

'CAMEL' Model, A Conceptual Framework For Financial Performance Evaluation Of Banks In India



COMMERCE

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ABSTRACT

The development or progression of any economy is heavily dependent upon optimum utilization of available resources and operational efficiency of the various sectors. Banking sector always plays a very important role in the development of any economy. Banking sector is one of the important and rapidly growing sectors in India. The importance may be viewed in the context of help or support in stimulation of capital formation, encouraging innovation, influence or direction to economy, monetization in addition to monetary policy. Therefore, performance evaluation and analysis of banking sector is very important and effective measure to ensure sound financial system and economy. Evaluation of Indian Banking Sector is not an easy task to do. 'CAMEL' model or rating is a supervisory rating system originally developed in the U.S. to classify a bank's overall performance. 'CAMEL' model measures the performance of banks by applying important parameters like Capital Adequacy, Assets Quality, Management Efficiency, Earning Quality and Liquidity. In this paper, an attempt has been made to explain the concept of 'CAMEL' model for performance evaluation of banks in India.

INTRODUCTION TO 'CAMEL' MODEL:

The 'CAMEL' rating is a supervisory rating system originally developed in the U.S. IN 1979-80 to classify a Bank's overall position. It is applied to every bank and credit union in the U.S. and also implemented outside the U.S. by various banking supervisory regulators. The uniform financial institution rating system commonly termed to the acronym 'CAMEL' rating was accepted by the federal financial institution examination council on November 13, 1979 and then afterwards by the national credit union administration in October 1987. The ratings are given based on the ratio analysis of the financial statement.

The Banking Regulation Act, 1949 empowers the Reserve Bank of India to inspect and supervise commercial banks. These powers are executed through on-site inspection and off -site surveillance. In 1995, the Reserve Bank of India established a working group under the chairmanship of shri S. Padmanabhan to review the entire supervision system of banking sector. On the base of recommendations and suggestions given by this committee, a rating system namely 'CAMEL' model (based on an internationally adopted model) which was later modified as 'CAMELS' was introduced for banks commencing from July, 1998 audit and inspection cycle. Committee recommended that the banks should be rated on a five point scale (1 TO 5) based on the guideline of the international 'CAMEL' rating model. This model measures banks on the five parameters: (1) Capital Adequacy (2) Asset Quality (3) management (4) Earning and (5) Liquidity. Later on a sixth parameter relating to 'Sensitivity to Market Risk' has also been added to this 'CAMEL' model.

Under this model, banks are evaluated (subject to on site examination) on the basis of these five (at present six) parameters to their operations and financial performance.

EXPLANATION OF 'CAMEL' MODEL

Following are the various parameters of 'CAMEL' model-

Capital Adequacy:

Capital Adequacy is the capital expected to maintain balance with the risks exposure of the bank, like credit risk, market risk and operational risk with a view to absorb the potential losses and protect the bank's debt holder. The capital adequacy represents the overall financial condition of the bank and its ability to meet the need for additional capital. Capital adequacy of a bank is measured by the ratio of capital to risk weighted assets (CRAR). A sound capital adequacy ratios or position strengthen the confidence of various stakeholders in the bank.

Asset Quality:

It takes into consideration the percentage of banks loan that are NPAs (non performing assets). The main or prime reason behind

determining the asset quality is to ascertain the ingredients of NPAs as a percentage of total assets. It also measures the movement of NPAs. The gross non-performing loans to gross advances ratio is an indication towards the quality of credit decisions of the bank management. Higher NPAs means that loans given by banks are of lower quality. It affects by two ways: first, it increases the provision and reduces profit and second it affects the internal accruals for banks in the form of reduced profit. So, it is not a good thing for banks.

Management :

it indicates a subjective analysis for measuring the performance of management. There are so many ratios that indicates the performance of management, e.g. total advance to total deposit ratio, net profit per employee, return on net worth, non-interest expenditure to total assets etc., higher non-interest expenditures ratios (it includes variety of expenses) implies that bank management is not able to control some needless expenses.

Earning Quality

This rating reveals not only the quantity and trend in earning, but also the factors that may affect the sustainability of earning. It refers to the net profit made by bank after taking into account all the factors. Higher earning shows that banks performance is healthy but simultaneously it is very important to see that this good earning is an account of main or core banking, i.e. interest income on lending operations. This aspect gains importance now in a days in the light of argument, that one big portion of bank's earnings is earned through non- core activities, like treasury operations, investment advisory services, corporate advisory services and other activities. So, earning from core banking activity is very important.

Liquidity :

Liquidity is one of the important parameters to evaluate the performance ability of bank. This parameter ascertains the ability of a bank to pay its liabilities as and when they matured. Higher liquidity implies that the banks will be able to meet any untimely withdrawals by the depositors. Not only that but sometimes in a liquidity crunch situation in the market, bank can earn good interest income in call money market also. There must be sufficient liquidity sources for present and future requirements and also availability of assets that can be readily convertible in to cash without undue loss. Liquidity of a bank can be measured by various ratios.

So, Indian banks are rated as per above supervisory rating model 'CAMEL' approved by the Reserve Bank of India.

VARIOUS RATIOS FOR CALCULATION FOR PARAMETERS OF 'CAMEL' MODEL

Following are some of the ratios that are being used for the calculation for various parameters of 'CAMEL' model:

CAPITAL ADEQUACY :-

- Capital Adequacy ratio
- Debt- equity ratio
- Government securities to total investments
- Advances to assets

ASSETS QUALITY :-

- Gross NPAs to net advances
- Net NPAs to net advances
- Net NPAs to total assets
- Total investments to total assets ratio
- Percentage change in net NPAs

MANAGEMENT EFFICIENCY :-

- Total advances to total deposits
- Business per employee
- Profit per employee
- Return on net worth

EARNING QUALITY :-

- Spread or net interest margin (NIM) to total assets
- Interest income to total income
- Operating profit to average working fund ratio
- Operating profit to total assets
- Non- interest income to total income
- Return on average capital employed

LIQUIDITY :-

- Liquid assets to total assets
- Government securities to total assets
- Liquid assets to demand deposits
- Liquid assets to total deposits

CONCLUSION

Objects of 'CAMEL' model are to provide a good, accurate and consistent assessment of a bank's financial position in the various key areas like capital, asset quality, management, earning quality and liquidity. Furthermore, in a situation where, financial markets are increasingly becoming more and more integrated, providing a common model for measurement or assessment of overall financial performance of the banks is of a big importance for financial markets in general and banking sector in particular.

'CAMEL' model of rating is also provides significant compliance data or information that is needed for the regulators. This information helps them to ensure the extent of supervisory concern and response to issue timely warnings to reduce the negative effects on the banks.

So, 'CAMEL' model is very useful for performance evaluation for banks in India. Sometimes, its index works as a bank's failure predicting model also. In nutshell, still 'CAMEL' model is very important for the banking sector and banking regulator as a whole.

REFERENCE

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