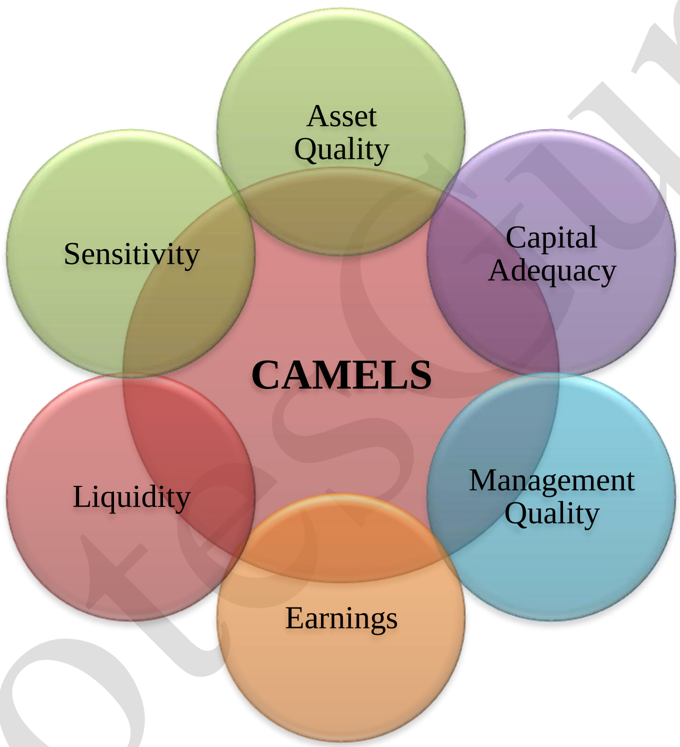
CAMELS Approach

CAMELS Rating is the rating system wherein the bank regulators or examiners (generally the officers trained by RBI), evaluates an overall performance of the banks and determine their strengths and weaknesses.

CAMELS 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. In this Rating system, the officers rate the banks on a scale from 1 to 5, where **1** is the **best** and **5** are the **worst**. The parameters on the basis of which the ratings are done are represented by an acronym **"CAMELS".**



Elements of CAMELS

Banks that are given an average score of less than two are considered to be high-quality institutions. Banks with scores greater than three are considered to be less-than-satisfactory institutions. The acronym CAMELS stands for the following factors that examiners use to rate bank institutions:

Capital Adequacy

Examiners assess institutions' capital adequacy through capital trend analysis. Examiners also check if institutions comply with regulations pertaining to risk-based net worth requirements. To get a high capital adequacy rating, institutions must also comply with interest and dividend rules and practices. Other 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.

Asset Quality

Asset quality covers an institutional loan's quality, which reflects the earnings of the institution. Assessing asset quality involves rating investment risk factors the company may face and balance those factors against the company's capital earnings. This shows the stability of the company when faced with particular risks. Examiners also check how companies are affected by the fair market value of investments when mirrored with the company's book value of investments. Lastly, asset quality is reflected by the efficiency of an institution's investment policies and practices.

Management

Management assessment determines whether an institution is able to properly react to financial stress. This component rating is reflected by the management's capability to point out, measure, look after and control risks of the institution's daily activities. It covers management's ability to ensure the safe operation of the institution as they comply with the necessary and applicable internal and external regulations.

Earnings

An institution's ability to create appropriate returns to be able to expand, retains competitiveness, and adds capital is a key factor in rating its continued viability. Examiners determine this by assessing the company's growth, stability, valuation allowances, net interest margin, net worth level and the quality of the company's existing assets.

Liquidity

To assess a company's liquidity, examiners look at interest rate risk sensitivity, availability of assets that can easily be converted to cash, dependence on short-term volatile financial resources and ALM technical competence.

Sensitivity

Sensitivity covers how particular risk exposures can affect institutions. Examiners assess an institution's sensitivity to market risk by monitoring the management of credit concentrations. In this way, examiners are able to see how lending to specific industries affects an institution. These loans include agricultural lending, medical lending, credit card lending, and energy sector lending. Exposure to foreign exchange, commodities, equities, and derivatives are also included in rating the sensitivity of a company to market risk.

Disclosure Requirement for Bank's Financial Health

Disclosure is the process through which an entity communicates with the outside world (Chandra, 1974). Disclosure refers to the publication of any economic information relating to a business enterprise, quantitative or otherwise, which facilitates the making of investment decisions (Choi, 1973). The **American Accounting Association** defines it as "the movement of information from private (i.e., inside information) into the public domain." It emerges from these definitions that disclosure means reporting of quantitative and qualitative information of financial and non-financial nature regarding the reporting, entity to outsiders for the purpose of their decision making. Information about the affairs of the company can be communicated through different media viz. prospectus, financial press releases, annual report, interim reports and personal contacts with company officials. In addition, newspapers, business and industry magazines, investment advisory services and government statistics also provide information about a company. Despite the existence of different sources of information, the annual report is regarded as the most important of information about a company's affairs. Corporate annual reports represent the most easily accessible and extremely important source of basic information concerning an enterprise.

The central focus of corporate financial reporting has changed with the passage of time. In the past, corporate financial reporting was oriented to providing stewardship information, which was essentially backward looking. The essence of stewardship reporting lies in giving an account of what management has done with the money entrusted to it. Today, the preparation and presentation of corporate financial reports is being driven by the consideration of providing information that is useful for making economic decisions, i.e., decision oriented financial reporting. Decision oriented financial reporting is basically concerned with providing information that will enable the users of the financial statements to judge the ability of the company to generate cash flows in the future. This shift in emphasis is fully reflected in the objectives of financial statements developed by Financial Accounting Standards Board (FASB). According to the **True Blood Study Group Report**, "the basic objective of financial statements is to provide information useful for making economic decisions." (Sorter & Gams, 1974)

Objectives of Disclosure

- The basic objective of financial statements is to provide information useful for making economic decisions.

- Provide information about economic resources, claims to resources and changes in resources and claims.

- Provide information useful in assessing amount, timing and uncertainty of future cash flows.

- Provide information useful in making investment and credit decisions.

Qualitative Objectives of Financial Reporting

- Relevance and Materiality
- Understandability
- Verifiability
- Reliability
- Freedom from bias
- Neutrality
- Timeliness
- Comparability
- Consistency
- Completeness