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Camel Framework in Banks - Indian Scenario

KEYWORDS

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ABSTRACT *As creators of money, depositories of public savings, allocators of credit and conduits of the payment system, the banks have a unique position in the economy of any country. To bolster the larger public interest, public policy for banks is put in place by the government, the goals of which may vary depending on the nature of economy and priorities of the government. One such policy is Camel rating which measures financial soundness of banks.*

Objective of the study:
Banks serve as backbone to the financial sector, which facilitate the proper utilization of financial resources of a country. The banking sector is increasingly growing and it has witnessed a huge flow of investment. In addition to simply being involved in the financial intermediation activities, banks are operating in a rapidly innovating industry that urges them to create more specialized financial services to better satisfy the changing needs of their customers.

Banking supervision has been increasingly concerned due to significant loan losses and bank failures from the 1980s till now. In the light of the banking crisis in recent years worldwide, CAMEL is a useful tool to examine the safety and soundness of banks, and help mitigate the potential risks which may lead to bank failures.

Thus the objective is to determine efficiency of CAMEL framework in bank supervision.

Review of Literature:
The CAMELS ratings is a supervisory rating system originally developed in the U.S. to classify a bank's overall condition. It's applied to every bank. The ratings are assigned based on a ratio analysis of the financial statements, combined with on-site examinations made by a designated supervisory regulator.

"CAMEL rating has become a concise and indispensable tool for examiners and regulators". This rating ensures a bank's healthy conditions by reviewing different aspects of a bank based on variety of information sources such as financial statement, funding sources, macroeconomic data, budget and cash flow. Nevertheless, bank's CAMEL rating is highly confidential, and only exposed to the bank's senior management for the purpose of projecting the business strategies, and to appropriate supervisory staff. Its rating is never made publicly available, even on a lagged basis.

CAMEL is an acronym for five components of bank safety and soundness:.

- (C)apital adequacy
- (A)ssets
- (M)anagement Capability
- (E)arnings
- (L)iquidity (also called asset liability management)
- (S)ensitivity (sensitivity to market risk, especially interest rate risk)

Capital Adequacy
Fundamentals of Capital Adequacy

Capital adequacy is the capital expected to maintain balance with the risks exposure of the financial institution such as credit risk, market risk and operational risk, in order to absorb the potential losses and protect the financial institution's debt holder. "Meeting statutory minimum capital requirement is the key factor in deciding the capital adequacy, and maintaining an adequate level of capital is a critical element.

Karlyn (1984) defines the capital adequacy in term of capital-deposit ratio because the primary risk is depository risk derived from the sudden and considerably large scale of deposit withdrawals. In 1930, FDIC created a new capital model as capital-asset ratios since the default on loans came to expose the greatest risk instead of deposit withdrawals. To gauge the capital adequacy, bank supervisors currently use the capital-risk asset ratio. The adequacy of capital is examined based upon the two most important measures such as Capital Adequacy Ratio (CAR) or Capital to Risk-weighted Assets

Capital Adequacy Ratios
The capital adequacy is estimated based upon the following key financial ratios,

Ratio	Formula	Criteria
CAR	(Tier1 capital-goodwill)+Tier2 capital Risk – Weighted assets	>=8%
Equity Capital to total assets	Total Capital Total assets	>=4-6%

Were:
Tier 1 capital (core capital) is shareholder equity capital. Tier 2 capitals (supplementary capital) are the bank's loan loss reserves plus subordinated debt which consists of bonds sold to raise funds. Risk-weighted assets are the weighted total of each class of assets and off-balance sheet asset exposures, with weights related to the risk associated with each type of assets.

This capital ratio is required to meet a minimum of 8% set by the Bank for International Settlement (BIS).However, it is important to note that in some countries the required minimum capital may vary depending on the local regulators; and the bank might like to have as high a capital ratio as possible.

Rating of Capital Adequacy
Each of components in the CAMEL model is scored from 1 to 5. In the context of capital adequacy, a rating of 1 indicates a strong capital level relative to the financial institution's risk. Meanwhile, the rating of 5 indicates a critical deficient level of capital, in which immediate assistance from shareholders or external resources is required.

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Asset quality
"Poor asset quality is the major cause of most bank failures". A most important asset category is the loan portfolio; the greatest risk facing the bank is the risk of loan losses derived from the delinquent loans. The credit analyst should carry out the asset quality assessment by performing the credit risk management and evaluating the quality of loan portfolio using trend analysis and peer comparison. Measuring the asset quality is difficult because it is mostly derived from the analyst's subjectivity.

the asset quality indicators highlight the use of non-performing loans ratios (NPLs) which are the proxy of asset quality, and the allowance or provision to loan losses reserve. As defined in usual classification system, loans include five categories: standard, special mention, substandard, doubtful and loss. NPLs are regarded as the three lowest categories which are past due or for which interest has not been paid for international norm of 90 days. In some countries regulators allow a longer period, typically 180 days. The bank is regulated to back up the bad debts by providing adequate provisions to the loan loss reserve2 account. The allowance for loan loss to total loans and the provision for loan loss to total loans should also be taken into account to estimate thoroughly the quality of loan portfolio.

Trends should be noted such as loan concentrations, intragroup lending, and real-estate exposure. For a bank which heavily exposes to lend some specific business sectors and/ or business entities, lack of diversification will make its loan portfolio vulnerable.

RATIO	FORMULA	CRITERIA
NPL's to total loans	NPL TOTAL LOAN	≤ 1%
NPL's to total equity	NPL,s Total equity	≤ 1%
Allowance for loans loss atio	Allowance for loan loss Total loans	≥1.5%

Rating of Asset Quality
Each of the components in the CAMEL rating system is scored from 1 to 5. In the context of asset quality, a rating of 1 indicates a strong asset quality and minimal portfolio risks. On the other hand, a rating of 5 reflects a critically deficient asset quality that presents an imminent threat to the institution's viability.

Management quality
Management quality is basically the capability of the board of directors and management, to identify, measure, and control the risks of an institution's activities and to ensure the safe, sound, and efficient operation in compliance with applicable laws and regulations

Management is considered to be the single most important element in the CAMEL rating system because it plays a substantial role in a bank's success; however, it is subject to measure as the asset quality examination

AIA approach to bank analysis states that the management has clear strategies and goals in directing the bank's domestic and international business, and monitors the collection of financial ratios consistent with management strategies. The top management with good quality and experience has preferably excellent reputation in the local communication. The management requirements are taken into CAMEL approach to Bank Analysis as below:

- Ownership: the bank is majority-owned by the government because government support is the most important mitigating factor to potential financial problems, or by large Private Corporation that have economic significance.
- Size: top local ranking in term of assets.
- Year of operations: long operation history since establishment.

The Management is estimated based upon the following key financial ratios, and to be considered as good banks they must meet certain criteria detailed below:--

RATIO	FORMULA	CRITERIA
Total asset growth rate	Average of historical asset growth rate	Nominal GNP growth
Loan growth rate	Average of historical loan growth rate	Nominal GNP growth
Earnings Growth rate.	Average of historical earning growth rate	≥ 10-15%

Rating of Management
Each of components in the CAMEL rating system is scored from 1 to 5. In the context of management, a rating of 1 is assigned to note the management and board of directors are fully effective. On the other hand, the rating of 5 is applicable to critically deficient management. Replacing or strengthening may be needed to achieve sound and safe operations.

Earning ability
This rating reflects not only the quantity and trend in earning, but also the factors that may affect the sustainability of earnings. Inadequate management may result in loan losses and in return require higher loan allowance or pose high level of market risks. The future performance in earning should be given equal or greater value than past and present performance

a consistent profit not only builds the public confidence in the bank but absorbs loan losses and provides sufficient provisions. It is also necessary for a balanced financial structure and helps provide shareholder reward. Thus consistently healthy earnings are essential to the sustainability of banking institutions. Profitability ratios measure the ability of a company to generate profits from revenue and assets.

The earning requirements are taken into CAMEL approach to Bank Analysis (1996) as mentioned below:

- Majority of earnings is annuity in nature (low volatility).
- The growth trend of the past three years is consistent with or better than industry norm and there are multiple sources of income (both interest and non-interest income).

The profitability is estimated based upon the following key financial ratios, and to be considered as good banks in they must meet certain criteria detailed below:

Earning Ability Ratios Analysis:

RATIO	FORMULA	CRITERIA
Net interest income Margin (NIM)	Net interest income Average earning assets	> 4.5%
Cost to income ratio	Operating expenses (excludes provision loss) Net interest income + non-interest income	≤ 70%
Return on asset (ROA)	Net intrest income Asset growth rate	≥ 1%
Return on equity (ROE)	Net intrest income Share holders equity growth rate	≥ 15%

Rating of Earning Ability
Each of the components in the CAMEL rating system is scored from 1 to 5. In the context of earning, a rating of 1 reflects strong earnings that are sufficient to maintain adequate capital and loan allowance, and support operations. On the other hand, a rating of 5 experiences consistent losses and represents a distinct threat to the institution's solvency through the erosion of capital

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Liquidity:
There should be adequacy of liquidity sources compared to present and future needs, and availability of assets readily convertible to cask without undue loss. The fund management practices should ensure an institution is able to maintain a level of liquidity sufficient to meet its financial obligations in a timely manner; and capable of quickly liquidating assets with minimal loss.

It emphasizes that "the liquidity expresses the degree to which a bank is capable of fulfilling its respective obligations". Banks makes money by mobilizing short-term deposits at lower interest rate, and lending or investing these funds in long-term at higher rates, so it is hazardous for banks mismatching their lending interest rate..

The liquidity requirements for CAMEL approach to Bank Analysis

- Majority of the funding is coming from customer's deposits, and no concentration of funding sources.
- Is there a maturity or interest rate mismatch?
- Does the central bank impose reserve requirements?

The profitability is estimated based upon the following key financial ratios, and to be considered as good they must meet certain criteria detailed below:

RATIO	FORMULA	CRITERIA
Customer deposits to total assets	Total customer deposit Total assets	≥ 75%
Total loan to customer deposits (LTD)	Total loans Total customer deposits	≤ 80%

Rating of Liquidity
Each of the components in the CAMEL rating system is scored from 1 to 5. In the context of liquidity, a rating of 1 represents strong liquidity levels and well-developed funds as the institution has access to sufficient sources of funds to meet present and anticipated liquidity needs. On the other hand, the rating of 5 signifies critical liquidity-deficiency, and the institution demands immediate external assistance to meet liquidity needs.

Composite rating and exposure limit
After computing the rating for each of elements, the composite rating is the average of the sum of five elements. The composite rating is defined in AIA's CAMEL approach to Bank Analysis, 1996 as a tool to select the better banks among potential banks. Depending upon the composite rating of an individual bank, the financial analyst proposes an exposure limit comparable to the level of the bank.

Rating Scale	Rating range	Rating Analysis	Exposure limit	Rating interpretation
1	1.0-1.4	Outstanding	1st limit (maximum)	The bank outperforms the average bank in all respects and by easily measurable differences
2	1.6-2.4	Superior	2nd limit	Measurably better than the average bank, but not quite outstanding in all respects
3	2.6-3.4	Average	3rd limit	a well-run, good bank that just meets all of the major standards
4	3.6-4.4	Under Performance	Not Recommended	The bank demonstrates a major weakness that if not corrected, could lead to a very severe or unsatisfactory condition that will threaten its existence. This would also include major financial and/or managerial surprises
5	4.6-5	Doubtful	Not Recommended	The bank's financial health is substandard, with asset quality impairing over half of the bank's primary capital. If not corrected further deterioration will lead to regulatory control and a high probability of failure

Conclusion:
The liquidity in a bank is what blood is in a human body but there should be tradeoff between liquidity and profitability. For this an appropriate strategy of liability and assets management is designed. Camel provides a measurement of banks current overall financial, managerial, operational and compliance performance. Thus the current study has been conducted to analyze the framework of CAMEL.

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