CHAPTER- 4

LEGISLATIVE FRAMEWORK OF CAMEL MODEL

4.1 Meaning of Credit Rating Analysis: - A specific analysis of the risk profile is done through a qualitative-cum-quantitative approach following structured methodology called the "CAMEL" model. As per the rating criteria, the financial strengths and weaknesses of each entity in comparison to its competitive group are evaluated. Apart from the CAMEL Rating system, CRISIL and other rating agencies also evaluate the market position of the bank in the emerging competitive scenario. Earlier, it was made compulsory for the banks to provide ratings to themselves to raise capital from capital market through IPO. With a view to safeguarding the interest of the future investors, depositors, shareholders and creditors, bank management for their overall performance it has been made compulsory for all banks to provide themselves credit ratings through the credit rating agencies. Banks will also disclose this credit rating in their published annual financial statements.

4.2 CAMEL Rating System: - CAMEL Rating System is an internal supervisory and monitoring rating system was developed in U.S. to clarify the financial strength of the banks. It is useful to every bank, financial institutions and credit union in U.S. and is also employed outside the U.S. through several banking supervisory and monitoring regulators. The CAMEL ratings are so provided are based on the ratio analysis technique of the financial statements of bank, with on-site examinations through a selected supervisory and monitoring regulators. In U.S. these supervisory regulators are the Federal Reserve, the Office of the Comptroller of the Currency (OCC), and the National Credit Union Administration or Uniform Financial Institution Rating system and Federal Deposits Insurance Corporation(FDIC). These ratings are not disclosed to the public, only available with the top management or board of directors of institution to make a possible running of a bank which gets a CAMELS rating reduce. Weakened institutions are ultimately resolved through a formal perseverance process designed to safeguard the investors.

4.3 Development of CAMEL Rating System: - The Uniform Financial Institution Rating System was first adopted by the Federal Financial Institution Examination Council (FFIEC) on November 13 1979, and later globally, following by the recommendation of U.S. Federal Reserve. The system became internationally known with the abbreviation
CAMEL, This system was developed by ACCION (Americans for Community Cooperation in other nations). In 1980’s to help regulator banks of North America (Milligan, 2002, p 70) CAMEL methodology adopted by North America Bank regulators to know the financial and managerial reliability of commercial lending institutions and then after adopted by the National Credit Union Administration in October 1987. In 1980’s to help regulator banks of North America (Milligan, 2002, p 70) CAMEL methodology adopted by North America Bank regulators to know the financial and managerial reliability of commercial lending institutions. Similarly, the Uniform Financial Institutions Rating System was adopted by the Federal Financial Institution Examination Council in the US. Here the acronym CAMEL refers to the five areas of bank’s performance which are Capital adequacy, Asset quality, Management quality, Earnings ability, Liquidity and Sensitivity to market risk, was added as a sixth component of CAMEL in 1997; .In 1994, Reserve Bank of India has established the Board of Financial Supervision (BFS In 1995, RBI had set up a working group under the chairmanship Shri S. Padmanabhan to review the banking supervision system. The Committee made certain recommendations based on the suggestions. It recommended that the banks should be rated on the basis of CAMELS model.

**On-site bank examination:** - The Off-site Monitoring and Surveillance System (OSMOS) were introduced in 1995 as an additional monitoring tool for the commercial banks. It was introduced with the aim to supplement the on-site inspections. After the examination and analysis, the bank supervisors provides the composite rating to the regulatory banks based on the information collected through on-site examination and these composite ratings are considered as CAMEL rating system. The annual on-site inspection of bank was officially made compulsory for most of the commercial banks under the adoption of the Federal Deposit Insurance Corporation Improvement Act of 1991. Nevertheless, it is not necessary to conduct the bank examination in every twelve months because it is performed in every twelve to twenty-four months and high importance are given to financially weakened banks whereas lower attention provided to banks which have sound capitalization and have sufficient earnings.

**Off-site banking surveillance**

The financial market is rapidly adaptive changes over the years, so the examination of the banks is needed to be conducted regularly. It effects, the bank regularly monitoring on the off-site examination to supplement the on-site inspection. On the other hand, it provides
daily relevant, financial information, and also provides the source for financial assessment of the bank analyses. Off-site surveillance highlights the risk exposure based on the annual reports of the financial data, and it helps the banks ‘supervisors schedule the exams on those suspected banks. The bank supervisors go through the results of on-site inspection -, if necessary; and they also compares the bank’s performance to that of its peer in the industry. There were two commonly used off-site tools are supervisory screens and econometric models:

4.4 Legal Regulatory Framework of Camel Rating System: - CAMEL Rating System is regulated by the three authorities:

1. FEDERAL RESERVE (The Federal Reserve Act 1913)
2. OCC (Office of the Comptroller of the Currency)
3. FDIC (Federal Deposit Insurance Corporation Act)

4.4.1 FEDERAL RESERVE:- The Federal Reserve Act of 1913 was formed the Federal Reserve System with a view to provide a safer, flexible, risk free and more stable and sound monetary and financial system to the country. The main function of the Federal Reserve in accomplishing this objective is to regulate and control various financial institutions. It achieves this goal through micro prudential regulation and monitoring of banks; holding s and their subsidiary companies; and other financial companies including non- banking financial institutions. Off-Site Monitoring in its ongoing off-site supervision of banks and holding companies, the Federal Reserve applied automated systems to, actively identify the institutions with poor or weakened financial profiles and help to detect adverse trends developing in the banking industry. The supervision of U.S. Banks, the Federal Reserve has supervising and controlling responsibility for the international operations of state member banks. These responsibilities include

- Authorizing the formation of foreign branches of national banks and state member banks, and modifiable the scope of their activities;
- Leasing and regulating the activities of Edge Act and agreement.
- Through authorizing the foreign investments of member banks, Edge Act and agreement corporations, and BHCs, and changing the activities of foreign banks acquired by these investors.

4.4.2 OFFICE OF THE COMPTROLLER OF THE CURRENCY (OCC):- The OCC is the principal regulator of banks chartered under the National Bank Act and federal
savings associations chartered under the Home Owners Loan Act of 1933. This rating of the institution’s overall condition also assimilates the ratings of these four areas which consist of risk management practices, operational performance, monitoring, legal, and asset management quality. Similar CAMELS ratings, the composite ratings for ROCA assigned from 1 to 5 are mentioned above. Disclosure of the ratings of all the commercial banks, the CAMELS composite ratings, and all applicable line area ratings, are formally provided to the bank’s board of directors and top management with the help of written document which is Report of Examination. National commercial banks must get a chance of having on-site examination minimum one time during the period of 12 months. The OCC supervisory can increase this requirement to 18 months if the following conditions are satisfied:

- The bank must have total assets value of less than 500 million dollars;
- The bank must be well capitalized;
- The bank is not having a issue of a legal proceeding by the FDIC, OCC, or Federal Reserve System authorities.

4.4.3 FDIC ACT: - The FDIC’s expectations for distressed or weakened institutions should be visibly communicated to top management of the bank before the close of an assessment and the issuance of an administration action. An analysis or inspection letter should be delivered by FDIC field supervisors to chief executive officer or presidents before the examination of the bank meetings, exits or earlier, for any newly bank of financial institution which has been given a CAMELS composite rank of 3 or worse. The letter should also clarify to the management about the actions taken to improve the institution’s balance sheet or risk profile is varying with regulatory expectations. The letter should also indicate that they are needed to acquire a NOC (Non-Objection Certificate) from the director before involving in any transactions that would significantly change the bank’s balance sheet structure, such as considerably increasing the total assets or funding sources. Immediate remedial measures, including the issuance of a temporary order requiring a bank to be windup and discontinue, may be suitable in higher-risk conditions, such as when management:

- Takes actions that composite the problems of banks;
- Increases the use of aggressive funding sources;
- Increases the credit limit in an unsafe and unsound conditions;
- The bank is well capitalized as per the definition in Section 324.403(b)(1) of the FDIC Rules and Regulations;
• The bank currently is not issue for a legal enforcement proceeding or order by the FDIC, OCC, or Federal Reserve System; and

4.4.4 **UNIFORM FINANCIAL INSTITUTIONS RATINGSYSTEM**

The Uniform Financial Institutions Rating System (UFIRS) was first accepted by the Federal Financial Institutions Examination Council (FFIEC) on November 13, 1979. Above the period of time, the UFIRS has proved to be more efficient and effective internal supervisory mechanism for assessing the financial health of the financial institutions on a regular basis it also finding out the weakened institutions which require special supervisory control. Various revisions have been made. The changes to UFIRS consists, by adding a sixth component of CAMEL i.e. sensitivity to market risks, It reflects the situation of risk management practices while assessing the management component rating, and the identification of future risks, complexity and component rating descriptions.

The main aim of these amendments in UFIRS is neither proposed to add the unnecessary supervisory burden on the organization, nor needed additional policies or practices. In fact amendments are made with a view to promote efficient analysis & supervisory process and to update the rating system, while assessing the basic CAMEL ratings.

4.5 **Adoption of CAMEL 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 depended on licensing, maintain the minimum level of capital requirements, pricing of services including administration of interest rate on deposits as well as credit rates, reserves and liquid asset needs. In these circumstances, the regulatory authority had to focus on solvency issue. After the development of the BIS (Bank for International Settlement) prudential standards in 1988, the RBI took the measures to rearrange its monitoring and regulatory standards almost on a same level with best international practices. The whole regulatory mechanism has been rearranged since 1994 in the guidelines of a newly established Board of Financial Supervision (BFS), which works under the guidance of the RBI, to accompany the needs required for a strong and an efficient financial system. The regulatory control of the BFS now increases to the whole financial system excepting the capital market and the insurance corporations. The regular on-site inspections, and the planned assessments by the RBI, are now complemented by off-site investigation, which absorbing the potential risk of the supervised institution.