance, and liquidity risks will be assessed.

Management by the numbers

For purposes of the regulatory approach, the Management rating is based on an assessment of 12 issues. These range from the level and quality of oversight, to performance of the institution and its risk profile (of course).

A 1 rating indicates a strong performance by management and the board and strong risk management practices. A 5 rating indicates critically deficient management and board performance, or similar risk management practices.

You guessed it, a 2 is "satisfactory," a 3 is "needs improvement," and a 4 indicates deficient management and poor performance.

Basically, A, B, C, D, and F, just like in elementary school.

Clearly, the Management rating is the most subjective of all ratings, and as noted in the previous blog, will primarily be driven by the condition of the institution no matter how capable management is on its own or would be considered if operating another healthier institution.

How fair is that?

Next, the critical element of Earnings.

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