Chapter 3

CAMELS MODEL
SIGNIFICANCE AND ITS IMPLEMENTATION IN BANKS
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CAMELS Model: Significance and its Implementation in Banks

Over the last few decades, both developed and developing economies have witnessed a spate of financial crisis spearheaded by failure in the banking system (Debasish, 2004). 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 (RBI, 2000). At the same time, there is also a considered view that banks’ supervisory function can provide the central bank with requisite information essential to maintain control over the institutions and markets that would assist in attaining the ultimate goals of financial stability and overall sustainable growth.

Banking is one of the more closely supervised industries in the world because failures of bank would adversely affect economic activity of the nation rather than any other business (Mohan, 2005). Banks play a very significant role in directing the activities in an economic system. The role of banks in expanding economy of a country like India can neither be underestimated nor overlooked. Banking acts as a catalyst in the socio-economic transformation as well as economic growth. Thus, strong, efficient and healthy banking is essential for the development of any economy. A typical way to address the issue is to tighten prudential supervision (Mishkin, 2001) and to innovate tools to monitor banks that facilitates in providing timely early warning signals to supervisors as well as bank’s internal management.

The government grants authority to bank supervisors to limit the risk of failure assumed by banks. Supervisors impose sanctions on the banks that are being identified as being in poor financial condition. Effective bank supervision, therefore, requires accurate information about the condition of banks. Bank
supervisors use on-site examination and off-site surveillance to identify the banks most likely to fail.

In India, the legal and institutional framework for bank supervision 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 (NBFCs) 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 (BFS) was set up in accordance with 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.

In the age of financial sector labialisation along with organisational and geographical integration there is excessive pressure on banking to improve the margin and adopt international benchmarks. In modern days banks performance and its strength cannot be justified only on the ground of balance sheet figures. The viability of banks depends largely on the effective supervisions (on-site & off-site) and efficient Early Warning System (Gunther, et al, 2000 and Kolari, et al, 1996).

Supervisory screenings are combinations of financial ratios, derived from bank balance sheets and income statements that have provided warning with respect to safety-and-soundness problems. Supervisors draw on their experience to weigh the information content of these ratios. (Collier et al 2003)
Safety of banking is essential to maintain the confidence of the public. Thus, most important challenge for regulators and banks management is to effectively diagnose the forth-coming risk factors that lead to failure of banks. Various financial ratios such as capital adequacy, asset quality, earnings, liquidity and managerial performance ratios are very useful tools in the hands of regulators and bank management to identify such risks, take corrective actions in advance and avoid economic turmoil. Thus, CAMELS Model plays a very significant role in this regard as it covers both financial and non-financial parameters on which the regulators judge the performance of any bank (Sharma Gaurav V, 2004)

1. Overview of CAMELS Model
CAMEL was originally developed by the FDICIA\(^1\), USA for the purpose of determining when to schedule an on-site examination of a bank. (Gilbert et al, 2000) Bank Supervisors of USA added the “S” component (Market risk) in January 1997. CAMELS Approach assesses different aspects of commercial banks’ operations that are essential to determine their financial soundness. (Mudenda E., 1998). Supervisors evaluate performance of banks and assign ratings to banks using CAMELS model. The use of this model demonstrates the method of identifying forthcoming internal risks, monitoring procedures and internal control system. For this purpose the supervisors use following variables that are essential for carrying out inspection.

C - Capital Adequacy
A - Asset Quality
M - Management Competence
E - Earning Ability
L - Liquidity Risk
S - Supervision and Control

\(^1\) FDICIA- The Federal Deposit Insurance Corporation of America
The above-mentioned parameters taken in the model are indicators of financially and technically strong banks. Besides indicating financial soundness these parameters also act as check post and help in identifying the problem bank that is heading towards failure or have almost failed.

Global experience of financial turmoil led to the search for appropriate supervisory strategies to avoid bank failures (Curry et al, 1999). Presently, this model is being used in both advanced and developing countries. No industry benchmarks are set and agreed upon for all the selected ratios used in the CAMELS Model, as indicators of bank performance except for ratios with internationally set guidelines, like the Capital Adequacy Ratio (CAR). Bank supervisors set the standard for other parameter according to industrial average in the respective countries. Trigger points have been set up under the three parameters, i.e. CRAR, Net NPAs and Return on Assets (RoA) under Prompt Corrective Action Framework. The triggers based on these ratios take care of a bank’s performance in four critical areas that are quantifiable and form integral part of the rating framework viz. Capital Adequacy, Asset Quality, Earnings, Liquidity and Supervisions and Controls. The last parameter “S” also varies from countries to countries viz. strategic planning, Sensitivity to Market Risk and Supervision & Control.

II. CAMELS’ Model in India’s Perspective
The supervisors of Indian banks examined a number of methodologies for bank supervision and they felt that the CAMELS model could be adopted in the Indian context also. India introduced for inspection CAMELS rating system for domestic banks in July 1998. Department of Banking Supervision of RBI regenerated the model for domestic banks in India. The Inspecting Officers concentrate on core assessments based on the CAMELS Model Variables. However, foreign banks are rated on CACS model (Capital Adequacy, Assets Quality, Compliance and Systems).
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The Annual Financial Inspection (AFI) focuses on statutorily mandated areas of solvency, liquidity and operational health of the bank. Introduction of the model in supervisory rating system was essential to facilitate consistency in measuring of bank’s standing in terms of financial performance and control mechanism adopted by concerned bank management. The CAMELS MODEL aims at attaining the following objectives:

- Evaluation of bank’s safety and soundness
- Appraisal of the quality of board and top management
- Ensuring compliance with prudential regulations
- Identifying the areas where corrective actions are required to strengthen the bank
- Assessing efficient funds management system in banks.
- Analysis of key financial factors such as capital, earning, and liquidity
- Assessing Operation Risk status and its management in Banks
- Review of compliance with banking law and regulations as well as supervisory guidance conveyed on specific policies.

Under this approach core assessments based on individual components under CAMELS are used to assign a rating for the bank on the scale of **1 (Best)** THROUGH **5 (Worst)**. A composite rating is arrived at again on the scale of 1 through 5 after inspecting individual components under CAMELS. As the supervisory on-site examinations are resource intensive, they are generally conducted once in a year. However, it can be increased or reduced depending on the financial position, methods of operation and compliance record of the bank. (Gilbert et al, 1999)

The inspection teams base their reports on primary records of selective representative across section of branches, controlling offices and the head office of the bank. The supervisors identify banks and place them under special watch category in case of weakness, with a Senior Officer in the jurisdictional Regional Office of the Bank entrusted with the special monitoring efforts. The Deputy Governor / Executive Director in-charge of banking supervision can call the
CEOs of those banks, wherein serious deficiencies are reported in the inspection reports for the purpose of discussion and specific steps to be taken by the banks’ top management to improve their financial strength and operational soundness. The compliance to the inspection findings is followed up in the usual course. The top management of the Reserve Bank of India addresses supervisory letters to the top management of the banks highlighting the major area of supervisory concern that need immediate rectification. The Supervisors hold discussions with banks’ management and draw up an action plan for prompt corrective actions. All these are followed up vigorously. Indian commercial banks are rated as per supervisory rating model approved by the BFS that is based on CAMELS concept. Significance and implementation of CAMELS Model has been discussed in section IV of this Chapter that follows

IV. Significance and Implementation of CAMELS Model

Regulators, researchers and academics in many countries have been using CAMELS Model for supervision and performance evaluation of banks. The survey of literature available on the model significance and implementation of CAMELS model in the banking industry can be summarised as follows.

1) The choice of CAMEL Variables is based on the fact that each alphabet of the word is representative of a major element in a bank’s financial statements. The Model highlights the key aspects of a bank that an analyst should be interested in - Capital, Asset Quality, Earnings and Liquidity etc. Weaknesses in any of these major factors present a threat to a bank’s continuing existence. These threats represented in the CAMEL Model have following implications for banking industry.

- A measure of Capital Adequacy (C) represents past income with its cushion to absorb future losses
- Loss of Assets (A) represents the loan and advances that banks have provided. Bad quality assets lead to accumulation of Non Performing Assets (NPAs). Accumulations of NPAs have opportunity cost due to
provisioning requirements and non-recovery advances further lead to erosion of profitability and capital.

- Short-term Liquid Assets (L) are important to a bank’s existence, as they assist in covering loan payment defaults and offset the threat of losses or large withdrawals that might occur.

- A measure of earnings (E) describes present income. Both of these can assist in covering the threat of losses.

- The management (M) factor opens or closes the door to risk, as management takes action with assets (long-term and short-term) and makes decisions related to capital and earnings.

2) The CAMEL-S model adopts flexible approach for the effective diagnosis and prediction of bank failures.

3) The model is able to monitor macroeconomic factors, industry specific factors and bank specific conditions.

4) It also offers the flexibility of selecting the most appropriate ratios that a regulatory authority feels are most applicable to its own financial environment and set own benchmarking according to performance of banking industry.

5) Further, it helps in identifying the problem banks in the industry.

6) For off-site analysis, the model offers a framework within which to select the appropriate ratios and specify the standards against which to evaluate the performance of an individual bank and performance of the industry. The Model leaves room for subjective analysis and interpretation. The CAMELS Model greatly assisted in providing in uniform manner to analyse the performance of commercial banks.

7) In addition, CAMEL ratings are increasingly being used for other supervisory purposes, such as setting deposit insurance rates and expediting bank applications for various regulatory purposes. For example it is used for pricing of deposit insurance by DICGC in India, which is risk based on the latest available CAMELS.
V. Component of CAMELS and their significance to banks

A. Capital Adequacy
Capital is essential and critical to the perpetual continuity of banks as a going concern. A minimum amount of capital is required to ensure safety and soundness of the banks and to build trust and confidence of the customers because during the course of operation banks face risks of potential losses. Adequate capital helps financial intermediaries to survive even during the period of substantial losses. Besides acting as cushion against insolvency it protects against loss of liquidity and ensure public confidence. It reflects bank’s ability to cope up with adverse economic situations. It gives them time to re-establish the business and avoid a break in operations.

i. The measurement of capital Adequacy Ratio
The banking regulators as well as banks have put in place effective control and risk management strategies to minimise these risks. The process has been evolving over the period of time. As risks in banks have grown over the years, the regulators have been prescribing various types of requirements to take care of the risks and the likely losses arising out of them. (IIBF, 2004)

Computation of Capital Adequacy Ratio:

\[
\text{Capital Adequacy Ratio} = \frac{(\text{Tier I capital} + \text{Tier II capital})}{\text{RWA}}
\]

The CRAR at present is 9% and Tier-II capital cannot be more than 100% of Tier-I capital.
To compute CAR, we need to calculate:
- Tier I capital
- Risk Weighted Assets (RWA)
- Tier II capital
Following method has to be followed for computation of CRAR

**Step 1: Computation of Tier I capital:**
Tier I capital is the most permanent and readily available support against unexpected losses. It consists of-
1. Paid up equity capital
2. Statutory reserves
3. Capital reserves
4. Other disclosed free reserves

**Less:**
1. Equity investments in subsidiaries
2. Intangible assets
3. Current and Accumulated Losses, if any

**Step 2: Compute Risk Weighted Assets**
The weights are specified depending on the risk associated with each items of assets. For example, balances with the RBI and investment in Government or other trustees’ securities have 0% weightage; whereas, other investments, loans guaranteed by Public Sector Units of State Governments or GOI have 100% risk weightage. RWA are calculated by multiplying the relevant weights to the value of assets on the balance sheet and off the balance sheet items. *(Annexure I)* for Risk weightage assigned to each asset on the balance sheet). Off balance sheet items such as bank guarantees, Letters of Credit and acceptances etc. are first multiplied by the corresponding credit conversion factors. Then it is multiplied by the risk weights attributable to each item. Credit Conversion factors for off-balance sheet is given in the Table No. 3.1 in the next page.
Table No. 3.1: Credit Conversion Factor for Off-Balance Sheet Items

<table>
<thead>
<tr>
<th>Items</th>
<th>Credit Conversion Factors</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Direct Credit Substitutes</td>
<td>100</td>
</tr>
<tr>
<td>2. Certain transaction related to contingent items</td>
<td>50</td>
</tr>
<tr>
<td>3. Short term self liquidating trade related contingencies</td>
<td>20</td>
</tr>
<tr>
<td>4. Sale and repurchase agreement and asset sales with recourse, where the credit risk remains with the bank</td>
<td>100</td>
</tr>
<tr>
<td>5. Forward and asset purchases, forward deposits and partly paid shares and securities</td>
<td>100</td>
</tr>
<tr>
<td>6. Note issuance facilities and underwriting facilities</td>
<td>50</td>
</tr>
<tr>
<td>7. Other commitments with an original maturity of over 1 year</td>
<td>50</td>
</tr>
<tr>
<td>8. Similar commitments with an original maturity of over 1 year, or which can be cancelled at any time.</td>
<td>0</td>
</tr>
<tr>
<td>Aggregate outstanding foreign exchange contracts of original maturity</td>
<td></td>
</tr>
<tr>
<td>Of less than 1 year</td>
<td>2</td>
</tr>
<tr>
<td>For each additional year or part thereof</td>
<td>3</td>
</tr>
</tbody>
</table>

In the Mid-term Statement on Monetary and Credit Policy for 1998-99, a risk weight of 2.5 per cent was introduced for the risk arising out of market price variations for investments in Government and other approved securities, with effect from the year ending March 31, 2000. In view of the growing share of investments in the assets of banks, the risk weight of 2.5 per cent is being extended to cover all investments including securities outside the SLR.

Step 3: Computation of Tier II capital

This is neither permanent in nature nor readily available and consists of:

a. Undisclosed reserves and cumulative perpetual preference shares—Cumulative preference shares should be fully paid and should not contain clauses which permit redemption by shareholders

b. Revaluation Reserves (RR)— Only 45% of RR is taken in calculation of Tier II capital

c. General Provisions and Loss Reserves (GPLR)— Actual GPLR or 1.25% of Risk Weighted Assets, whichever is lower, is taken.
d. Hybrid Debt Capital Instruments—Securities having combined characteristics of both equity and debt. As they are quite similar to equity, they are included in the Tier II capital.

e. Subordinated Debts—These must be fully paid up, unsecured, subordinated to the claims of other creditors, but there should be no clause, which permits redemption. The amount of subordinate debt to be taken as Tier II capital depends upon the maturity of debt, but will be limited to 50% of Tier I capital.

f. It has to be noted that sum total of Tier II capital cannot be more than 100% of Tier I capital. Remaining Maturity period, discount rate and amount to be taken has been presented in the Table No 3.11

Table No 3.11: Remaining Maturity period and discount rate

<table>
<thead>
<tr>
<th>S.No.</th>
<th>Remaining term to maturity</th>
<th>Discount Rate (%)</th>
<th>Amount to be taken in %</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Where the date of maturity is above 5 years</td>
<td>0</td>
<td>100</td>
</tr>
<tr>
<td>2</td>
<td>Where the date of maturity is above 4 years but doesn't exceed 5 years</td>
<td>20</td>
<td>80</td>
</tr>
<tr>
<td>3</td>
<td>Where the date of maturity is above 3 years but doesn't exceed 4 years</td>
<td>40</td>
<td>60</td>
</tr>
<tr>
<td>4</td>
<td>Where the date of maturity is above 2 years but doesn't exceed 3 years</td>
<td>60</td>
<td>40</td>
</tr>
<tr>
<td>5</td>
<td>Where the date of maturity is above 1 year but doesn't exceed 2 years</td>
<td>80</td>
<td>20</td>
</tr>
<tr>
<td>6</td>
<td>Where the date of maturity does not exceed 1 year</td>
<td>100</td>
<td>0</td>
</tr>
</tbody>
</table>

*Note: Tier II capital cannot be more than Tier I capital.*

ii. Implementation of the New Capital Adequacy Framework

Given the financial innovations and growing complexity of financial transactions, the Basel Committee on Banking Supervision released the New Capital Adequacy Framework (Basel II) on June 26, 2004 which is based on three pillars of minimum capital requirements, supervisory review and market discipline. The revised framework has been designed to provide options to banks and banking systems, for determining the capital requirements for credit risk, market risk and operational risk and enables banks/supervisors to select
approaches that are most appropriate for their operations and financial markets. The revised framework is expected to promote adoption of more comprehensive risk management practices in banks. Under Basel II, banks' capital requirements will be more closely aligned with the underlying risks in banks' balance sheets. A detail discussion has been made in the next Chapter.

B. Assets Quality
The basic objective of managing Quality of Assets is to maintain balanced portfolio with lowest possible risk and Maximum Value Creation Capacity (Ansari, 2004). Asset Quality management includes variables related to loan concentrations, risk and/or volume. Assets side of the banks' balance sheet can be classified into four categories such as Liquid assets, (cash +balance with other banks and RBI + money at call and short notice) investments, advances and fixed assets. Quality of assets is much more important than quantity of assets. The asset portfolio of bank shows the pattern of the employment of funds.

Among the various heads on the assets side of the balance sheet Loans and advances granted by banks are very significant. Bankers should assure credit quality by granting credit with adequate due diligence before disbursal so that chance of bad loan is minimized. In order to maintain Good Quality Assets on the bank's balance sheet, bankers should assure credit quality by regularly assessing the total credit exposure on following lines.

I. Composition:
This means total structural break-up of loans and advances should be analysed. This is essential because loans and advances to different categories have different profile in terms of risk and return thus different approaches and strategies would be required for the purpose of control. Maintaining records on different structure, as a separate structure would facilitate better control and thus maintain better quality of assets. In building assets it is important develop asset mix that would facilitate in optimising return and create lowest possible risk weightage. This is possible by analysing assets using following ratios so that
Credit concentrations to different segments could be recorded and concept of diversification could be implemented in order to maintain risks.

a. Credit to priority to total loans and advances
b. Non priority sector to total loans and advances
c. Exposure to sensitive sector to total loans and advances
d. Non fund based limits to total loans and advances
e. Credit concentration to total loans and advances,

II. Credit Quality:

The biggest task in the area of credit management is to protect loans and advances given by banks from becoming NPAs. NPAs hit profitability hard in the sense that besides losing interest income bank is deprived of the use of capital as well. Provisioning upto 100% of NPAs becomes further drain on profitability. This also creates Assets Liabilities maturity mismatch and creates liquidity problem for banks. Recoveries of dues in respect of existing bad and doubtful advances and monitoring of advances is essential to check depletion in quality of assets. The parameter that may be used to measure the credit quality covers the following areas:

a. Classification of Advances into standard, sub standard, doubtful category
b. Loss assets Special Watch Accounts,
c. Quick Mortality Loans,
d. Devolved Liabilities and their movement.
e. Quality of securities/collaterals
f. After classification of advances ratios can be computed in relation to total assets for purpose comparison.

III. NPA Analysis:

High level of NPAs drains the profitability and adversely affects the liquidity in banks (Gujral, 2003). NPAs’ control is essential because of provisioning norms that create pressure on the productivity of funds and profitability. Consistent with the recommendations of the Committee on Banking Sector Reforms (Narasimham Committee II) and with a view to moving closer to the best
international practices in regard to asset classification norms, banks were advised that with effect from March 31, 2005 an asset would be classified as doubtful if it remained in the sub-standard category for 12 months. Banks are permitted to phase the consequent additional provisioning over a four-year period, commencing from the year ending March 31, 2005 with a minimum of 20 per cent each year. Banks are also required to disclose the maturity pattern of Assets and Liabilities.

Thus, banks have to maintain proper record of quantum of NPAs. Their movements should also be tracked for effective corrective actions. This purpose could be solved if banks maintain their records on following parameters.

   a. Trend of Gross NPAs,
   b. Chronic NPAs,
   c. Net Addition to NPAs,
   d. Recoveries under compromise settlements,
   e. NPAs target Achieved, and written off

IV. Provisioning Adequacy:

Provision is essential for regulatory purpose. 100% provision has to create for assets being classified as NPAs. Apart from this it also acts as a cushion against probable loss. Provisioning also has opportunity cost of funds. Thus banks have to maintain proper records on the provisions against NPAs. Bankers have to ensure the following

   a. Total Provisions Trend,
   b. Understatement of provisions,
   c. Provision as percentage to NP As,

Next important element on the assets side is investment, which requires prudent management. In this regard bankers should lay emphasis on liquidity, safety, return and risk profile. The investment of the banks should be analysed in terms of Value at Risk (VaR) and on Mark to Market basis.
C. Management Appraisal

Another important variable for researchers in the development of CAMEL models has largely been the choice of a representative measure for management quality (M) and successful management offers strong vision of where they want their organisations to be in future. The management (M) factor opens or closes the door of risk, as management takes action with assets (long-term and short-term) and makes decisions related to capital and earnings. This measure represents management's willingness to accept risk in relation to loans and the bank's major assets (Thomson, 1991 & Whalen, 1991). The management effectiveness lies in channelising the distinct qualities and obtaining the best results from each employee to create an organization that is always energised, profitable and enthusiastic. Effectiveness can be ensured through consistent planning, performance management, training, recognizing employee's areas of natural talent and making jobs challenging setting up targets for each employee.

The quantitative ratios that can be used to rate the management ability and effective are as follows. (Phatak, 2003).

**Productive Ratios**

a. Business Per Branch,

b. Operating Profits Per Branch,

c. Business Per Employees,

d. Operating Profits Per Employees

**Operational Efficiency Ratios**

a. Non-Interest Income to Average Working Funds (A WF),

b. Interest Income to A WF

c. Operating Expenses Ratios.

d. Cost Income Ratios

However, (a) cost of deposit and (b) cost of borrowing which have negative effects on profitability can also be taken into account. Management in banks can also be rated in terms of Total Value Creation (TVC).
D. Earnings

A measure of Earnings (E) in the CAMELS' Model describes income of banks. The rating of banks on the Earnings parameter is significant because sustained high level of profitability enables a bank to boost its capital and improve its economic performance. There is negative relationship between profitability and the probability of failure. The earnings (E) measure in the Model also provides a ratio representative of management's level of effectiveness in utilization of assets to earn profits.

The important ratios that can be considered for rating of banks through the CAMELS Model are as follows:

a. Return on Assets.
b. Return on Equity.
c. Net Interest Income.
d. Net Interest Margin.
e. Interest Rate Spread.
f. Loans Yield Rate.

E. Liquidity

"L" represents a measure of Liquidity, in the “CAMELS” Model. Managing and measuring liquidity needs are vital to the operations of a bank (Holmström and Tirole's, 2001). Liquidity can be defined as the ability to obtain needed cash quickly and at a reasonable cost. As need for funds may be unpredictable and uncontrollable in banks must maintain adequate liquidity to ensure that cash or access to it can be obtained on short notice and with little or no loss of capital. Liquidity is necessary for banks to carry out daily business transactions, to cover emergency needs for funds, to satisfy the customers demand for loans and to provide flexibility in taking advantage of especially favourable investment opportunities.

Liquidity indicates bank's ability to meet financial commitments when due. In banking business, liquidity is more important than earnings (Khurana, M.L.) Liquidity is essential both for survival and growth of banks. Liquidity is a double-edged weapon and banks must play safe with respect to Liquidity.
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Liquidity and profitability are equally competitive. If you run after profitability, you lose liquidity and vice versa. However, the truth is that both are indispensable (Merrill, 1999).

Liquidity is essential for growth as it provides funds to reap the benefits of new business opportunities and ability to take new business proposition and generating profits (IIBF, 2004). The source of liquidity is distributed on both assets and liabilities of balance sheet. A banker with good funds management skills derives liquidity from either side of balance sheet. Efficient cash management is essential to ensure liquidity.

In banking business funds have to be invested in such a way that liquidity is not impaired and it can be build when market offers it. In modern banking business managing LIQUIDITY RISK (maturity mismatch of Asset & Liabilities) is one of the greatest challenges. Various dimensions of liquidity risk management are measuring & managing net funding requirements, managing market access and contingency planning.

Fund managers must estimate and provide liquidity efficiently and economically. A bank with adequate liquidity is able to shift and rearrange mix of assets and liabilities that respond to changing business conditions. A bank with little liquidity may be forced to obtain needed funds at high cost or may find it difficult to obtain needed funds at reasonable cost. A bank with excess liquidity also pays penalty for failing to manage its liquidity position efficiently because the cost of more liquidity is usually lower earnings. Excess liquidity means that some of the bank’s available funds are not being used to their full advantage. A liquidity ratio measures an entity’s ability to pay its short-term obligations out of liquid assets. Various ratios that can be used to measure liquidity are as follows:

a. Liquid Assets Ratio
b. Total Deposit To Total Assets Ratio
c. Gross Loans To Total Deposit Ratio
d. Funding Volatility Ratio (FVR)
E. System and Control

“Prevention is better than cure” and this is possible only through proper supervision and control process. As there is absence of any sophisticated models for “Risk Management Systems”, banks should devote the necessary resources to quantify the level of operational risks and incorporate them into the assessment of their overall capital adequacy as envisaged in the New Capital Accord.

In recent years, size of operation of banks has increased manifold. Besides, banks are entering into various other activities in the financial services sector. Due to increased exposure of banks to various activities, the risks associated with them have also increased. Operational risk arises out of deficiencies in internal systems and controls and non-adherence to prescribed procedures.

Operational risk covers a broad range of risks that are specific to the bank and have received less attention in the past than other kinds of risks. However, attention is increasingly being focused on the issue because of the scale of losses that banks have suffered as a result of breakdown in internal controls.

Under the PCA* framework, RBI can initiate certain structured actions in respect of banks, which have hit the trigger points in terms of CRAR, net NPA and ROA (RBI’s PCA Framework). RBI, at its discretion, will resort to additional actions (discretionary actions) as indicated under each of the trigger points. It would be better for banks to avoid coming under PCA framework.

Thus “S” has been incorporated in the model that represents a measure of System & Control. The ratio used to measure System & Control includes the following.

a. Vulnerability /Prudential Ratios
b. Cost Function Ratio.

The above-mentioned ratios are representative of the extent of supervision and control that exists in banks.

* PCA: Prompt Corrective Action
Thus, we see that CAMELS Model can be one of the important tools in hand of supervisors and bankers for performance evaluation of banks as it covers every aspects of risks inherent in banking business. After brief discussions on the CAMEKS Model and its implications in Banks in the next chapter a brief review of Basel I and Basel II has been covered along with the status of supervision in India.
REFERENCES


