CAMEL PERFORMANCE ON DOMESTIC AND FOREIGN BANKS IN MALAYSIA

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ABSTRACT

(Using CAMEL analysis, the aim of this study is to examine and compare the performance of the Malaysian’s domestic banks and foreign banks in the financial sector. The CAMEL analysis consists of items which are Capital adequacy, Assets quality, Management efficiency, Earning quality and Liquidity. Measuring the performance of the banks in terms of Capital adequacy, Assets quality, Management efficiency, Earning quality and Liquidity (CAMEL) for both domestic and foreign banks are able to provide detailed performance of the banks in the banking system. Financial analysis based on CAMEL are collected for total of seven local banks and three foreign banks covering period in between 2007 to 2011. The overall result shows that foreign banks perform better compare to local banks. Although most of the local banks stood top position in terms of CAMEL analysis, foreign banks score better average ranking compare to local banks. Result show that Malayan Banking Berhad, Alliance Bank Berhad, Public Bank Berhad and Hong Leong Berhad stood top position in Capital adequacy, Earning quality and Liquidity respectively. On the other hand, HSBC Bank Malaysia Berhad and United Overseas Bank Malaysia Berhad stood top position in Assets quality and Management efficiency respectively.)
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CHAPTER 1
INTRODUCTION

1.1 Research Background

The global financial crisis during 1998 had greatly affected the financial institutions. Main players in the global financial services had leveraged their business to every nation to reduce risk while others opted for cross borders acquisitions and mergers. At the national level, Malaysia banks are left with no choices but to restructure themselves as an answer for tougher operating environment. In addition, higher funding costs, increased defaults and limited opportunities in the market are also the contributing factors for the increase in competition in the industry. All these changes had not only increased competition but also resulted in dramatic effect on the performance of commercial bank. The Central Bank of Malaysia had also introduced new policy and rules to ensure stability of the financial sector and economic growth. Martin. K (2004) stated that among them were allowing the currency to float with minimal control, maintaining an open capital regime, sharp increase in interest rate, control in monetary policy, and tremendous reduction in government expenditure.

The Central Bank of Malaysia had increased the interbank lending rates from 7.6 percent to 8.7 percent in 1997 and then to 11 percent in 1998. Government spending had reduced by 18 percent and ministers’ pay was cut by 10 percent in order to save Malaysia from the crisis. Criterion for NPL had also been tightened from 6 months to 3 months arrears to strengthen the financial quality. After more than a decade, it is therefore important to measure the performance of the banks in order to determine how far the policy and plan had spurred the growth of financial system in Malaysia.
1.2 Financial and Banking System in Malaysia.

Figure 1: Structure of Financial institution in Malaysia
Financial systems in Malaysia are all governed by Central Bank of Malaysia (Bank Negara Malaysia). The Central Bank of Malaysia was established on 26 January 1959 under Central Bank of Malaysia Act 1958 (CBA 1958). It is considered as statutory body that is wholly owned by government and reported directly to the Minister of Finance. The Central Bank of Malaysia major role is to ensure prudent conduct of the monetary policy, inflation stability, and preserving purchasing power of the Ringgit. Aside from that, the bank also plays important roles for financial stability, sound and progressive financial sector which indirectly drive the economic growth.

Under the financial system of Malaysia, the Central Bank of Malaysia governs financial institutions, intermediaries and developed financial institutions. Faezah and Darus (2007) stated that commercial banks have been under control by the Central Bank of Malaysia since 1957, two years after the country’s independence. This report will focus on commercial banks which fall in financial institutions category. Intermediaries are money brokers, insurance brokers, Takaful brokers’, loss adjusters and financial advisers.

On the other hand, Development Financial Institutions (DFI’s) are specialized financial institutions developed by government for specific purposes. DFI’s such as Agro Bank, SME Bank, Bank Rakyat and others are not considered as banks thus not included in this report. Financial institutions further fall into two categories which are banking institutions and Insurance and Takaful operators. Banking institutions include commercial banks, Islamic banks, investment banks, and others financial institutions. In terms of commercial banks, Malaysia currently has 27 banks inclusive of eight local banks and the remaining are foreign banks.
1.2.1 Development of Malaysia Banking Institutions

The history of banking industry started back in 1875 when Mercantile Bank (present name known as HSBC) and Chartered bank (present name known as Standard Chartered) set up their first office in Penang. Malaysia's first domestic bank was Kwong Yik Bank (now known as Malayan Banking Berhad) opened in 1913 at Selangor. At the beginning, almost 90 percent of the share of Malaysia banking in 1957 was held by foreign banks and slowly changed or declined due to some government policies against them.

For a start, Central Bank of Malaysia financial institution inclusive of 25 commercial banks whereby nine of them were domestically owned and 16 were foreign owned banks, 16 Islamic Banks, five international Islamic banks, 15 investment banks and two other financial institutions. Sufian (2009) in his research stated that there were only 10 domestic and 13 foreign banks in Malaysia by the year 2004. This was further supported by Said and Tumin (2011) research that concluded Malaysia commercial banks only constituted of nine local and 13 foreign banks. San et al (2011) claimed that the decline in the number of domestic banks was due to the bank merger in order to improve their performance. For example, the latest merger was between EON Bank and Hong Leong Bank on May 2011.

Aside from the changes in numbers of banks, banking system in Malaysia had also gone through tremendous change since independence in 1957 in terms of work process. The first Automated Teller Machine was introduced in 1980's which then led towards development of electronics banking such as tele-banking and PC banking. The technology advancement had changed the consumer banking significantly. Customers are exposed to easier and simpler method to perform their daily transactions. In addition, it also resulted in new products and
services such as debit and credit card, online banking and others. The innovation and changes in the banking sectors nowadays have made the overall banking system more secure and convenient for their customers.

Commercials banks act as financial intermediaries to accept deposits from customers and give loans to borrowers with certain interests charged and the interests act as income or profit to the banks. In addition to that, banks also facilitate traders with, for instance Letter of credit, shipping guarantee and banker’s acceptance.

1.2.2 List of Banks in Malaysia

Table 1: Lists of Domestic and Foreign Banks in Malaysia.

<table>
<thead>
<tr>
<th>Name of the Banks</th>
<th>Ownership</th>
<th>Establishment</th>
</tr>
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<tbody>
<tr>
<td>Bank Negara Malaysia</td>
<td>Central Bank</td>
<td>1959</td>
</tr>
<tr>
<td>JP Morgan (M) Berhad</td>
<td>Foreign</td>
<td>1964</td>
</tr>
<tr>
<td>HSBC Bank (M) Berhad</td>
<td>Foreign</td>
<td>1994</td>
</tr>
<tr>
<td>Bank of China (M) Berhad</td>
<td>Foreign</td>
<td>1991</td>
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<tr>
<td>Bangkok Bank (M) Berhad</td>
<td>Foreign</td>
<td>1959</td>
</tr>
<tr>
<td>Malayan Banking Berhad</td>
<td>Domestic</td>
<td>1960</td>
</tr>
<tr>
<td>CIMB Bank Berhad</td>
<td>Domestic</td>
<td>1965</td>
</tr>
<tr>
<td>Public Bank Berhad</td>
<td>Domestic</td>
<td>1972</td>
</tr>
<tr>
<td>Hong Leong Bank Berhad</td>
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<td>2011</td>
</tr>
<tr>
<td>AmBank Berhad</td>
<td>Domestic</td>
<td>1975</td>
</tr>
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<td>RHB Bank Berhad</td>
<td>Domestic</td>
<td>1966</td>
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<td>Royal Bank of Scotland (M) Berhad</td>
<td>Foreign</td>
<td>1964</td>
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<td>OCBC Bank (M) Berhad</td>
<td>Foreign</td>
<td>1912</td>
</tr>
<tr>
<td>Mizuho Corporate Bank (M) Berhad</td>
<td>Foreign</td>
<td>1973</td>
</tr>
<tr>
<td>United Overseas Bank (M) Berhad</td>
<td>Foreign</td>
<td>1993</td>
</tr>
<tr>
<td>CitiBank (M) Berhad</td>
<td>Foreign</td>
<td>1994</td>
</tr>
<tr>
<td>Standard Chartered Bank (M) Berhad</td>
<td>Foreign</td>
<td>1875</td>
</tr>
<tr>
<td>Affin Bank Berhad</td>
<td>Domestic</td>
<td>2000</td>
</tr>
<tr>
<td>Alliance Bank Berhad</td>
<td>Domestic</td>
<td>2004</td>
</tr>
<tr>
<td>Deutsche Bank (M) Berhad</td>
<td>Foreign</td>
<td>1967</td>
</tr>
<tr>
<td>BANK of Tokyo-Mitsubishi UFJ (M) Berhad</td>
<td>Foreign</td>
<td>1959</td>
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<tr>
<td>Bank of Nova Scotia Berhad</td>
<td>Foreign</td>
<td>1973</td>
</tr>
<tr>
<td>BNP Paribas (M) Berhad</td>
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</tr>
</tbody>
</table>
1.3 Problem Statement

Banks serve as backbone of the financial system and help the nation with the utilization of financial resources. The banking sector in Malaysia had been growing throughout the years and showing large amount of investments. Sundararajan et al. (2002) stated that the financial systems, (especially banks) were exposed to different kinds of risks that were becoming more complex. The increase of the risk complexity throughout the years had influenced researcher to study their performance in the ever changing environment. The risk can be start from personal loan to overall country economy. In order for banks to sustain with the increasing risk complexity and unpredicted financial risk, it is important to evaluate the overall performance of the banks regularly. One of the measurements is the CAMEL rating system which was put into use by United States of America (USA) with effect in 1979 and it is now well accepted globally.

Most of the previous studied on performance Malaysia’s banks focused on financial ratios analysis such as profitability ratios, and efficiency ratios. These analyses were different from CAMEL as it only covers specific areas such as return of equity, return of assets, and turnover. Previous studies mostly noted an improvement in terms of efficiency in Malaysia Banking industry throughout the years. The improvement in banking sector is mostly due to Financial Sector Master Plan (FSMP, 2001-2005) that aimed to develop more competitive and dynamic financial system practices.
In terms of profitability, previous study also reveal that foreign banks profitability were better compare to local banks until global financial crisis at 2008. Unlike CAMEL analysis, it covers all the performance measurement aspect such as profit, management, efficiency, and liquidity. In addition, this analysis also used latest data from each banks’ financial statement within period of 2007-2011 which are different from previous studied that used older data period.

1.4 Objective

The objective of this study is to measure the financial performance of both local and foreign banks in Malaysia. The measurement allows us to compare and rank them in Malaysia Banking system. The World Bank (2002) summarized that entry of foreign bank increases the efficiency of domestic banks. As such, analysis is needed to determine whether our domestic banks are on par with foreign banks in Malaysia.

1.4.1 Specific Objective

Aside from the objective, the specific objectives are to compare the performance of the local and foreign banks. Moreover, CAMEL analysis allows measurement to be taken in terms of categories such capital adequacy, assets quality, management efficiency, earning quality and liquidity. These enable us to measure and compare specifically the performance of the banks in each category.
1.5 Significant of Studies

CAMEL analysis is used in this analyst because of its distinctive features in order to determine the performance of the banks by eliminating the judgment based on volume, size and market share. In addition, financial ratio analysis goes beyond the numbers to reveal how efficient the bank’s performance in terms of profitability, liquidity, and credit quality. Measuring the financial performance is vital in order to understand the company’s performance in terms of numbers.

This study gave further values such as understanding the banks in different aspect based on the capital adequacy, assets quality, management efficiency, earning quality and liquidity. The performances of the banks are clearly seen based on each category and easily evaluated within each banks.
CHAPTER 2
LITERATURE REVIEW

2.1 Introduction

Literature on banks performance in Malaysia was well researched and received significant
tention from the past. There have been large numbers of studies regarding commercial
banks performance around the globe (see Yeh, 1996; Webb, 2003; Lacewell, 2003; Halkos
and Salamouris, 2004; Tarawneh, 2006). As such, consumers are exposed to large amount of
information regarding profitability of the banks around them. Consequently, the consumer
might expect better prices and service quality and greater security and soundness of financial
systems (Berger et al, 1993).

In order to understand deeper in bank financial performance, number of studies had been done
based on CAMEL model but on different perspectives and in different periods. Cole et at
(1995) conducted (A CAMEL rating shelf life) and concluded that if a bank has not been
examined for more than two quarters, Off-site monitoring system would give a better report
on sustainability than CAMEL rating.

2.2 Performance of Banking

2.2.1 Financial Ratios Studies

Nenide et al (2010) had conducted studies with the use of financial ratios in his research to
determine problems associated with and recommendations for using large databases. The
study used sample data of 250 firms from Kauffman Center for Entrepreneurial Leadership
Financial Statement Database to explain and highlight the data error identification, handling
the problem of denominator being negative, effective techniques for transforming the data to
achieve approximation of normal distribution and others. The study suggested researchers to use financial data samples that will meet the minimal required characteristics for the use of valid multivariate statistical analysis.

Kumbirai and Webb (2013) conducted a financial ratio analysis of performance for the commercial banks in South Africa. The study used data from the period of 2005 to 2009 to measure the liquidity, profitability and credit quality performance of five large South African based commercial banks. They found out that the overall bank performance increased steadily in the first two years of analysis but showed a significant change of performance trend during global financial crisis in 2007. The financial crisis affected the profitability, low liquidity and downward moving in credit quality of the South African Banking Sector.

Anil and Harjinder (2013) concluded that District Central Cooperative Bank (DCC) in India had sufficient growth with liquidity and solvency in good position. His study analyzed the DCC Bank based on financial ratio analysis using the data from 2008 to 2011. The reason for the study to be conducted was because DCC bank holds great responsibility in agricultural and rural development. As such, its financial strength needs to be read in order to meet the credit needs in the district.

Dr. Yee (2003) had done a research on a study on financial ratios of major commercial banks in Oman. The main purpose of the study was to find out the financial ratios of major commercial banks in Oman and also compare their financial management practices as shown in the ratio. Data had been drawn from balance sheet and income statement from 1997 to 2004 which was analyzed in terms of liquidity management ratios, interest rate risk management
ratios, credit risk and others. The result shows that different banks have differences in financial practices thus resulting in a different ranking under each financial ratio category.

Scholtens (2000) conducted a research on competition, growth and performance in the banking industry. The research analysed the relationship between performances of the banking industry and the market structure. He concluded that bank profits are inversely related to the amount of bank assets but positively related to the amount of bank’s capital.

Gerlach, Peng and Shu (2005) analysed the macroeconomic conditions and banking performance in Hong Kong by using a panel data for 29 banks covering the period of 1994 to 2002. They used only two ratios of profitability determinant which were Net Interest Margin (NIM) and Non-Performing Loans (NPLS) because they were unable to obtain enough data due to some confidentiality issues. For instance, they were not able to access the asset size of individual banks and they also did not have any information about banks ownership. The findings of the study revealed that changes in macroeconomic conditions have direct impact on the banks’ performance and financial health.

Nada (2012) in his study evaluated financial performance of banking sector in countries such as Bosnia, Herzegovina, Croatia, Serbia and Slovenia by comparing the financial performance within the period of 2005 to 2010. Measurements such as return on asset (ROA) return on equity (ROE), capital adequacy ratio (CAR), share of non-performing loans (NPL), participation of deposits, assets and loans in Gross Domestic Products (GDP) of the country were taken into account. Result showed that banking system of the countries was suffering
mostly due to huge debt with International Monetary Fund (IMF), political situation, financial crisis, internal situation and other political factors.

Molyneux and Seth (1998) conducted an analysis for both foreign commercial credit extension and bank profitability for the period covering in between 1987 to 1991 in the USA and they found out that the capital strength and demand on loan have positive effect on the foreign bank profitability but were not related to an improvement in commercial lending. Moreover, a foreign bank in USA should deal with a considerable capital, in other words with a certain higher level of capital as compared to other financial institutions in order to generate higher profitability.

Flamin and Schumacher (2009) carried out analysis on the determinants of commercial bank profitability by using a total sample of 389 banks in Sub-Saharan Africa (SSA). In terms of profitability, they concluded that their findings showed private and foreign banks are performing distinctly than public and local banks respectively. They also added on that activities such as diversification, bank size, and private ownership are positively related to the banking profitability in terms of return on asset. On the other hand, credit risk and macroeconomic variables have a reverse impact on bank profitability.

Samad (2004) investigated the performance of seven locally incorporated commercial banks during the period of 1994 to 2001 based on the performance of the seven commercial banks in comparison to banking industry in Bahrain which was considered a benchmark. Financial ratios were used to evaluate the credit quality, profitability, and liquidity performances. The article applied a Student’s t-test to measure the statistical significance for the measures of
performance. They concluded that commercial banks in Bahrain were relatively less profitable, less liquid and exposed to higher credit risk than the banking industry, in which wholesale banks were the main component.

In the case of Malaysia, Sufian (2009) analysed the factors that influenced bank profitability in Malaysia covering the period of 2000 to 2004. He was focusing on foreign and domestic commercial banks and the result showed that there was a negative relationship between credit risk and loan concentrated for Malaysian banks. As such, the higher the credit risks of a bank, the more its exposure to loan payment which will end up with low level of profitability. On the other hand, he found out that capital size, income from non-interest sources and operating expenses have a positive effect on Malaysian banking profitability. Apart from that, well capitalized bank will generate higher profitability due to lower cost of borrowing but on the contrary, it is possible otherwise. In addition to the result showed that, the negative relationship between economic growth and profitability in the Malaysian banks can be affected by high inflation rate.
2.2.2 Efficiency Studies

Joseph and Loretta (2008) did a research on efficiency in banking and provide an overview of two broad approaches in measuring bank performance and applications of these approaches. The two broad approaches are structural and non-structural approaches which are commonly used to measure banking efficiency.

Chotigat (2008) conducted a study on efficiency of domestic and foreign banks in Thailand since the Asian Financial Crisis. The study had been conducted using quarterly financial time-series data from 1997 to 2003 for both domestic and local banks in Thailand. The study found out that both the efficiency ratio and loan loss provisions resulted in negative performance for domestic banks while only loan loss provisions had negative impact on the performance of foreign banks.

Casu and Molyneux (1997) focused on comparative study of efficiency in European Banking by using data from 1993 to 1997. They investigated the productive efficiency of European Banking system after the EU legislative harmonization through creation of the Single Internal Market. In addition to that, they also studied the determinants of European bank efficiency using TOBIT regression model approach. Result showed that EU’s Single Market Program allows small improvement in efficiency of the banks.

Sufian (2004) analysed the effects of efficiency after bank mergers and acquisitions in a developing economy by using Malaysia as an example. The efficiency of domestic commercial banks during the merger year, pre-end and post-merger period had been analysed based on Non parametric frontier approach. He concluded that merger program on small and
medium size banks in Malaysia were a success. The banks via economies of scale have benefited the most from the merger and expansion.

Matthews and Ismail (2005) analysed the efficiency and productivity of Malaysian domestic and foreign commercial banks by using figures from 1994 to 2000. They figured out that productivity is based on technical change and efficiency is related to size instead of profitability. They concluded that foreign banks are in a better financial soundness than domestic banks in the case of efficiency.

Gupta et al (2008) state that in other study about performance of the Indian banking sector, TOBIT model was used to finds the determinants of productive efficiency. Results of the study shows that State Bank of India (SBI) and its group have the highest efficiency followed by private banks, and the other nationalized banks. Karas et al (2010) studied on banks efficiency with regards to bank ownership in Russia studied and they found out that foreign banks were better in terms of efficiency than domestic private banks. In addition, domestic private banks were less efficient compare to the domestic public banks.

Loukoianova (2008) conducted a study on the efficiency and profitability of Japanese banks. The results showed that there were significant differences within the banking sector, with regional banks being less cost and revenue efficient relative to both City and Trust banks although the performance of Japanese banks have improved steadily. While Japanese banks profitability is lower compared to other advanced countries, there is room for efficiency gains, particularly through increased cost sharing arrangements among regional banks, consolidation
of regional banks with major or other regional banks, and the creation of bank consortia to pool resources for asset and risk management.

O'Donnell and Van der Westhuizen (2002) conducted an analysis measuring the efficiency of a South African bank at branch level. Their main focus was investigating branches which were performing well and those that were doing badly, where efficiency could be improved. They found that many branches were operating on a scale that was too small and could help increase their operational scales. As such, it has improved the overall efficiency of the bank.

Chortareas et al (2010), studied hypothesis for over 2,500 banks in Latin American countries about market power (structure-conduct-performance and relative market power) and efficient structure (X- and scale efficiency). Reliable efficiency measurement such as Data Envelopment Analysis (DEA) technique was used for the study. The result showed that most important factors in determining profits for these Latin American banks were capital ratios and bank size.

Rangan et al. (1988) used larger sample of 215 U.S. banks in their attempts to break down inefficiency to that stemming from pure technical inefficiency and scale inefficiency through applied DEA. They used the intermediation approach by using three inputs (labor, capital and purchased funds) and five outputs (three types of loans and two types of deposits). They concluded that banks could have produced the same level of output with only 70% of the inputs actually used, while scale inefficiencies of the banks were relatively small, suggesting that the sources of inefficiency to be purely technical rather than scale.
Dadgar and Niknemat (2008) used Charnes, Cooper and Rhodes (CCR) and Banker, Charnes and Cooper (BCC) models to measure the efficiency of Tejarat bank in the whole country and then ranked based on the efficient units. They found out that calculating the efficiency with the help of BCC is more meaningful and compatible than CCR as well as by applying the two inputs is more meaningful than one input and likewise calculating the efficiency with status of variable returns to scale have been recognized to be more suitable.

2.2.3 CAMEL Studies

A research done by Prasad et al (2011) to analyse Nationalised Banks in India used CAMEL model. As much as 20 nationalised banks had been chosen to be analysed based on equal weights. The study concluded each of the banks by selecting the best out of each category under CAMEL (Capital adequacy, Assets quality, Management efficiency, Earning quality and Liquidity in ranking.

Arena (2008) concluded that bank level fundamentals proxied by CAMEL variables which affected the likelihood failure of banks and also explained why banks were going to fail. The fundamental also stated that the systemic and macroeconomic and liquidity shocks that triggered the crisis not only caused trouble to the weak banks but also to the relatively stronger banks.

Hirtleand Lopez (1999) in their study stressed that the bank’s CAMEL rating only allows certain access by the bank’s senior management for the purpose of projecting the business strategies, and to appropriate supervisory staff due to its highly private and confidential.