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A Review of Camels Rating Approach for Financial Institutions

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Abstract-

Banks across the country are going through rapid technological transformation and banking crisis. Thus, it is essential to understand the strength of our banking institutions in managing their risks effectively. The present study examines the CAMELS rating approach, a leading approach to rate and analyze the banks. CAMELS rating of financial institutions aids in ensuring banking soundness and efficiency. An indepth investigation into the components of CAMELS rating approach has been performed under the study.

Index terms- CAMELS, financial instituting, rating, banking soundness

1. Introduction

The basic functions of a bank are accepting money as deposits and lending money as loans. Banks and financial intermediaries, form a part of the banking system. The banking system is a mechanism through which the money in the economy is created and controlled. As far as the banking system of India is concerned, it consists of our central bank, the Reserve Bank of India (RBI), commercial banks such as The State Bank of India (SBI) and Canara Bank, cooperative banks like Chhattisgarh Cooperative Bank and Bihar Cooperative Bank, and development banks, Industrial Finance Cooperative of India (IFCI) and Industrial Investment Bank of India (IIBI). Thus, the above four categories of banks forms India's Banking system. Moreover, Commercial banks in India are further divided into 2 categories that are Public Sector Banks and Private Sector Banks in India. A bank in which the Central Government may hold 50% or more stakes can be understood as a Public Sector Bank. As of today, there are 12 public sector banks in India.

On the other hand, a private sector bank is one where more than 50% stake is held by shareholders and not the government, and is controlled and managed by private promoters. As of today, there are 21 private sector banks in India.

There are a number of ways to assess the adequacy of banking system of a country; one of them is the CAMELS rating approach. Globally implemented, the CAMELS approach is a method to ascertain the overall condition and robustness of banks and financial institutions. In India, CAMELS rating approach is utilized by the regulator to assess the efficiency of Indian banks.

2. CAMELS Rating Approach:

This technique was developed in the United States in 1979, then it was named 'Uniform Financial Institutions Rating Systems (UFIRS)'. However, internationally it came to be known by the acronym 'CAMEL'. Further in 1995 the letter 'S' was added and the term became 'CAMELS'. Moreover, it is being utilized by various Central Banks of different countries and their corresponding authorities in order to understand the soundness of the financial sector for their respective country. Further, the approach is also used by rating agencies and researchers to look into the financial soundness of the banking system.

The acronym 'CAMELS' stands for '*Capital Adequacy, Asset Quality, Management Capability, Earnings, Liquidity and Sensitivity to Market*' (S being added in 1995). A number of parameters are used to calculate the above factors. While assessing the banking system on the basis of CAMELS approach, generally rating may be given from 1 to 5. A rating of 1 refers to outstanding and 5 as poor. Normally, a rating of 2 or lower is considered to be good and a rating of 3 or higher may be considered as bad. CAMELS approach is based upon the principle that lowers the rating, better and robust is the banking system. Particularly in India, the CAMELS approach has been modified into 'CAMELSC'. The meaning of CAMEL is the same; however, S stands for 'Systems' and C for 'Compliance'.

3. Components of CAMELS Rating Approach

RBI has adopted CAMELS framework (i.e. Capital adequacy, Asset quality, Management, Earnings, Liquidity, Systems and controls) for supervision of commercial banks in India. The components of CAMELS Rating Approach are explained below-

I) Capital Adequacy –

As per Reserve Bank of India, the use of capital helps bringing in owner's stake in ensuring sound operations. Therefore, it was decided to include the following risk factors under capital adequacy viz. capital to risk weighted asset ratio (CRAR) and the presence of Tier I Capital. While, CRAR reflects the overall soundness of the bank, the level and nature of Tier I capital helps to assess the quality of the capital. Banks are required to maintain a minimum Capital to risk-weighted Assets Ratio (CRAR) of 9 % with regard to credit risk, market risk and operational risk on an ongoing basis. Capital adequacy is critical for a financial institution like bank to maintain and preserve stakeholder trust and avoid bankruptcy. Some authors point out that Capital base of financial institutions facilitates depositors in forming their risk perception about the organization. Also, it is important for financial managers to maintain adequate levels of capitalization.

II) Asset Quality

Asset quality refers to the quality of an institutional loan, which represents the institution's earnings. Rating investment risk factors that the bank may face and balancing those factors against the bank's capital earnings is part of assessing asset quality. This demonstrates the bank's resilience in the face of setbacks. Reserve Bank of India reports, states to utilize the following risk factors related to non-performing assets viz. the percentage of Gross NPAs to Gross Advances to reflect overall asset quality, percentage of Net NPAs to Net Advances to assess the strength of balance sheet based on the provisions made for NPAs.

III) Management

An institution's ability to respond to financial stress is determined by a management evaluation. This aspect reflects management's ability to identify, assess, track, and regulate risks associated with the institution's daily operations. The consistency of a bank's business plan, financial results, and internal controls forms this category. Thus, management efficiency is another indispensable component of the CAMEL framework,.

IV) Earnings Quality

RBI states that performance under the earnings parameters provides a useful insight into bank's potential to sustain its capital ratios. Under earnings, three risk factors are seen viz. Return on Assets (RoA), cost to income ratio and Net Interest Margin (NIM). RoA is compiled as percentage ratio of profit after tax to average total assets and is indicative of the productivity of assets. Cost to income ratio, is defined as percentage ratio of operating expenses to total of net interest income plus non-interest income and reflects the degree of efficiency of expense management. Lastly, the NIM depicts pricing efficiency of liabilities and assets. It also captures the adverse effect of NPAs(non performing assets) as they generate no interest income.

V) Liquidity

RBI indicates that liquidity is represented by the share of term deposits in total deposits and the ratio of liquid assets to total deposits and borrowings. As regards liquidity on the balance sheet, it held the view that all market assets and the assets maturing within one month would denote liquidity. It was decided that the liquid assets would consist of cash and bank balances (including balances with RBI), monies placed with counterparties (interbank) and maturing within one month, and investments in government securities. In a typical state of bank liquidation, these assets would generate cash more easily. Therefore, higher the share of such assets, more liquid is the balance sheet.

VI) Sensitivity to market risk

Regulators describe sensitivity to market risk as the extent to which changes in interest rates, foreign exchange rates, commodity prices, or stock prices can impact a bank's earnings and, as a result, its financial health. This factor therefore has an impact on profitability and capitalization of banks and financial institutions. It focuses on an institution's ability to identify, monitor, manage and control its market risk, and provides institution management with a clear and focused indication of supervisory concerns in this area.

4. Literature Review:

S.NO.	NAME OF AUTHOR (Year)	OBJECTIVES	PERIOD OF STUDY	CONCLUSION
1	Dubey S. & Puri Y. (2021)	The study analyzed the financial performance of top five public and private sector banks based on its total assets through CAMEL approach model	2015-2020	Based on composite index rating it was found that Kotak Mahindra Bank has performed better and hold first position among all banks and Punjab National Bank hold the least position.
2	Banu M. and Vepa S.(2021)	The study aims at analyzing the financial and operating performance of 2 largest public and private sector banks on the basis of CAMEL approach	2010-2019	It was found that in terms of capital adequacy and asset quality, private banks overtook public sector banks while in terms of liquidity and sensitivity public banks overtook private sector banks.
3	Mahmud and Rahman (2020)	The study evaluated and compared the financial soundness of 6 Islamic and 17 Conventional PCBs operating in Bangladesh based on CAMEL approach	2015-2019	Based on composite index ratings it was revealed that Brac Bank Ltd secures top position among all the conventional banks ; there is no significant difference in performance of two types of banks except for Liquidity. Islamic

				banks have better performance.
4	Raman, Mayakkannan & C.Jayasankar (2020)	The study analyzed the relative financial position and performance of top 10 public and private sector banks selected on the basis of net margin, total assets through CAMEL approach	2015-2020	Based on all ratios it was concluded that public sector Banks performed better than private sector banks.
5	Ledhem M.A. & Mekidiche M.(2020)	The study measured the financial performance of Islamic finance and economic growth in banking sector by using CAMEL approach	2014-2018	It was found that the return on equity is the only significant parameter of CAMELS model which affect economic growth and financial performance
6	Banu M. and Vepa S.(2019)	It attempts to analyse the operational performance namely short term liquidity, solvency and profitability of the Indian Banking Sector	2007-08 to 2016-17	The results indicate that there exists a strong correlation among public, private and foreign sector banks with regard to return on equity, return on investments, return on assets and return on advances on the profitability.
7	Banu M. and Vepa S.(2018)	It attempts to analyse the adverse effect of non-performing assets on the performance and profitability of the banking sector.	2008-2017	There exists an imperative inverse relationship between the non-performing asset and the return on asset and return on equity across

				all banking sectors
8	Meena G. L. (2016)	CAMEL approach is used to know the performance of the public sector and private sector banks by use of tools like different tools like capital adequacy, asset quality, management capability, earnings capacity, liquidity	2015	Profit per employee, debt-equity ratio, total advances-to-total deposits ratio, net NPA-to-total advances ratio are the major factors impacting financial performance of banks
9	Ahsan M. K. (2016)	to analyze the financial performance of three selected Islamic Banks using CAMELS approach	2007-2014	With the use of CAMEL Rating approach it is found that all the selected Islamic banks are in strong position on their composite rating system

5. Conclusion:

All the seven components of CAMELS Approach form a distinct parameter for the evaluation of bank's stability and sustainability. It is essential to understand the strength of our banking institutions to assess their ability to sustain and manage risks effectively. CAMELS Rating approach is a method to ascertain the overall condition and robustness of banks and financial institutions. In India, this approach is utilized by the regulator, reserve bank of India, to assess the efficiency of Indian banks. It is further suggested that the Banking regulators should timely evaluate and rate the banks on CAMELS Approach to enable Banking sector efficiency and valuable comparisons among the Indian banks.

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