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Evaluating the soundness of banks through the Camel rating model

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Abstract
The purpose of CAMEL ratings is to determine a bank's overall condition and to identify its strengths and weaknesses-Financial, Operational and Managerial. Each bank is assigned a uniform composite rating based on five elements. The system provides a general framework for evaluating the banks. The model takes into consideration capital adequacy, asset quality, management capability, earnings capability and liquidity.

Keywords: asset quality, banking industry, capital adequacy, earnings capability, liquidity position

Introduction

Banking industry is pre-eminently a service-oriented industry. For successful survival and sustained growth, a bank has to be efficient and effective in utilisation of resources and provide excellent services to the customer. Efficiency of a bank is reflected in its profitability. Productivity is one of the major factors affecting profitability of a bank. It is a function of an input-output relation.

The banking structure existing at present in India is the outcome of a process of expansion, reorganisation and consolidation which has been going on for many years and yet continues. The banking system in India has undergone three phases *viz*.

- Pre-nationalisation phase,
- Post-nationalisation phase, and
- Market Development phase.

Pre-nationalisation period and Post-nationalisation period are the two distinct phases of the development process. of late, it has extended to a third phase, *viz*; Market development through innovation and diversification into new areas with exclusive focus on customers' services and through mergers.

Prior to nationalisation growth of banks was governed purely by economic considerations. However, post-nationalisation period witnessed greater emphasis having being accorded to social objectives resulting into widening of branch networks, the length and breadth of the county and greater mobilisation of savings through banks deposits and greater channelization of resources into the selected sector. Now-a-days, the soundness of banks are being evaluated based on quantitative as well qualitative aspects.

The CAMEL Rating Model

CAMEL, an acronym for Capital Adequacy, Asset Quality, Management Capability, Earnings Capacity and Liquidity is an internal supervisory tool for evaluating the soundness of banks and for identifying those banks which require special supervisory attentions or concern. CAMEL model of rating was first developed in the 1970s by the three federal banking supervisors of the U.S (the Federal Reserve, the FDIC and the OCC) as part of the regulators' "Uniform Financial Institutions Rating System", to provide a convenient summary of bank condition at the time of its on-site examination. Prior to 1991, the Reserve Bank was conducting two types of inspection, *viz*., Financial Inspection and Annual Financial Reviews. In 1995, RBI had set up a working group under the chairmanship of Shri S. Padmanaban to review the banking supervision system. S. Padmanaban Committee recommended that banking supervision should focus on the parameters of the financial soundness, managerial and operational efficiency and firmness. The committee has suggested CAMEL rating system. Each of the five dimensions of performance is rated on a scale of 1 to 5, varying from fundamentally strong bank to fundamentally weak bank. The RBI conducts its periodical on-site inspections using this model.

The components of CAMEL Rating are Capital Adequacy 20%, Asset Quality 20%, Management 20%, Earnings 15%, Liquidity 10% and Sensitivity to Market Risk is 10%. The purpose of CAMEL ratings is to determine a bank's overall condition and to identify its strengths and weaknesses - Financial, Operational and Managerial. Each. bank is assigned a uniform composite rating based on five elements. The system provides a general framework for evaluating the banks. It is a standardized method which allows the assessment of the quality of banks according to standard criteria providing a meaningful rating.

Framework of CAMEL Rating

A brief outline of the framework of CAMEL Rating is being presented hereunder:

C- Capital Adequacy

Capital adequacy determines how well financial institutions can cope with shocks to their balance sheets. It indicates whether the bank has enough capital to absorb unexpected losses. It is required to maintain depositors' confidence and preventing the bank from going bankrupt. The following ratios measure capital adequacy:

- Capital Adequacy Ratio
- Debt-Equity Ratio
- Advance to Assets Ratio
- Government Securities to Total Investments

A-Asset Quality

Asset quality determines the healthiness of financial institutions against loss of value in the assets and it indicates the type of debtors of the bank. The weakening value of assets, being prime source of banking problems, directly pour into other areas, as losses are eventually written-off against capital, which ultimately expose the earning capacity of the institution. The following ratios measure Asset quality:

- Net NPAs to Total Assets Ratio
- Net NPAs to Net Advances Ratio
- Total Investments to Total Assets Ratio

M - Management Capability

It involves analysis of efficiency of management in generating business and in maximizing profits. The performance of management capacity is usually qualitative and can be understood through the subjective evaluation of management systems, organization culture and control mechanisms and so on. However, the capacity of the management of a bank can also be gauged with the help of certain ratios of off-site evaluation of a bank. The following ratios measure Management Capability:

- Total advances to Total Deposits Ratio
- Profit per employee
- A Business per employee

E-Earnings Capacity

Good earnings and profitability of banks reflects the ability to support present and future operations. Specifically, this determines the capacity to absorb losses, finance its expansion, pay dividends to its shareholders, and build up an adequate level of capital. To survive in the competitive financial environments, banks have to generate adequate earnings to meet out all the non-operating expense and to maintain adequate spread by avoiding burden. The following ratios measure earning capacity:

- Return on Assets
- Spread to Total Assets Ratio
- Operating Profit to Average Working Funds Ratio
- Cost to Total Income Ratio

L-Liquidity

Banks are in a business where liquidity is of prime importance. Among assets, cash and investments are the most liquid of a bank's assets. An adequate liquidity position refers to a situation, where institution can obtain sufficient funds, either by increasing liabilities or by converting its assets quickly at a reasonable cost. Risk of liquidity is curse to the image of bank. Bank has to take a proper care to hedge the liquidity risk; at the same time ensuring good percentage of funds are invested in high return. Generating securities, so that it is in a position generate profit with provision liquidity to the depositors. The following ratios measure liquidity.

- Liquid Assets to Total Deposits Ratio
- Liquid Assets to Total Assets Ratio
- G-Sec to Total Assets Ratio
- Approved Securities to Total Assets Ratio

Rating Provisions

Each element is assigned a numerical rating based on five key components

- Strong performance, Sound Management no cause for supervisory concern.
- Fundamentally sound, compliance with regulations, stable, limited supervisory needs
- Weaknesses in one or more components. Unsatisfactory practices, weak performance but limited concern for failure.
- Serious financial and managerial deficiencies and unsound practices. Need close supervision and remedial action
- Extremely unsafe practices and conditions, deficiencies beyond management control. Failure is highly probable and outside financial assistance needed.

Based on the ratings of each element, a composite rating of 1 through 5 is assigned to the bank All the factors reflected in the key components ratings are considered in assigning the composite rating.

Conclusion

Economic development of any country is mainly influenced by the growth of the banking industry in that country banking sector is one of the fastest growing sectors in India. Today's banking sector becoming more complex. Evaluating Indian banking sector is not an easy task. There are so many factors, which need to be taken care while differentiating good banks from bad ones. Due to the nature of banking and the important role of banks in the economy in capital formation, banks should be more closely watched than any other type of economic unit in the economy. The CAMEL supervisory system in banking sector is a substantial improvement over the earlier systems in terms of frequency, coverage and focus. It is a ratio-based model convenient to use and easily understandable by all.

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