Getting Over the Hump in CAMELS Ratings:

Leaked CSI Puts Bad Policy on Public Display

by STEPHEN SCOTT

In July it was reported that the Office of the Comptroller of the Currency (OCC) experienced a leak of what is known as Confidential Supervisory Information (CSI). The information is telling and provides a rare glimpse into the priorities and practices of a principal U.S. banking regulator. Rare, because CSI is meant to be kept secret; disclosure of such information is viewed as theft of government property and is a punishable offense.

The OCC scores risk management among firms across six dimensions — such as credit quality, asset quality, etc. — to form what is known as a composite "CAMELS" rating. The 'M' in the acronym pertains to the regulator's assessment of management quality. Where the other dimensions of the aggregate score lend themselves to spreadsheet analysis, assessment of management capability has always been the most subjective component.

In addition to being the most subjective, in the regulator's own words, the M component is also "the broadest component of OCC's supervisory framework." For instance, lumped into its assessment of the 'M' component is how well the OCC considers a firm to be managing its operational risks, taking into account things like risk management systems, processes, controls, and even the perceived fitness of management and staff.

In its *Semiannual Risk Perspective for Spring 2024*, the OCC warned that current events put operational risks at elevated levels. Therefore, "It is crucial that banks establish an appropriate risk culture that identifies potential risk," it asserts. How well the OCC believes a firm is doing to maintain such a risk culture is seen in the 'M' component in its CAMELS rating. And it is this that makes the leaked CSI particularly interesting.

Do as I say, not as I do

According to news reports, on its five-point scale, several of the nation's largest banks scored a three or worse on the 'M' component of their most recent CAMELS ratings. Because it is a composite measure, doing poorly on any one element torpedoes a firm's overall score. And, as the OCC itself warns, "banks that are assigned weak CAMELS ratings confront a number of potentially costly supervisory implications."

Moreover, a poor CAMELS rating has several other implications: it sets limits on the activities in which a firm may participate, like the business lines in which it may engage and the acquisitions it will be allowed to make; it triggers increases in the insurance premiums a firm will face; reduces its access to some funding sources; and requires it to hold more reserve capital — all of which limits the returns it may generate for shareholders, of course.

As Bank Policy Institute head Greg Baer argues, a poor 'M' rating acts as a large financial penalty that remains in place for years. And, because the CAMELS rating is secret, a firm cannot realistically contest such a penalty, nor issue any public complaint at all, without violating secrecy rules and facing further penalty. This is bad policy, antithetical to the principle of due process, and contrary to the basics of a democratic government.

With the recent OCC leak, therefore, insult is added to injury. Were any bank found to have permitted for a leak of such CSI, it would have been penalized by regulators. Indeed, the fact that such a leak occurred might be taken to reflect poor risk management processes, a problematic risk culture, or both, likely impairing the 'M' component in its CAMELS rating and triggering all the above noted costs and commercial complications.

Yet when the same failings are in public display at the OCC, there is no commensurate call for redress or accountability. The implicit double-standard erodes the trust essential to collaborative engagement between a regulator and those it regulates. And this, in turn, makes it *more* likely that idiosyncratic risks will be hidden and that systemic risks will go unnoticed until they erupt in crisis, *undermining* the cause of good supervision.

We need more than a nose in the tent

According to the OCC, "the CAMELS rating system is intended to provide supervisors with a uniform and objective measure of banks' risk that can be used to effectively identify weak, problem banks." But, at least inasmuch as assessment of management quality is concerned, our current system fails to provide

for objective measures and, worse, an insistence on secrecy assures that supervisory subjectivity goes without effective challenge.

Skeptics suggest that regulators like it this way. But perhaps current circumstances simply reflect constraints on our ability to assess qualitative components of risk and the management thereof? If so, we should look to lift those constraints wherever possible and, in recent years, AI-powered tools that embrace learnings from the behavioral sciences have begun to do just that, promising for more objective standardized measures.

Over five years ago, for instance, we demonstrated at HSBC an ability to devise metrics with AI that get to core management behaviors that the OCC looks to assess with the 'M' score. This includes things like whether desirable risk management behaviors have taken hold, the status of collaboration across first- and second-line risk functions, and the presence of hidden barriers that reliably anticipate future risk management failures.

The OCC was made aware of what HSBC achieved with these new capabilities, but has not sought to explore their further development — despite legislative activity specifically encouraging bank regulators to support innovation. Unless the skeptics are correct, and regulators prefer to talk up objectivity while asserting conditions that successfully disallow for it, then they should rush to explore the potential such innovations permit.

Reliance on subjective assessments and opaque decision-making, coupled with a system that penalizes firms without offering them a fair chance to contest or even to understand the basis for those penalties, stifles innovation, restricts growth, and undermines trust. It's time to embrace technologies that ensure greater transparency, consistency, and fairness in how we assess the effective management of qualitative operational risks.

A version of this piece was first published by the FT's Banking Risk and Regulation on 2 September 2024 and The Banker on 3 September 2024.

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About Starling

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