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Sustainability of Camel Framework as A Performance Evaluator For Banking Industry

[1]Nik Mohd Norfadzilah Nik Mohd Rashid, [2]Siti Nurain Muhmad,
[3]Nadiah Abdul Hamid, [3]Zarinah Abdul Rasit and [3]Rohaya Md Noor

[1]Faculty Economic & Management Science, Universiti Sultan ZainalAbidin, Terengganu, Malaysia
[2]School of Maritime Business and Management, Universiti Malaysia Terengganu, Terengganu, Malaysia
[3]Faculty of Accountancy, Universiti Teknologi MARA Puncak Alam, Selangor, Malaysia

Abstract: Banking industry has been through a number of difficult phases, especially during the financial crisis. Most of the banking institutions have endeavoured to become more resistant in order to maintain their financial position. The evaluation of bank performance is deemed to be very important as a mitigation measure and improvement to deal with any problems that might arise in the future. CAMEL framework is the ultimate choice to the practitioner around the world chooses as a performance evaluator. The sustainability of CAMEL framework can be seen when it is still usable since more than thirty years ago. Thus, this study highlight the sustainability of the CAMEL framework, which is, present the factors that practitioners and researchers remain employed this model. The strong reason for the withstanding is CAMEL framework act as a detector to the risk and fragility of the banking institution. Numerous researchers around the world have proved it. This study provide vision to the practitioner, regulator and researchers to increase knowledge on how CAMEL framework is been chosen for long period of time as a performance evaluator for the banking industry.

Key words: CAMEL framework · Banking performance · Banking industry1

INTRODUCTION

Banking industry is the most challenges institutions especially in facing the financial crisis globally. As a financial resource to the economy, it plays an importance role to maintain their performance to ensure it is not been fading out by the global economic fragility. Thus, establishing the best indicators as a performance evaluator is a must to the financial sector. CAMEL (capital adequacy, asset quality, management competency, earning quality, liquidity) is one of the common financial indicators used by researchers to measure bank performance [1]. The CAMEL rating system was developed by federal regulators in the US specifically to help in organizing the examination process in the early 1970s. It's applied to every bank and credit union in the U.S. (approximately 8, 000 institutions). The use of the CAMEL framework to measure the financial performance of banks has become popular globally since the adoption of the CAMEL rating system by the Uniform Financial Institutions Rating System for the evaluation of bank performance.

The greatest impact on banking institutions in Malaysia was felt when some banks were categorized as ill and needed government intervention. For example, Bank Bumiputra Malaysia Berhad (BBMB) reported losses of RM1.41 billion in 1998 and needed as much as RM750 million in fresh capital to reestablish its business. As a result, in October 1999, the government ordered BBMB to merge with Bank of Commerce and change the name to Bumiputra Commerce Bhd. Shortly thereafter, in 2000, the Central Bank of Malaysia intervened on behalf of the government by placing financial sector mergers at the forefront of its banking policy. This was done as part of an agenda for improving the financial system soundness through strengthening pre-emptive and prudential regulations. Following the crisis, researchers became interested in investigating bank performance.

As a result, performance and its measurement is well-advanced within the finance, accounting and management fields. Studies on assessing the banking sector performance in different countries were captured by the existing literature on accounting, Islamic banking and finance. The evaluation of bank performance, either

Corresponding Author Siti Nurain Muhmad, School of Maritime Business and Management, Universiti Malaysia Terengganu, Terengganu, Malaysia.

foreign or local, is important for all parties including depositors, investors, bank managers and regulators. In a competitive financial market, bank performance provides a signal to depositors and investors whether to invest or withdraw funds from the bank. Similarly, it gives direction to bank managers whether to focus on improving productivity, profitability and management efficiency for their company. In addition, this study provides a clear signal to policymakers to understand the real situation about bank performance in Malaysia. The outcome of this study is important to policymakers in assessing the bank performance that could determine the future direction of the banking system in Malaysia.

The CAMEL ratings are assigned based on the ratio analysis of the financial statement and it is not released to the public but only to the top management to prevent the institution from receiving downgraded CAMEL ratings. The institutions that obtained the declining CAMEL rating are subject to increased supervisory scrutiny [2]. Until now, the CAMEL rating system sustain almost thirty years since industry practitioner and researchers still use it to evaluate the bank performance recently [3, 4, 1, 5].

The sustainability of CAMEL framework as a performance evaluator in the banking industries for thirty years becomes a question mark to the certain practitioners. It must have a strong reason for the withstanding. Therefore, this conceptual paper would present the factors that practitioners and researchers choose CAMEL framework as a performance evaluator for banking industry.

Evolution of CAMEL Framework: At the beginning of employing the CAMEL rating system, the evaluation used the rating system from 1 to 5 in each CAMEL category (capital adequacy, asset quality, management competency, earning quality, liquidity). Rating 1 indicates strong performance while rating 5 indicates unsatisfactory performance. The rating system is designed to reflect all significant financial and operational factors in assessing the performance of the institutions, which used the combination of specific financial ratios. [6] used the CAMEL rating system to evaluate whether regulators in the 1980s influenced inadequately capitalized banks to improve their capital by using the component of capital adequacy. Other researchers such as [7] and [8] continuously used the CAMEL rating system. According to [9], the CAMEL rating system is a useful supervisory tool and the main model for assessing bank performance.

Apart from using the rating system, researchers also employed the CAMEL framework by using solvency bankometer and CLSA stress test parameters as a method to assess bank performance [10]. However, the most common method used by researchers nowadays to evaluate bank performance is by employing the financial ratio analysis using each component of the CAMEL framework [11, 12, 13, 14]. The CAMEL framework is among the popular methods to assess the financial soundness of banks [15, 5, 16 17] and it is still applicable for current studies despite having been designed almost 30 years ago.

CAMEL Indicators: A recent study by [18] employed the group of financial variables known as CAMEL ratios, which stand for capital adequacy, asset quality, management competence, earnings quality and liquidity. In fact, U.S. regulators recognized it is not adequate in the current global competitive markets without the sixth factor of CAMEL namely sensitivity to market risk that include interest rate, foreign exchange and price risk [19]. However, most researchers only used five factors for their evaluation. CAMEL ratios are the most important ratios to predict failure and evaluate the performance of finance companies. It has been study by many researchers including

The elements of the five CAMEL indicators signify a major aspect in a bank's financial statement. This implies that when the five elements are inadequate, it increases the prospects of bank failure. This means that all the CAMEL indicators play an important role in presenting the best measurement for performance of the financial institutions [20, 21] mentioned that the attributes of the CAMEL rating system are an essential tool in evaluating bank performance and should be used by researchers and regulators. According to [9], the CAMEL rating system is able to prevent the risk of bank failure and it is a useful method to evaluate bank performance. In addition, the CAMEL rating system is globally standardised and has become the primary model to evaluate the performance of banks as well as measure the safety and efficiency of the banks.

Based on [13], the outcome of the study is important in supporting the central banks to recognise their skills to formulate a strategy and guidelines that will encourage a better and effective banking system. [11] stressed that by using capital adequacy, asset quality, management competency, earning quality and liquidity, the bank's position under review is good, robust and satisfying. Thus, according to [22, 12, 7, 20, 11] the CAMEL framework is the best technique to measure the financial performance of banks.

With regard to the first element of the CAMEL framework, [23] and [24] referred to capital adequacy as the measurement of the financial strength of the bank. It shows the capital position of the banks, while protects depositors from the potential losses incurred by banks [7] and enables the bank to avoid bankruptcy [25]. Additionally, this indicator is the benchmark for the bank to manage the necessary additional capital and indirectly responds to the financial performance of the bank [25]. [26] studied the impact of capital on the survival of banks and market share during both normal times as well as financial crisis and revealed that capital helps the banks survive during crisis and normal times. This shows that capital adequacy acts as the inner strength of the bank, which could help the bank avoid bankruptcy either in the present or during crisis.

According to [27], the banking sector largely depends on asset quality, which relies on the financial health of their borrowers. This is supported by [9] who contends that the major cause of bank failure is poor asset quality. Management competency plays an important role in determining bank performance. According to [18] and [27], management quality is hard to measure compared to other indicators because it has a large range of issues such as education and the expertise of the staff and management of the bank. Additionally, [27] stated that earnings quality is an indicator of financial health for banking institutions. According to [10], the earnings quality of an institution depends on the effectiveness and efficiency of the management of the assets and liabilities of the institution. Liquidity refers to a bank's ability to meet depositors' withdrawals, maturing liabilities and loan requests without delay [28]. Banking institutions should maintain a level of liquidity sufficiency and be able to liquidate assets with minimal loss for sound liquidity management.

Sustainability of CAMEL Framework: The review proof that CAMEL framework is the best method to evaluate the bank performance. More than thirty years since introduced by the U.S regulators, it still useable until today. However, it still becomes a question mark to the practitioner to know the factor of using CAMEL framework for performance evaluator in banking industry. Apart of researchers used for their evaluation, banking industry around the world also employed this framework for their performance evaluator. However, certain banks are not using the term of CAMEL instead of using single factors of capital adequacy, asset quality, management competency, earning quality and liquidity.

According to [29], risk in banking is closely related to the CAMEL variable. The first importance thing is placed on liquidity and capital mainly due to regulatory changes and the next focus is asset quality. Anything that is wrong with this will lead to the earning risk and management agility to face the downfall. Risk management is always becomes the priority agenda for banking industry. Thus, the financial institutions keep using CAMEL approach to detect the bank fragility. The study by [30] reveals that CAMEL framework is the best indicator for credit risk management, which proved that it has strong impact to the bank performance. Additionally, [31] agreed that CAMEL is a systematic methodology to evaluate the solidness, soundness and more importance is the bank general security.

CAMEL framework is considered as an early warning which monitor the impact of economic downturns to the bank. All bankers recognize the importance of bank examinations and the significance of the resulting CAMEL ratings. Moreover, it has been proved to be a useful and efficient tool in response to the financial crisis [32, 33]. One of the reason that given by [34] and [8] is CAMEL framework still remains in use to this day because it plays a great role in a bank's success.

CONCLUSION

The sustainability of CAMEL framework is proven by numerous researchers around the world which is still employed this method for their evaluation towards bank performance especially for health check financial performance. In annual report, CAMEL variables become the compulsory things to disclose especially for the sub topic under bank performance indicators. It is verified by reviewed the top ten annual report in the developing countries. CAMEL indicators are important to test for financial soundness and as a precautionary step for any banking risk that may arise.

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