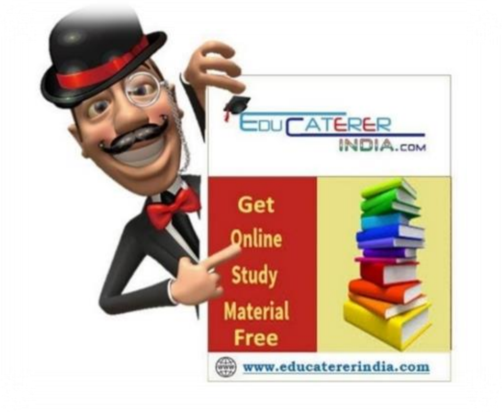
CAMELS Rating System- Explained



Introduction

CAMELS is a rating system developed in the US that is used by supervisory authorities to rate banks and other financial institutions. It applies to every bank in the U.S and is also used by various financial institutions outside the U.S. This rating system was adopted by National Credit Union Administration in 1987. In 1988, the Basel Committee on Banking Supervision of the Bank of International Settlements (BIS) proposed the CAMELS framework for assessing financial institutions.

Purpose:

The ratings are assigned based on the financial statements of the bank or financial institution. This system helps the supervisory authorities to identify banks that need maximum amount of regulatory concern. It is used to measure risk and financial stability of a bank. It determines the banks overall conditions in the areas of financial, managerial and operational aspects.

Score scale:

The rating system consists of a score from one to five with score one considered as best and score five considered as the worst for each factor. Banks which obtain the score of one are considered most stable, banks with a score of 2 or 3 are considered average and those with 4 or 5 considered as below average and are subjected to supervisory scrutiny.

Factors for giving scores:

CAMELS is an acronym of the following factors on which ratings are given by supervisory authorities.

C- Capital Adequacy

Capital adequacy refers to the amount of capital the financial institutions has to hold as required by its financial regulator. It is expressed as the Capital Adequacy ratio, which can be defined as the ratio of banks capital to risk weighted assets. This ensures the protection of depositors and investors and financial soundness of the bank. Factors involved in rating and assessing an institution's capital adequacy are its growth plans, economic environment, ability to control risk, and loan and investment concentrations.

A- Asset Quality

Asset quality evaluates the quality of asset/loan the bank offers. The assets of a bank include cash, government securities, investments, real estates and interest earning loans. Assets such as loans provide returns to the financial institutions in terms of interests and comprise a majority of banks assets carrying high risk. Asset quality deals with quality of the loans, investments; and banks effectiveness in controlling and monitoring the credit risk. This provides the stability of the company when faced with particular risks.

M- Management

Assessment of management determines ability of an institution to diagnose and react to financial stress. This component rating is reflected by the management's capability to identify, measure, and control risks of the institution's daily activities. It ensures safe operation of the institution with effective policies and guidelines. The management has to address the risk related to credit, rate of interest, transactions etc.

E- Earnings

Ratings on earnings are based on the financial institution's ability to create returns on its assets. These returns enable the institution to expand, retain competitiveness, and provide adequate capital. It can be measured as the return on asset ratio. company's growth, stability, valuation allowances, net interest margin, net worth level and the quality of the company's existing assets are assessed to rate the Earnings.

L- Liquidity

To meet unexpected withdrawals from depositors without affecting the daily operations, the bank must maintain liquid cash and assets that can be easily converted into cash. The ratio of liquid cash to asset ratio can be used as a parameter to measure banks liquidity.

S- Sensitivity

Sensitivity refers to effect on bank due to market changes. In other terms it refers to market risk. Banks sensitivity to changes in interest rates, foreign exchange rates, changes in price of commodities, etc is measured. It primarily evaluates the interest rate risk and sensitivity to all loans and deposits.

Camels composite rating:

The CAMELS system is also based on composite ratings on a scale of one to five based on ascending order of supervisory concern. Each factor is assigned a weight as follows:

- Capital adequacy 20 %
- Asset quality 20%
- Management 25%
- Earnings 15%
- Liquidity 10%
- Sensitivity 10%