A STUDY ON THE FINANCIAL PERFORMANCE OF FOREIGN COMMERCIAL BANKS IN SRI LANKA: AN APPLICATION OF CAMEL RATING SYSTEM

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ABSTRACT

Banks serve as backbone to the financial sector, which facilitate the proper utilization of financial resources of a country. The banking sector is increasingly growing and it has witnessed a huge flow of investment. The banking sector of developing countries is different from the developed countries in term of performance. The banking sector, especially commercial banks of Sri Lanka plays a vital role in the Sri Lankan economy. The focus of this study was to investigate the financial performance of foreign commercial banks in Sri Lanka. Many studies are conducted in different countries to study the financial performance of banking sector using the various statistical methods. In this study, the CAMEL rating system is used to study the financial performance of foreign commercial banks in Sri Lanka. The study selects three foreign banks for the analysis. Data was collected for the time period of 2008-2014. According to the findings foreign sector banks are good in the performance of capital adequacy and earnings while other variables show an average performance.

KEYWORDS

CAMEL rating system, Financial performance, Foreign banks

1. INTRODUCTION

The economic downturn of 2008 which resulted in bank failures, are triggered in the U.S. and then wildly spread worldwide. It therefore increasingly urges the need of more frequent banking examination. In order to cope with the complexity and a mix of risk exposure to banking system properly, responsibly, beneficially and sustainably, it is of great importance to evaluate 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, and now is in use by three U.S. supervisory agencies-the Federal Reserve System, Office of the Comptroller of the Currency (OCC), and Federal Deposit Insurance Corporation (FDIC). It has been proved to be a useful and efficient tool in response to the financial crisis in 2008 by U.S. government.

This study attempts to find how foreign banks performing in the Sri Lankan economy. Foreign banks are a type of banks that is obligated to follow the regulations of both the home and host countries. Because the foreign branch banks loan limits are based on the parent bank's capital, it believes that foreign banks can provide more loans than subsidiary banks. The history of foreign banks in Sri Lanka goes to the year 1892. As the oldest foreign banks in Sri Lanka, HSBC and Standard Chartered banks are still playing a major role in Sri Lankan economy. These two banks hold a higher position than some domestic banks functioned here. So that an efficacious study on that area will be very important and very appropriate. Especially for those who are keen on financial sector.

It is widely recognized that one of the most important functions of a management crew at all levels of an institute is planning, and planning requires substantial information regarding the related phenomenon. The trends of foreign banking sector as well as whole private sector financial trends are important for decision making at levels of financial sector from the government of host-country to the home-country. To provide a satisfactory service to the customers, each institute should aware of their turning points. In the view of customers, it is very important that the awareness of the negotiability of the institute. However, it was noted that foreign banks in Sri Lanka mainly operate in metropolitan areas and their branch network was not extensive. Thus, their performance in economic development is trivial. This seems to be a common characteristic of many of the developing countries (Bhattacharyya et. al. 1997). But, after the year 2010 Sri Lankan foreign bank sector showed a rather expansion and whole commercial banking system showed a significant growth during post war era. So, Sri Lanka needs a new study on the performance of foreign banks. To fulfill this research gap CAMEL rating system has been used for the study. There are five variables are studied here.

1.1. CAPITAL ADEQUACY (C)

Capital adequacy is the capital expected to maintain balance with the risks exposure of the financial institution such as credit risk, market risk and operational risk, in order to absorb the potential losses and protect the financial institution‘s debt holder.

1.2. ASSETS QUALITY (A)

Assets quality includes which assets are uncollectible or whose true value is less than that shown on the bank’s balance sheet. To rate asset quality, it is usually necessary for the bank examiners to conduct an on-site examination. Examiners who are well trained in evaluation of loans, advances, and other credit facilities will assign a classification to the problem loans based on analysis of collectible data.

1.3. MANAGEMENT SOUNDNESS (M)

Management soundness is the third component in CAMEL rating system. A good banks need experience management, integrity, technical and managerial skills well spread, clear and logical business / sales strategy, size and market reputation, good training, good internal / external communication, and good customer care in their management performance to enhance good reputation in banking management system.

1.4. EARNINGS (E)

Earnings is a component which indicates the profitability. High ROA and ROE, always profitable year after year, stable income stream, and few exceptional items are the indicators for high earnings acceptable by the banks. Banks need to be profitable in order to add their capital.

1.5. LIQUIDITY (L)

Liquidity indicates the ability of a bank to quickly meet its obligation without a loss. Banks must have available liquid assets which can quickly be converted in cash, or they must be able to raise funds on very short notice to meet an obligation.

1.6. RESEARCH OBJECTIVES

The overall objective of this study is to measure the financial performance of foreign commercial banks in Sri Lanka by using CAMEL rating system and to provide reliable and accurate information about the foreign sector commercial banks in Sri Lanka.

2. LITERATURE REVIEW

Over the past decade, it is obvious that many studies were focused on international banking. Fundamentally, the literature on banking system is huge with various types of empirical analyses. But most of researchers apply CAMEL rating system. The review is as follows.

Mishra,Gadhia,Bibhu,Biswabas and Shivi (2013) have used CAMEL rating system to analyze the efficiency of private and public banks in India during the time period of 2000-2011 and it is established that private sector banks are at the top of the list with their performance. On the other hand, the early study made an attempt to measure the efficiency change of those selected banks during 2010-2012 by using frontier based non-parametric technique, Data Envelopment Analysis (DEA)

A study was conducted to analyze the performance of selected private commercial banks in Bangladesh (Anwarul and Suman,2012) The findings of the study reveal that IFIC bank's capital adequacy ratio, leverage ratio and asset quality show better performance while EXIM bank shows a better performance in the return on equity, net worth protection and income per share.

Sarker (2005) in Bangladesh examined the CAMEL model for regulation and supervision of Islamic banks by the central bank. This study enabled the regulators and supervisors to get a Shariah benchmark to supervise and inspect Islamic banks and Islamic financial institutions from an Islamic perspective. Nurazi and Evans (2005) investigated whether CAMEL(S) ratios could be used to predict bank failure. The results suggested that adequacy ratio, assets quality, management, earnings, liquidity and bank size are statistically significant in explaining bank failure.

Olweny and Shipo (2011) found that poor asset quality and low levels of liquidity are the two major causes of bank failures. Poor asset quality led to many bank failures in Kenya in the early 1980s. Ongore andKusa (2013) concluded that the financial performance of commercial banks in Kenya was driven mainly by board and management decisions, while macroeconomic factors have insignificant contribution.

Research Journal of Management Sciences Vol.1(3),9-14, October (2012) "Analyzing Soundness in Indian Banking : A CAMELS Approach"The objectivity of this paper is to analyze the performance of 12 public and private sector banks over a period of eleven years (2000-20011) in the Indian banking sector. For this purpose, CAMELS approach has been used and it is established that private sector banks are the top of the list, with their performances in terms of soundness being the best. Public sector banks like Union Bank and SBI have taken a backseat and display low economic soundness in comparison. (Kumar, 2012) According to the above literature reviews researcher found that the CAMEL rating system is the most applicable measurement for the current study, since it is well define the performance of banking institutes.

3. METHODOLOGY

3.1 DATA SOURCES

In order to fulfill the objectives of the study and to do the analysis of the study data was collected from secondary sources mainly from annual financial statements of selected banks, which were published by respective banks. All the annual report's financial statements have independent auditors. Especially private banks are audited by chartered accountants. Normally financial statement of the Sri Lankan banks include statement of income, statement of financial position, statement of cash flow, statements of changes in equity and relevant notes. Here bank's statement of income and statement of financial position was used in this study. Mainly Fitch Rating Lanka annual reports were used to collect relevant data.

3.2 SAMPLE DESIGN

Researcher selected three foreign banks for the study. Data for the study was collected for the time period of 2008-2014.

3.3 MODE OF ANALYSIS

The data is analyzed by applying ratio analysis according to the necessity of the CAMEL rating system in this study. This rating system was extensively used by many researcher in assessing the efficiency of financial institutions (Hilbers, Krueger and Moretti, 2000) So that the variables of this study;

- Capital Adequacy (C)
- Assets Quality (A)
- Management Soundness (M)
- Earnings (E)
- Liquidity (L)

Table 1: Ratios used for the study

Aspect	**Ratios**	**Formula**
Capital Adequacy	Equity Capital to total Assets	$\frac{\text{Equity Capital}}{\text{Total Assets}}$
Assets Quality	Loans & Advances to Total Assets	$\frac{\text{Loans \& Advances}}{\text{Total Assets}}$
Management Soundness	Operating Cost to Profit after Tax	$\frac{\text{Operating Cost}}{\text{Profit after tax}}$
Earnings	➢ Return on Assets (E1)	$\frac{\text{Net profit after tax}}{\text{Total Assets}}$

	➢ Net Interest Margin (E2)	Net interest income / Total Assets
	➢ Net Profit Margin (E3)	Profit after tax / Total loan & advances
	➢ Diversification Ratio (E4)	Noninterest income / Total income
Liquidity	➢ Loan to Deposit Ratio (L1)	Total loans / Total deposits
	➢ Customer deposits to total assets (L2)	Total deposits / Total assets

Source: CAMEL Approach for Bank Analysis (1996)

4. Analysis, Results And Interpretation

This section intends to apply the CAMEL framework to analyze banks' overall condition which helps to identify the strength and weaknesses of the bank. The author implements the CAMEL model in analyzing the investigated banks' overall performance from 2008 to 2014 on capital, assets, management, earnings and liquidity.

4.1 Capital Adequacy Analysis

Table 2: Capital adequacy of selected banks

Bank	2008 (%)	2009 (%)	2010 (%)	2011 (%)	2012 (%)	2013 (%)	2014 (%)	Average Value
HSBC	9.41588	10.7223	8.45658	9.34383	11.8796	13.1981	11.906	10.7032
Standard Chartered bank	13.6628	7.55735	19.6639	19.4502	21.0685	23.3241	19.249	17.71095
Citibank	14.1344	37.7827	34.1235	29.1332	35.7270	32.4453	34.447	31.1134

Table 2 shows capital adequacy of foreign banks. Here the ratio indicates that equity capital on total assets of the banks. It was calculated equity capital divided by total assets of the banks. This shows that all the banks have met the required minimum of (> 4-6) capital adequacy which considers by CAMEL approach. It further shows that Citibank Sri Lanka holds the highest rate of capital adequacy according to the average values of each bank.

4.1.1 Fluctuation Of Capital Adequacy

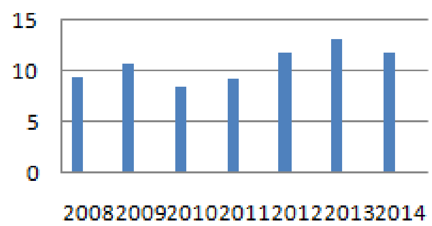

Figure 1: HSBC capital adequacy

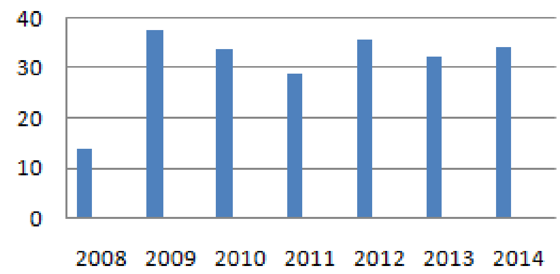

Figure 2: Citibank's capital adequacy

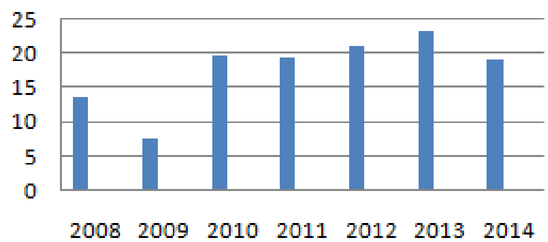

Figure 3: Standard Chartered bank's capital adequacy

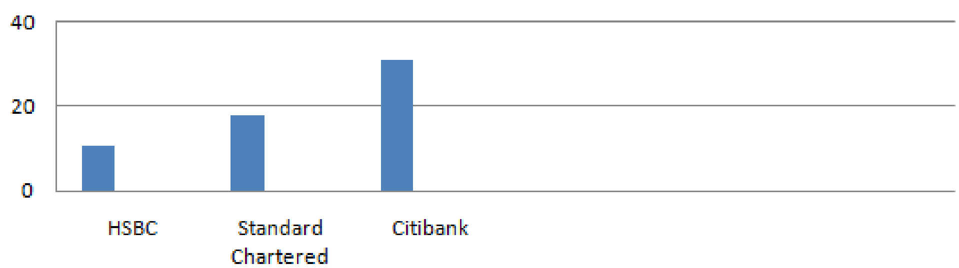

Figure 4: Capital Adequacy behavior

4.2 Assets Quality Analysis

Table 3: Assets quality of selected banks

Bank	2008 (%)	2009 (%)	2010 (%)	2011 (%)	2012 (%)	2013 (%)	2014 (%)	Average Value
HSBC	58.161	46.82	43.3210	49.2411	44.3935	40.2767	48.257	47.211
Standard Chartered bank	61.635	58.77	57.2550	52.6274	58.8550	51.0824	56.968	56.742
Citibank	74.152	41.49	36.9417	45.9015	42.0487	30.3294	26.787	42.52247

Table 3 reveals that assets quality of foreign commercial banks which shows amount of loans and advances on the bank's total assets. It was calculated loans and advances divided by total assets of the banks. Here HSBC and Citibank have low assets quality ratio.

4.2.1 Fluctuation Of Assets Quality

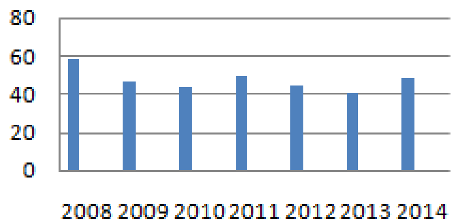

Figure 5: Hsbc Assets Quality

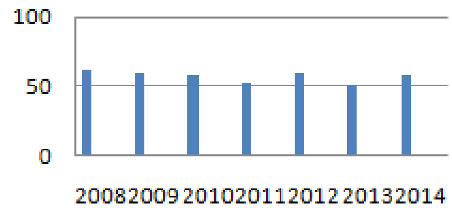

Figure 6: Standard Chartered bank's assets quality

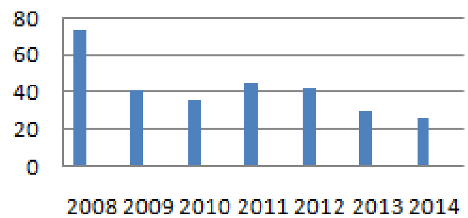

Figure 7: Citibank's Assets Quality

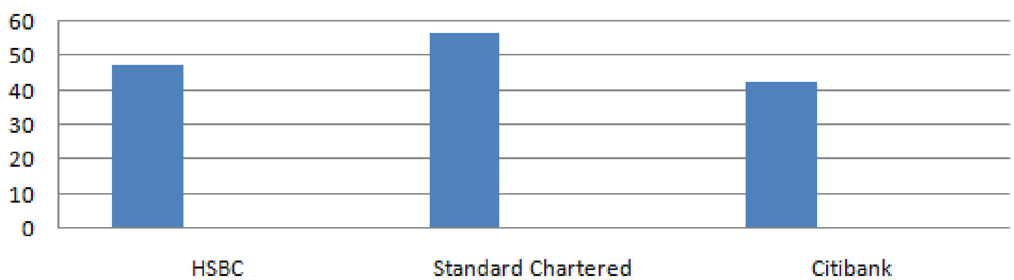

Figure 8: Assets quality behavior

4.3 Management Soundness Analysis

Table 4: Management soundness of selected banks

Bank	2008 (%)	2009 (%)	2010 (%)	2011 (%)	2012 (%)	2013 (%)	2014 (%)	Average Value
HSBC	24.665	18.333	16.7522	15.9966	10.2917	9.6441	12.297	15.42599
Standard Chartered bank	9.5554	3.6797	2.72599	15.7148	13.3703	11.892	12.037	9.853705
Citibank	6.8820	10.049	30.1736	32.6658	7.37909	9.0330	9.8159	15.14275

Table 4 indicates that management soundness of foreign commercial banks in Sri Lanka which reflects the amount of operating cost on the profit for the year. It was calculated operating cost divide by profit after tax. According to the results of table 4, it can be seen that Standard Chartered bank has a low level of management soundness.

4.3.1 Fluctuation Of Management Soundness

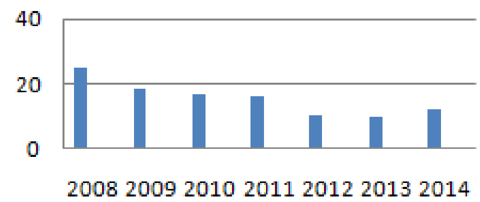

Figure 9: HSBC management soundness

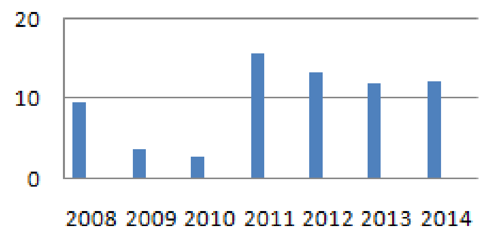

Figure 10: Standard Chartered bank's management soundness

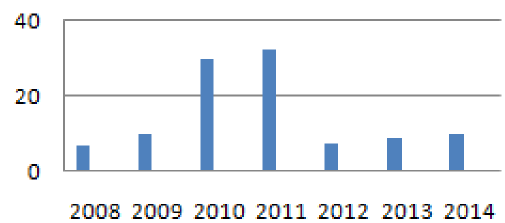

Figure 11: Citibank's management soundness

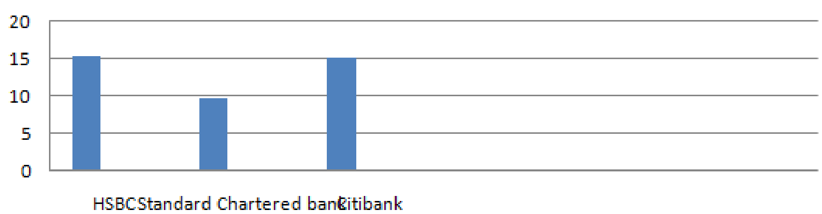

Figure 12: Management soundness behavior

4.4 EARNINGS QUALITY ANALYSIS

Table 5: Earnings quality of selected banks

Bank	Ratio	2008 (%)	2009 (%)	2010 (%)	2011 (%)	2012 (%)	2013 (%)	2014 (%)	Average Value
HSBC	E1	1.4351	1.9990	1.9267	1.9686	2.8956	2.523	1.846	10.25
	E2	6.8287	6.5876	5.0096	4.4869	5.3139	5.512	4.197	
	E3	2.4675	4.2691	4.4475	3.9980	6.5226	6.266	3.826	
	E4	25.972	29.005	32.795	35.681	31.310	23.16	24.66	
Standard Chartered bank	E1	2.4379	7.6543	11.818	2.6263	3.8483	4.070	3.674	13.78
	E2	5.0134	5.5953	5.0053	4.3334	5.2528	5.111	4.662	
	E3	3.9553	N/A	N/A	4.9905	6.5387	7.969	6.449	
	E4	40.214	38.557	38.365	41.841	34.742	40.58	38.64	
Citibank	E1	2.5718	4.8300	1.7404	1.6720	5.5620	4.482	5.440	15.76
	E2	4.1962	8.8327	5.9859	5.2981	6.574	6.261	7.732	
	E3	3.4683	11.639	4.7114	3.6426	13.227	14.77	20.31	
	E4	51.427	33.621	39.469	37.630	48.056	43.27	44.80	

Table 5 shows the earnings of foreign commercial banks in Sri Lanka which consider earnings on the total assets. Here, four ratios have been used to analyze the earnings quality including ROA, NIM, NPM and diversification ratio.

According to the results, HSBC, Standard Chartered bank and Citibank have met the required minimum level of (> 1%) ROA ratio. Standard Chartered bank is the best performing bank in return on assets.

4.4.1 FLUCTUATION OF EARNINGS QUALITY

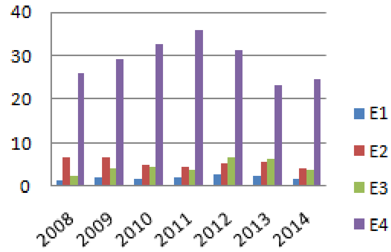

Figure 13: HSBC Earnings Quality

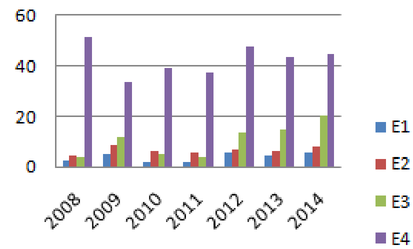

Figure 14: Citibank's earnings quality

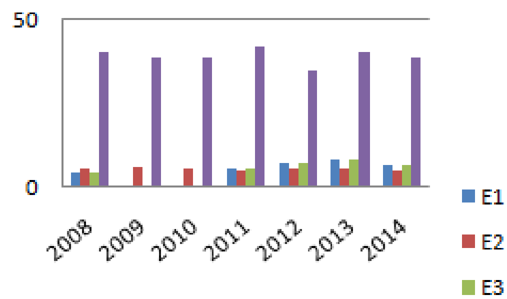

Figure 15: Standard Chartered Bank's Earnings Quality

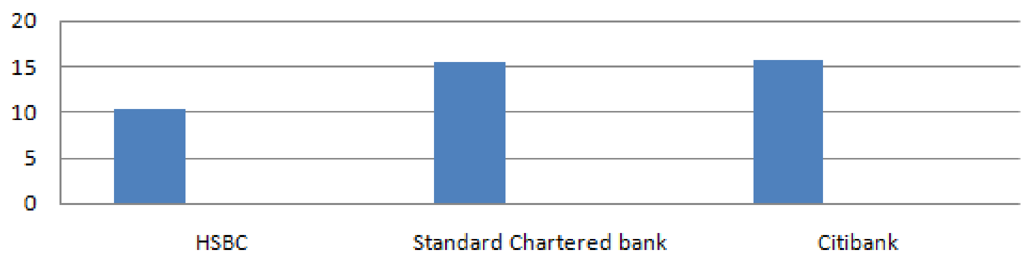

Figure 16: Earnings quality behavior

4.5 Liquidity Analysis

Table 6: Earnings quality of selected banks

Bank	Ratio	2008 (%)	2009 (%)	2010 (%)	2011 (%)	2012 (%)	2013 (%)	2014 (%)	Avg: Value
HSBC	L1	93.20	72.207	72.134	83.984	84.006	84.781	110.72	85.86
	L2	62.40	64.848	60.055	58.631	52.845	47.506	43.583	55.69
Standard Chartered bank	L1	99.20	75.933	77.194	72.712	82.389	71.385	76.129	79.27
	L2	62.12	77.396	74.169	72.377	71.435	71.558	74.831	71.98
Citibank	L1	N/A	91.352	74.770	92.783	75.849	N/A	N/A	83.68
	L2	N/A	45.423	49.407	49.471	55.436	N/A	N/A	49.93

Table 6 reveals that liquidity position of foreign commercial banks in Sri Lanka which shows the liquidity strength of the bank. Two liquidity ratios have been used for the analysis (Loan to deposit ratio and Deposits to total assets ratio) Here, only Standard Chartered bank stand below the required maximum of (<80%) loan to deposits ratio. The other selected banks have a higher rate of liquidity than the maximum point.

4.5.1 FLUCTUATION OF LIQUIDITY

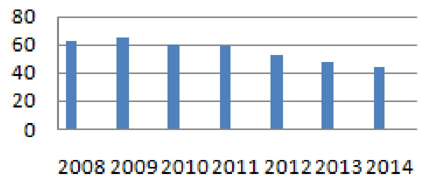

Figure 17: HSBC liquidity

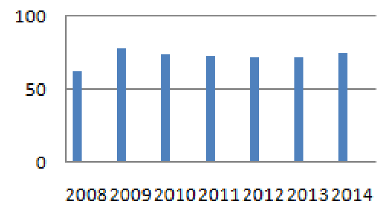

Figure 18: Standard Chartered bank's liquidity

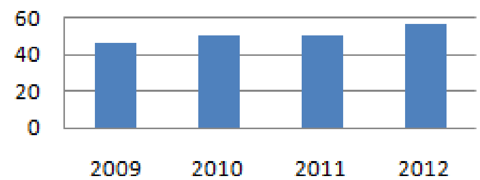

Figure 19: Citibank's liquidity

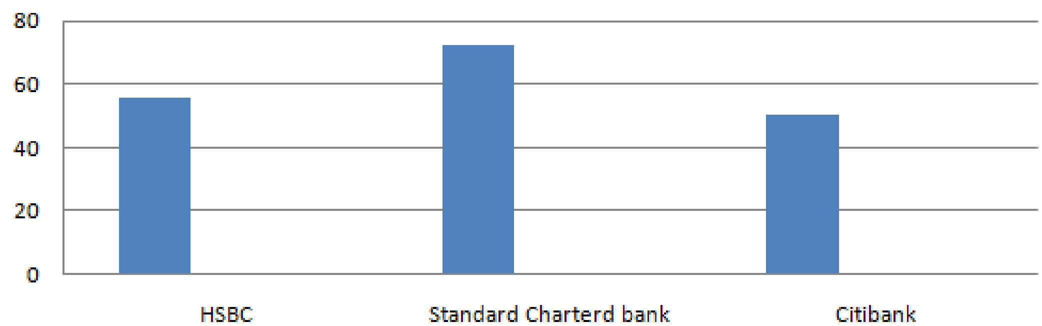

Figure 20: Liquidity behavior

5. CONCLUSION AND RECOMMENDATIONS

Effective financial performance is much needed for every firm as well as banks. Basically financial performance considers all the aspects of the firm as capital, liquidity, earnings, risk and management soundness of the firm. CAMEL rating system is one of the great systems to compare the financial performance of the banks. Generally CAMEL rating system is a quantitative technique and widely used in various countries. Country's economic development is affected by the amount of banking industry growth in that country (Mortaza et, al.,) This study was conducted the aim of the compare the financial performance of the foreign sector commercial banks with the use of CAMEL rating system in Sri Lanka during post war period. According to the findings it can be stated that foreign sector banks are better in the performance of capital adequacy and earnings than the other variables.

5.1 RECOMMENDATIONS

a) According to the assets quality foreign sector should take necessary steps to recover the loans and advances from the customers and from others. It is one of the risks for the banks. Because of that such banks must go for better decision when they will go to give loan and advances in the future.

b) Standard Chartered bank needs to increase the total income of the bank through effective investment ideas and keep well proportion of fund on the banking activities such as loan, pawning and other investments. This bank should try to reduce its operating cost through avoid over staffs, unnecessary promotion and advertisement activities.

c) To stipulate the liquidity position HSBC and Citibank would try to increase in the source of current assets through well recovery of the loan and advances and avoid the invests in the non-current assets and try to reduce current liabilities through avoid short term borrowings.

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