ASSESSMENT OF FINANCIAL PERFORMANCE OF COMMERCIAL BANKS UNDER THE FRAMEWORK OF CAMEL

A Proposal for Thesis

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1.1 Background of the Study

The banking sector, being a fundamental component of financial system is the backbone of the modern economic system. Banks are one of the oldest financial institution in the financial system, which play a curcial role in the mobilization of deposits and disbursement of credit among the various sectors of the economy. A sound banking system act as fuel injection which stimulates economic efficiency by mobilizing savings and allocating them to high return investment. Various research studies substantial that countries with a well developed banking system grow faster in contrary to countries having weak banking (Aspal, 2016).

The word 'Bank' has been derived from the Italaian word ' Banco' which means a place for keeping, lending and exchanging money. The bank is a financial institution, which deals with money. It accepts deposits from individual and organization and grants loans to them. It allows interest on the deposits made and charges interest on the loans granted. The history of banking in Nepal may be describes as a component of gradual and ordinary evaluation in the financial and economic sphere in the Nepalese life. The establishment of ‘Tejarath Adda’ during the Tenure of prime minister Ranoddip Singh in 1933 B.S. was the first step toward the institutional development of banking in Nepal. It was fully subscribed by the government in Kathmandu. Tejarath provided credit loans to the general public at 5% interest rate on securities i.e. gold, silver and other ornaments. It objective was to provide credit or loans to the general public but it failed to accept deposits from them. The concept of modern banking institution in Nepal was introduced when the first commercial bank, Nepal Bank Limited establish on 30thKartik, 1994 B.S. Banking sector was first started in Nepal after the establishment of Nepal Bank Limited in 1994 B.S. Then Nepal Rastra Bank was established on 14 Baisakh, 2013 B.S. as the central bank under the Nepal Rastra Bank Act 2012 B.S. Its function to supervise commercial banks and to guide the basic monetary policy of the nation. In 2013 B.S., Industrial Development centre was established and later it was converted into Nepal Industrial Development Corporation (NIDC) in 2016 B.S. As the monetary transaction got more and more complicated on 2022.10.10, Rastriya Banijya Bank was established as a fully government own commercial bank. Similarly, Agriculture Development Bank was established in 2024 B.S. The commercial bank act 2031 was enacted because after the reestablishment of democracy, the government has taken the liberal policy in banking sector so different private banks are getting permission to established with the joint venture of other countries and the trend is continuing till today as many Nepalese owned banks are to running. Today, there are altogether 28 commercial bank in Nepal. (Pandey, 2008).

Commercial banks play a vital role in the economic resource allocation of countries. They channel funds from depositors to investors continuously. They can do so, if they generate necessary income to cover their operational cost they incur in the due course. In other words for sustainable intermediation function, banks need to be profitable. Beyond the intermediation function, the financial performance of banks has critical implications for economic growth of countries. Good financial performance rewards the shareholders for their investment. This, in turn, encourages additional investment and brings about economic growth. On the other hand, poor banking performance can lead to banking failure and crisis which have negative repercussion on the economic growth, (Ongore and Kusa, 2013:237)

Performance of the banking sector is an effective measure and indicator to check the performance of any economy to a large extent. As banking system in economy has been allotted a crucial and noteworthy role in financing the planned economic growth. It therefore, has enforced the bankers for more frequent examination of its performance. Financial performance evaluates the overall performance of bank by implementing a regulatory banking supervision framework. One of such measures of supervisor information is the CAMEL rating system. The CAMEL analysis is the ratio based model to evaluate the performance of the banks based on parameter such as capital adequacy, asset quality, management efficiency, earning ability and liquidity risk (Kumar, 2017).

1.2 Statement of Problems

The overall performance of financial institution may not reflect by financial statement, so a major question emerges, whether these are adequate to reflect the overall performance of bank. Hence, there is needed to identify the overall performance of the banks. For these purpose, several financial and statistical tools and techniques are developed by different experts and financial institutions all over the world, one of them is CAMEL. There are many problem faced by banks. The problem can be separated in different parts. All the part of problems are assessed with the help of CAMEL rating. To examine, analyze and measure the performance of banks CAMEL is the popular and effective tool.

The study deal with the following research questions;

1. What are the financial performance of selected commercial banks by using CAMEL ratings system ?
2. What will be the composite CAMEL ratings of the selected banks?
3. What will be the relationship of components of CAMEL ratings and profitability of the banks ?

1.3 Purposes of the Study

The main purpose of the study will be to assess the financial performance of selected commercial bank under CAMEL framework. The study will be conducted to accomplish the following specific objectives:

1. To analyze the financial performance of selected Commercial banks by using CAMEL rating system.
2. To examine the composite CAMEL rating of selected Commercial banks.
3. To evaluate the relationship between the CAMEL and Profitability of the selected Commercial banks.

1.4 Significance of the Study

Financial institution specially 'A' class commercial banks play very significant role in the national economic and social development. Commercial banks are the key player among the financial institution so they have also very important role in the overall development of an economy. This study will be concerned with the evaluation of overall performance of commercial bank in Nepal. It is expected that this study will significantly provide the effective suggestions to improve the existing situation of bank under study in the field of Capital adequacy, Asset quality, Management efficiency, Earning capacity and Liquidity. The goal of the study is to examine the efficiency and performance of banks as reflected in the annual financial reports.

The following points are some of the significances of the study;

1. This study will help to show the financial position of the bank to the investor as well as concerned management.
2. This study will provide necessary information of performance capability of their banks to the management.
3. This study will benefits to the concerned scholars, academicians, investors, professionals, researchers and many others interested group and people for future in the view of review.
4. This study will directly help the concerned to make decision effectively by analyzing the financial as well as statistical results.
5. This study will provide real picture of performance which is beneficial to potential as well as existing shareholders.

1.5 Limitations of the Study

All research studies will be done to solve the particular research problem. It requires various kinds of data, material and other relevant information, which may not sufficient to the researcher. This study cannot escape from the frame of limitations. This study will mainly based on secondary data, particularly financial data and information given by respected banks, this is not sufficient for the deep and good research study.

Some limitations of the study are given below;

1. This study is mainly base on secondary data, so the limitations of secondary data may exist.
2. Out of twenty eight commercial banks here only ten banks and five fiscal year i.e. from 2012/13 to 2016/17 for the analysis of commercial banks. So this thesis shows the trend of commercial banks but not the whole mirror of all commercial bank.
3. In this study, only selected financial and statistical tools and techniques are used.
4. Lack of research experiences will appear as one of the most limitation during study.

2. Review of Literature

Review of literature comprises upon the existing literature and research related to the present study with a view to find out what had already been studied. The purpose of the reviewing the literature is to develop some expertise in one's area to see what new contribution can be made and to review some idea for developing research design. (Pant, 2067). This portion has been divided into two parts.

2.1 Conceptual Review
2.2 Empirical Review

2.1 Conceptual Review

Banking performance evaluates the overall performance of banks by implementing a regulatory banking supervision framework. One of such measures of supervisory information is the CAMEL rating system which was put into effect firstly in the U.S. in 1979. CAMEL rating system was first introduced by U.S. supervisory authorities as a system of rating for on-site examination of banking institutions. Under this system, each banking institution subject to on- site examination is evaluated on the basis of five critical dimensions relating to its operations and performance, which are referred to as the component factors. These are Capital adequacy, Assets quality, Management efficiency, earning ability and Liquidity used to reflect the financial performance, financial condition, operating soundness and regulatory compliance of the banking institution. A sixth component relating to sensitivity to market risk has been added to the CAMEL rating to make the rating system more risk- focused. Each of the component factor is rated on scale of 1 (best) to 5 (worst). The composite rating ranges between 1 (best) and 5 (worst), and also a certain amount of subjectivity based on the examiners overall assessment of the institution in view of the individual component assessments. (Gupta, 2014)

CAMEL rating is based on the financial statements of the banks, viz. Profit and Loss account, balance sheet and on- site examination by the bank regulators.

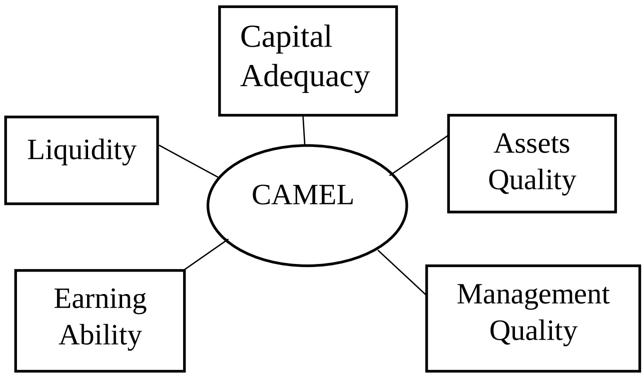

Figure: Meaning of CAMEL, *Source: Piyu,1992*

1. **Capital Adequacy :** The capital adequacy measures the bank's capacity to handle the losses and meet all its obligations towards the customers without ceasing its operations. This can be met only on the basis of an amount and the quality of capital, a bank can access. A ratio of capital to risk weighted assets determines the bank's capital adequacy.
2. **Asset Quality :** An asset represents all the assets of the banks, viz. current and fixed, loan investments, real estates and all the off- balance sheet transcations. Through this indicator, the performance of an asset can be evaluated. The ratio of Gross Non- performing Loans to Gross Advances is one of the criteria to evaluate the effectiveness of credit decisions made by the bank.
3. **Management Quality :** The board of directors and top- level managers are the key persons who are responsible for the successful functioning of the banking operations. Through this parameters, the effectiveness of the management is checked out such as, how well the duties and responsibilities are delegated, how well the compensation policies and job descriptions are designed etc.
4. **Earnings :** Income from all the operations, non- performing traditional and extra ordinary sources constitute the earnings of a bank. Through this parameter, the bank's efficiency is checked with respect to its capital adequacy to cover all the potential losses and the ability to pay off the dividends. Return on Assets ratio measures the earnings of the banks.
5. **Liquidity :** The banks ability to convert assets into cash is called as liquidity. The ratio of cash maintained by banks and balance with the central bank to total assets determines the liquidity of the bank. (Shrestha and Bhandari, 2004)

2.2 Empirical Review

Jha and Hui, (2012) had studied about comparison of financial performance of Nepalese public bank, joint venture and domestic private bank using CAMEL framework. They found that the ROAs of public sector banks were higher than those of joint venture and domestic private banks due to having utmost total assets but the overall performance of public sector banks was not observed sound because other financial ratio including ROE, CDR, CAR of most of the joint venture and domestic public banks were found superior. High overhead costs, political interventions, poor management and low quality of collateral created continued deterioration in financial health of public sector banks. The values determined for the financial ratios reveal that joint venture and domestic public banks are also not so strong in Nepal to manage the possible large-scale shocks to their balance sheet. They concluded that the capital adequacy ratio, interest expenses to total loan and CDR do not have any considerable effect on ROA. The CAR positively influence the ROE but the NPL, CDR, interest assign had no significant effect on ROE.

Oli, (2001) has reported that the current ratio of HBL was below than normal standard 2:1 so HBL suggested that the liquidity position of HBL, NSBL and NBBL were fluctuating and was not in satisfactory level. The capital structure of three JVBs was highly leveraged. The total debt to shareholders equity ratio has indicated that the use of debt by the three banks helped to enhance the rate of return on shareholder’s fund. However, excessive use of debt in non- profitable business may cause solvency of these banks. Profitability position of three JVBs was not found satisfactory but profitability position of HBL was comparatively better than the same NSBL and NBBK. So, NSBL and NBBL have been recommended to utilize their resources more efficiently for generating more profit margins. The major sources of income of three JVBs were from the interest income. NBBL has been investing more in government securities rather than investing loan and advances. The researcher further suggested that the banks needed to minimize their operation expenses as far as possible since it contributes to enhance the volume of profit. The researcher finally recommended that banks should fulfill some social obligations by extending their resources to rural areas and promoting the development of poor and disadvantageous groups. In order to do so the banks should open their branches in remote areas with the objective of providing cheaper banking services.

Furthermore, Baral, (2005) has conducted a research on health check-up of commercial banks in the framework of CAMEL. Bank under study were well capitalized and they were complying with the directives of NRB on capital. Nevertheless, their capital base relative to the risk- weighted assets is not so strong. It uncovered further, non- performing assets of joint venture banks on the average is at satisfactory level, but they are far below aggregate percentage of non- performing assets of commercial banks. The researcher has also concluded that management of NSBI is least efficient among sampled banks and SCBN has most efficient management. The profitability of NSBL is not so weak during the study period. Profitability of Nabil and SCBN was better than NSBI. Furthermore, the liquidity of joint venture banks was higher the industry average ratio. Thus with the view point of liquidity position, the health of joint venture banks is looked like a bit unhealthy.

Sharma, (2007) conducted a research of Nepal SBI Bank in the framework of CAMEL based on the secondary data covering the six year data, he concluded that Nepal SBI Bank Ltd was well capitalized and complying with the directives of NRB. The bank has maintained satisfactory level of past due loan on total loan except 2001. Earning per employees of the bank was found quite high. Net interest margin of the bank was found satisfactory. Further the liquidity position of the bank was found sound.

Furthermore, Dangol, (2012) found that NSBI has been operating its business in a satisfactory way and doing better each year of the study period except in its assets quality where the banks loss loan was found to be in increasing trend. But the provisioning for its loss loan was very near to the level though not equal in some instances, as set by the NRB. Overall, NSBI was not found to be very aggressive in profit maximization goal though it could be smelled that NSBI in a long run strategy of “slow and steady wins the race”.

Joshi, (2014) has analyses the financial performance of NSBI in CAMEL framework. She got that the bank is performing satisfactorily. Some sectors are to be improved by the bank like maintain the liquidity in optimal condition, managing the loan loss and Non- performing loan etc.

Acharya, (2011) had studied on CAMEL rating system of Commercial Banks in Nepal with reference to Bank of Kathmandu and Kumari Bank Limited. She had objective of analyzing and comparing the fundamental performance of BOK and Kumari Bank Limited. She found that KBL has capital adequacy than BOK which shows more conscious to the security of depositors. The loan loss provision of BOK is higher than that of KBL. KBL is improving in bad debts from its LLP. Management efficiency ratio of BOK seems to be consistence. BOK has earned higher profit. BOK has higher liquidity positon than KBL.

Shrestha, (2007) has used the CAMEL Rating System. The study was conducted with the objective of analyzing Capital Adequacy, Quality of Assets, earning and liquidity of the HBL and NABIL. Audited annual reports of condition for the period 2001/02 to 2005/06 are the primary source of information and treated as authentic. The both banks Core capital adequacy ratio varied positively NRB standard during the review period. Supplementary capital ratio of the banks was within the boundary of NRB regulation over the study period. The ROE ratio of NABIL was above the universal bench mark. The increasing trend of ROE showed that there turn per unit of equity invested by the shareholders was increasing year by year. The liquid assets to total deposit ratio of NABIL was above the industrial average ratio except in the initial period.

Gupta, (2014) has analyzed public bank in india and found that there is a statistically significant different between the CAMEL ratio and thus the performance of all the public institution. Likewise, Ahsan, (2016) measured financial performance based on CAMEL on selected Islamic banks in Bangladesh and it is found that all the selected Islamic banks are in strong position on their composite rating system. They are basically sound in every respect i.e., sound in capital adequacy, asset quality, management quality, earning capacity and liquidity conditions.

3. Research Methodology

Research methodology provides the overall framework or plan for the collection, analysis and presentation of data required to fulfill the objective of the study. Objective of using different tools and techniques for the analysis and presentation as well as to answer the research questions as explained under this section. Research methodology is the specific procedure of techniques used to identify, select, process, and analyze information about a topic. To meet the objectives, the methodologies applied in the study are described below.

3.1 Research Design

To fulfill the objectives of the study certain research design will essential so the analysis of the study will be based on the nature of data and tools for analysis. Therefore, the present study uses descriptive as well as analytical research design to describe, measure and analyze the financial performance of commercial banks to make a critical evaluation of the study to achieve the desired result.

3.2 Sources of Data

This research study will basically based on secondary data. The information required for study will collecting through following ways:

- Library research study
- Internet, homepage and related banks links
- Derivatives of NRB
- Annual report of related bank
- Published articles and journals from various researchers and lecturers

3.3 Population and Sample

The total number of commercial banks represent as the total population for the purpose of this study. There are 28 commercial banks in Nepal. Hence population consists of all commercial banks. Out of the total population ten commercial banks are used as sample. The selected banks will be based on the year of establishment of the bank which are listed by Nepal Rastra Bank according to their establishment (i.e banks started their operation). The first commercial bank of Nepal is Nepal Bank Limited. After the establishment of it, Rastriya Banijya Bank, Agriculture Development Bank, Nabil Bank, Nepal Investment Bank, Standard Chartered Bank, Himalayan Bank, Nepal SBI Bank, Nepal Bangaladesh Bank and Everest Bank respectively. (www.nrb.org.com)

3.4 Period Covered

To do this research work five years annual report will be taken of respective banks which are published by bank after audit to general public in the form of annual report. It will cover the fiscal year of 2012/13 to 2016/17.

3.5 Tools for Analysis

The available information will group as per the need of the research work in order to meet research objective. Both financial and statistical tools will be applied to meet the objective of the study.

3.5.1 Financial Tools

Capital Adequacy

Asset Quality

Management Efficiency

Earning Capacity

Liquidity

3.5.2 Statistical Tools

Correlation Coefficient

Multiple Regression Model

3.6 Organization of the Study

The study will be organized into five chapters.

Chapter I : Introduction

This chapter will provides a general background of the study with introduction of a selected bank, followed by statement of the problems, purposes of study, significance of the study, limitations and the organization of the study.

Chapter II : Literature Review

This chapter comprises the reviews of relevant previous writing and studies to find the existing gaps. It includes conceptual framework regarding banks and performance analysis of financial institutions, and review of related studies. Review of journal, books, thesis and newspaper will also include in this chapter.

Chapter III : Methodology

This chapter describes the research methodologies applied to the study. This includes research design, sources of data. It also comprises the population and sample of the study along with method of analysis using various financial and statistical tools used in the study.

Chapter IV : Results

This chapter comprises of presentation and analysis of financial data obtained from annual reports of selected bank for the past five years in the framework of CAMEL and concluded by major findings of the analysis. The data collected after processing will be presented using tables and result of statistical analysis will be interpreted in this chapter.

Chapter V : Conclusions

This chapter consists of summary of all previous four chapters and a conclusion of the study based on finding of the analysis. Similarly Implication for further research will be provided based on the overall study.

Finally, Reference will presented along with the Appendices at the end of the study

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