Applicability of CAMELS Rating for Supervisory Regulation of the Indian Banking System

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1. Camels Rating
2. Indian Banking System

Abstract

How should the strength of banks be best assessed? Answering this question is at the core of the business of two very different economic agents: policymakers and credit rating agencies. While the policymakers' main objective is to minimize the cost associated with existing financial markets safety nets, the objective of rating agency is to provide investors with an adequate measurement of risk involved in instruments issued by the financial institutions they rate. For rating banks, rating agencies use a relatively compact set of financial indicators derived from banks' balance sheet and income statements. CAMELS ratings are commonly viewed as summary measures of the private supervisory information gathered by examiners regarding banks' overall financial conditions. This rating system is used by three federal banking supervisors (the Federal Reserve, the FDIC and the OCCC) and other financial supervisory agencies to provide a convenient summary of bank conditions and bank ratings.To review, CAMELS is an acronym for the key financial and operational aspects of the bank, which examiners evaluate during the safety and soundness examination. The components are: capital adequacy; asset quality; management and board of directors' supervision; earnings performance; liquidity; and sensitivity to market risk. Ratings are assigned for each component in addition to the overall rating of a bank's financial condition. The ratings are assigned on a scale from 1 to 5. Banks with ratings of 1 or 2 are considered to present few, if any, supervisory concerns, while banks with ratings of 3, 4, or 5 present moderate to extreme degrees of supervisory concern.

INTRODUCTION

Supervisory regulations enhance transparency and accountability in the operations of the banks thereby compelling them to pay greater attention to the quality of lending. In addition, these regulations conform to the international accounting standards and would enable the Indian players to operate in the global markets. Hence, adherence to these guidelines would enhance the sustainability of banks and make them competitive. The reform measures were aimed at not only liberalizing the regulatory framework, but also to keep them in tune with the international standards. And since the banks had to move from a highly regulated environment to a deregulated environment, some of the public sector banks had to bear the ordeal of reformation. In an attempt to stabilize the banks positions during this transition phase, the Government contributed capital to a few among the weak nationalized banks to strengthen their capital base. It also permitted some of these banks to set off their accumulated losses against capital. All these measures were taken in order to ensure that the Indian banking system reaches the global standards.

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The Reserve Bank objective to have uniformity and in synchronization with international standards, it has been decided that all banks in India will implement it with specific approval from the RBI. The RBI will implement it after taking into account the experience of the more advanced G7 (Canada, France, Germany, Italy, Japan, The UK and The US) nations. India's decision to implement Basel II norms from March 2008 is expected to improve banks risk management system and provide them incentive for meeting the prudential norms.

BENCHMARKING AGAINST INTERNATIONAL STANDARDS

Further to the above-mentioned steps taken in response to the challenges posed by liberalization, steps were also taken to benchmark the Indian banking practices with the international standards. For this purpose, efforts are being made to ensure that the universally accepted standards and codes are practiced. The leading international agencies like the World Bank and IMF are emphasizing on following the global standards. In India the process has begun with the regulators and government concentrating on universally acceptable standards and codes for benchmarking domestic financial systems. With this the private sector can also bring into its purview issues relating to market

discipline, corporate governance, insolvency procedures and credit rights. The standards and codes are not final goals but instruments to enhance efficiency in financial intermediation while ensuring financial stability as well. There are three levels at which action is necessary, legal policy, procedures and market practices by participants. In several areas, fundamental changes in the legal and institutional infrastructure are pre-requisites. Since these changes can influence the socio-cultural as well as politico-economic culture to a great extent, appropriate adoption and some prioritization in implementation are unavoidable. In several areas, the issues are of a technical nature. Accordingly, the Standing Committee in International Standards and Codes, setup in December 1999, constituted ten Advisory Groups comprising eminent experts, generally non official, to bring objectively and experience into studying the applicability of relevant international codes and standards to each area of competence. The Advisory Group has submitted their reports. They have set out a roadmap to implement appropriate standards and codes in the light of existing levels of compliance, the cross-country experience and the existing legal and institutional infrastructure.

Globalization is both a challenge and an opportunity for Indian banks to gain strength in the domestic market and increase presence in the global market. RBI subjected banks to ratings under capital adequacy, asset quality, compliance and system and capital adequacy, assets quality, management, earnings, liquidity and systems models for differentiating supervisory priorities. When reform were first introduced under recommendation of the Narasimham committee I, the 27 (then 28) PSBs were placed under A, B and C categories, i.e. sound banks, banks with potential weakness and sick banks, respectively. Accordingly, recapitalization and restructuring were carried out for B and C categories. For individual ratings by international rating agencies, a bank is assessed as if it was entirely independent and could not rely on external support. The ratings are designed to assess a bank's exposure to risk, appetite for risk, and management of risks.

CREDIT RATING ANALYSIS - PROCESS AND ISSUES

The financial sector is going through a phase of transformation and convergence and there has been an increasing blurring of boundaries between the role of banks and financial institutions, which is likely to step up competitive pressure in future. This transformation is evident on both the assets and the liability side. On the asset side, banks are shifting from their historical business model of providing finance to corporate to aggressively focus on financing retail assets such as housing, automobiles and commercial vehicles. This is driven both by the weak demand from corporate as well as the paucity of clients with good credit quality. On the liability side, the transformation is from a passive retail strategy to a very active retail thrust to attract and retain customers and increase the deposit base. The entry of the newer private sector banks and the marketing strategy adopted by them has precipitated this transformation.

Banking today has transformed into a technology intensive and customer friendly model with a focus on convenience. The sector is set to witness the emergence of financial supermarkets in the form of universal banks providing a suite of services from retail to corporate banking and industrial lending to investment banking. While corporate banking is clearly the largest segment, personal financial services is the highest growth segment. Apart from this transformation, banks are also going through a phase of convergence wherein almost all banks are offering the entire gamut of products and services on the asset and liability side to both retail as well as wholesale customers. This transformation, dismantling of the consortium leading system and the deregulation in interest rate have further presented associated challenges of managing credit risks and asset liability profiles.

An entry specific analysis of the risk profile is done through a qualitative-cum-quantitative approach following a structured methodology called the "CAMEL" model. Based on the rating criteria, the relative strengths and weaknesses of each entity in comparison to its peer group are evaluated. Apart from the CAMEL model, CRISIL also evaluates the market position of the bank being rated and its strategy in the emerging competitive scenario.

Earlier, it was made mandatory only for the banks to have themselves credit rated to raise capital from capital market through IPO. With a view to safeguarding the interest of the prospective investors, depositors and creditors and also the bank management as a whole for their overall performance it has been made mandatory for all banks to have themselves credit rated by a credit rating agency. Banks will disclose their credit rating prominently in their published annual and half yearly financial statements.

By comparing a bank with its peers and with its historical performance, the relative strengths and weaknesses of the bank and emerging or reversing trends can be discerned. The heart of the analytical inquiry, as always, is to evaluate the bank's credit rating in general and specifically, to determine its strength, diversification and prospects of its business franchise, the quality and diversification of its loan

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portfolio, its vulnerability to economic shocks or business reverses and its ability to absorb such shocks and return to sustainable growth.

THE CAMEL RATING SYSTEM

In 1979, the bank regulatory agencies created the Uniform Financial Institutions Rating System (UFIRS). Under the original UFIRS a bank was assigned ratings based on performance in five areas: the adequacy of Capital, the quality of Assets, the capability of Management, the quality and level of Earnings and the adequacy of Liquidity. Bank supervisors assigned a 1 through 5 composite rating was known primarily by the acronym CAMEL.

A bank that received a CAMEL of 1 was considered sound in every respect and generally had component ratings of 1 or 2 while a bank with a CAMEL of 5 exhibited unsafe and unsound practices or conditions, critically deficient performance and was of the greatest supervisory concern. While the CAMEL rating normally bore close relation to the five components ratings, it was not the result of averaging those five grades. Rather, supervisors consider each institution's specific situation when weighing component rating and more generally, review all relevant factors when assigning ratings. The UFIRS was revised at year-end 1996 and CAMEL became CAMELS with the addition of a component grade for the Sensitivity of the bank to market risk. In the CAMEL credit rating system, each of the components is assigned a rating on a scale of 1 to 5, with 1 representing the best performance and 5 representing the poorest. The rating of each component is based on, but not limited to, the following evaluation factors:

Capital Adequacy

The level and the quality of the capital and the overall financial condition of the institution. The ability of management to address emerging needs for additional capital and the nature, trend and volume of problem assets along with the adequacy of allowances for loan and lease losses and other valuation reserves. Finally the balance sheet composition and an institution's access to capital markets and other sources of capital including support provided by a parent holding company or emergency lines of credit from affiliate institutions. Capital adequacy reflects the overall financial condition of the banks and also the ability of the management to meet the need for additional capital. As per latest RBI norms, banks in India should have a CAR of 9%. It is computed by dividing Tier-I and Tier-II capital by the weighted assets.

Asset Quality

The adequacy of underwriting standards, soundness of credit administration practices and appropriateness of risk identification practices. The level, distribution, severity and trend of problem, classified, non-accrual, restructured, delinquent and non-performing assets for both on and off balance sheet transactions. Also included is the adequacy of the allowances for loan and lease losses and other asset valuation reserves and the ability of management to properly administer its assets. The prime motto behind measuring the assets quality is to ascertain the component of Non- Performing Assets as a percentage of the total assets. Thus, assets quality indicates the type of the debtors the bank is having.

Management Efficiency

The level and quality of overseeing and support of all institution activities by the board of directors and management in addition to their ability to plan for and respond to risks that may arise from changing business conditions or the initiation of new activities or products. Management is also rated on the overall performance of the institution and its risk profile. The ratios in this segment involve subjective analysis to measure the efficiency and effectiveness of management. The management of the bank takes crucial decisions depending on its risk perception. It sets vision and goal for the organization and sees that it achieves them. This parameter is used to evaluate management efficiency as to assign premium to better quality banks and discount poorly managed ones.

Earning Quality

The level of earnings, including trends and stability and the ability to provide for adequate capital through retained earnings as well as the quality and source of earnings. Also monitored are the level of expenses in relation to operations and the exposure of earnings to market risk such as interest rate foreign exchange and price risk. This parameter gains importance in the light of the argument that much of a bank's income is earned through non-core activities like investment treasury operations, corporate advisory services and so on. In this section we try to assess the quality of income in terms of income generated by core activity-income from lending operations.

Liquidity

The adequacy of liquidity sources compared with present and future needs and the ability of the institution to meet liquidity needs without affecting its operations. The availability of assets readily convertible to cash without undue loss and the level of diversification of funding sources. Finally, the capability of management to properly identify, measure, monitor and control the institution's liquidity position.39 Liquidity is very important for any

organization dealing with money. Banks have to take proper care in hedging liquidity risk while at the same time ensure that a good percentage of funds are invested return generating investments so that banks can generate profits while at the same time provide liquidity to the depositor. Demand deposits offer high liquidity to the depositor and so banks have to invest these in high liquid form. It is interesting to note that a high majority of the banks hold more that 100% of the demand deposits in liquid assets. Through mandatory SLR and CRR, RBI ensures that banks maintain ample liquidity.

Sensitivity to Market Risk

The sensitivity of financial institution's earnings or the economic value of its capital to adverse changes in interest rates, foreign exchange rates, commodity prices or equity prices. Also the ability of management to identify, measure, monitor and control exposure to market risk given the institution's size, complexity and risk profile. This component reflects the degree to which changes in interest rates can adversely affect an institution's earnings or the market value of equity (MVE). When evaluating this component, consideration should be given to: management's ability to measure, manage, and control interest rate risk; the institution's size; the nature and complexity of asset/liability management activities; and the level of interest rate risk exposure relative to the adequacy of capital and earnings. One of the primary sources of interest rate risk arises from on- and off-balance sheet positions and their sensitivity to changes in interest rates.

Once each of the component ratings has been determined, the composite CAMELS rating is assigned as a summary measure and bank regulators use this rating as the primary

Table 1 : Important Ratios of CAMEL Model

Capital Adequacy	- Capital adequacy ratio - Debt equity ratio - Advances to assets - Govt.-Securities to total investments
Assets Quality	- Net NPA to total assets - Net NPA to net advances - Total investment to total assets - % Change in NPA's
Management efficiency	- Total advances to total deposits - Business per employee - Profit per employee - Return on net worth
Earning Quality	- Operating profits to average working funds - Spread to total assets - Net profit to average assets - Interest income to total income - Non interest income to total income
Liquidity	- Liquid assets to Demand Deposits - Liquid Assets to Total Deposits - Liquid Assets to Total assets - Govt.-Securities to Total Assets

Source: B.S. Bodla & Richa Verma,(2006), "Evaluating Performance of Banks through CAMEL Model", The ICFAI Journal of Bank Management, Vol. 5, No. 3, August, p-53.

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indicator of financial condition and performance. It should be noted that prior to 1997 regulators only issued the composite rating to senior bank management. Starting in 1997, however, regulators began releasing the rating of each component area, which resulted in the overall composite numerical rating. Composite ratings are assigned on a scale of 1 to 5. An institution rated a 1 warrants the least supervisory concern. The five composite rating levels, as set forth in the Commercial Bank Examination Manual produced by the Board of Governors of the Federal Reserve System, are summarized as follows:

1 Rating	An institution that is basically sound in every respect.
2 Rating	An institution that is fundamentally sound, but with modest weaknesses.
3 Rating	An institution with financial, operational or compliance weaknesses that give cause for supervisory concern.
4 Rating	An institution with serious financial weaknesses that could impact future viability.
5 Rating	An institution with critical financial weakness that render the probability of failure extremely high in the near term.

HOW THE RATING SYSTEM CAME INTO USAGE

This rating system is used by the three federal banking supervisors (the Federal Reserve, the FDIC, and the OCC) and other financial supervisory agencies to provide a convenient summary of bank conditions at the time of an exam. During an onsite bank exam, supervisors gather private information, such as details on problem loans, with which to evaluate a bank's financial condition and to monitor its compliance with laws and regulatory policies. A key product of such an exam is a supervisory rating of the bank's overall condition, commonly referred to as a CAMELS rating.

All exam materials are highly confidential, including the CAMELS. A bank's CAMELS rating are directly known only by the bank's senior management and the appropriate supervisory staff. CAMELS ratings are never released by supervisory agencies, even on a lagged basis. While exam results are confidential, the public may infer such supervisory information on bank conditions based on subsequent bank actions or specific disclosures. Overall, the private supervisory information gathered during a bank exam is not disclosed to the public by supervisors, although studies show that it does filter into the financial markets.

ROLE OF RBI IN CREDIT RATING OF BANKS

The Annual Financial Inspection (AFI) focuses on statutorily mandated areas of solvency, liquidity and operational health of the bank. It is based on internationally adopted CAMEL model modified as CAMELS, i.e., capital adequacy, asset quality, management, earning, liquidity and system and control. Based on the recommendations of the S Padmanabha Committee (appointed by RBI to recommend changes in the on-site supervision of banks), banks are rated on a five point scale (A to E), which is based on the international CAMELS rating model.

ADOPTION OF CAMELS BY RBI IN ITS SUPERVISORY REGULATIONS OF THE BANKING SYSTEM

The focus of the statutory regulation of commercial banks by RBI in India until the early 1990s was mainly on licensing, administration of minimum capital requirements, pricing of services including administration of interest rates on deposits as well as credit, reserves and liquid asset requirements. In these circumstances, the supervision had to focus essentially on solvency issues

After the evolution of the BIS prudential norms in 1988, the RBI took a series of measures to realign its supervisory and regulatory standards almost on a par with international best practices. At the same time, it also took care to keep in view the socio-economic conditions of the country, the business practices, payment systems prevalent in the country and the predominantly agrarian nature of the economy, and ensured that the prudential norms were applied over the period and across different segments of the financial sector in a phased manner.

The entire supervisory mechanism has been realigned since 1994 under the directions of a newly constituted Board for Financial Supervision (BFS), which functions under the aegis of the RBI, to suit the demanding needs of a strong and stable financial system. The supervisory jurisdiction of the BFS now extends to the entire financial system barring the capital market institutions and the insurance sector.

The periodical on-site inspections, and also the targeted appraisals by the Reserve Bank, are now supplemented by off-site surveillance, which particularly focuses on the risk profile of the supervised institution. A process of rating of banks on the basis of CAMELS in respect of Indian banks and CACS (Capital, Asset Quality, Compliance and Systems & Control) in respect of foreign banks has been put in place from 1999.

The Offsite Monitoring and Surveillance System (OSMOS) was introduced in 1995 as an additional tool for supervision of commercial banks to supplement the on-site examinations. The system consists of 12 returns (called DSB returns) focusing on supervisory concerns such as capital adequacy, asset quality, large credits and concentrations, connected lending, earnings and risk exposures (viz. currency, liquidity and interest rate risks).

The supervisory intervention by the RBI is normally triggered by the deterioration in the level of capital adequacy, NPAs, credit concentration, lower earnings, and larger incidence of frauds, which reflect the quality of control. RBI has issued a comprehensive Notification on the Supervisory System for Financial Institutions including the functions of the Board for Financial Supervision covering comprehensive information on the subject.

SUPERVISION OF THE INDIAN FINANCIAL SYSTEM BY RESERVE BANK OF INDIA

Internationally, following the failure of some large banks and bank related entities; there has been a debate on the segregation of supervision from traditional central banking, citing the conflict between monetary policy objectives and bank supervision objectives. At the same time, there is also a considered view that bank supervision function can provide the central bank with far more information from and control over the institutions and markets and thus assist in maintaining financial stability. The financial markets have become more sophisticated and global in nature, adding to the challenges faced by central banks while at the same time rapid strides in telecommunication and electronic data processing coupled with new funding instruments, growth of securitization, emergence of new institutions have increased the role and responsibilities of bank supervisors

The legal and institutional framework for bank supervision in India is provided under the Banking Regulation Act, 1949. Until 1994, different departments in Reserve Bank of India were exercising supervision over banks, non-banking financial companies and financial institutions. To keep a close watch on financial markets and avoid recurrence of crisis in the financial system, the Board for Financial Supervision was set up under the aegis of Reserve Bank of India (Board for Financial Supervision) Regulations, 1994 with the objective of paying undivided attention to the supervision of the institutions in the financial sector.

Prior to 1993, the supervision and regulation of commercial banks was handled by the Department of Banking Operations & Development (DBOD). In December 1993 the Department of Supervision was carved out of the DBOD with the objective of segregating the supervisory role from the regulatory functions of RBI. Globally, increasing financial dis-intermediation has led to an increase in the assets and reach of Non-Bank Finance Companies necessitating enhanced regulatory attention towards these non-bank and near-bank entities. The merger of Financial Institutions Cell with the Department of Supervision in June 1997 led to the formation of an exclusive Financial Institutions Division within the DoS that was entrusted with both supervision and regulation over All India Development Financial Institutions. Later, the Department of Supervision was split into Department of Banking Supervision (DBS) and Department of Non-Banking Supervision (DNBS) on July 29, 1997 with the latter being entrusted with the task of focused regulatory and supervisory attention towards the NBFC segment.

Supervisory Process

The major instrument of supervision of the financial sector is inspection. The inspection process focuses mainly on aspects crucial to the bank's financial soundness with a recent shift in focus towards risk management. Areas relating to internal control, credit management, overseas branch operations, profitability, and compliance with prudential regulations, developmental aspects, and proper valuation of asset / liability portfolio, investment portfolio and the bank's role in social lending are covered in the course of the inspection. The Department undertakes statutory inspections of banks on the basis of an annual program, which is co-terminus with the financial year for public sector banks. After the inspection, report is released to the bank, followed by a 'supervisory letter' based on the inspection findings to the bank, the concerns of the inspections are discussed with the CEO of the bank and a Monitor able Action Plan is given to the bank for rectification of those deficiencies. The Department submits a memorandum covering supervisory concerns brought out by the inspection to the Board for Financial Supervision (BFS). Specific corrective directions of the BFS are conveyed to the banks concerned for immediate compliance. The Memoranda submitted by the departments for supervisory scrutiny and consideration of BFS generally cover matters relating to supervisory strategy and operational supervision of individual banks, financial institutions and non-banking financial companies as also industry-wide issues and sect oral performance reviews.

In terms of the new approach adopted for the on-site inspection of banks, the Inspecting Officers concentrate on core assessments based on the CAMELS model (Capital adequacy, Asset quality, Management, Earnings appraisal, Liquidity and Systems & controls). This approach eschews aspects which do not have a direct bearing on the

evaluation of the bank as a whole or which should essentially concern the internal management of the bank. The new approach to Annual Financial Inspections was put in practice from the cycle of inspections commencing in July 1997.

A rating system for domestic and foreign banks based on the international CAMELS model combining financial management and systems and control elements was introduced for the inspection cycle commencing from July 1998. The review of the supervisory rating system has been completed so as to make it more consistent as a measure of evaluation of bank's standing and performance as per on-site review. Credit rating agencies in the business of rating banks claim as one of their main functions the assessment of a bank's financial strength as measured by its capacity to meet its obligations (without the support of government bailouts) and its effectiveness to manage risk. To a large extent, these functions are shared by domestic banking supervisors and, therefore, there is a common interest in identifying the best indicators of banks financial performance.

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