

Regulating Banking Business in the Eastern Caribbean Currency Union *CAMEL And The Business Of Bank Supervision*

The Eastern Caribbean Central Bank (ECCB) Agreement Act 1983, which established the ECCB, gave the Bank the authority to supervise and regulate banking business on behalf of and in collaboration with the eight member governments of the Eastern Caribbean Currency Union.

As regulator, the ECCB's role is to preserve the safety and soundness of the banking system. In carrying out this role, the ECCB monitors and evaluates the risk sensitivity and risk management profiles of banks and other financial institutions engaged in banking business. The ECCB also monitors and evaluates the performance of these institutions by using the **CAMEL** approach which assesses banks in five principal areas namely; **C**apital Adequacy, **A**sset Quality, **M**anagement Soundness, **E**arnings and **L**iquidity. Let us briefly examine these areas:

- i. **Capital Adequacy.** Financial institutions engaged in banking business are required by law to hold a certain amount of capital, which should serve as a buffer against losses.

- ii. **Asset Quality.** – The solvency risk of a financial institution often originates from the quality of its asset portfolio. An indication of asset quality is the ratio of non-performing credits (*loans and advances which are delinquent*) to total credits. In the ECCU, the ECCB stipulates an upper limit that this ratio should not exceed.

This stipulation is one of the measures designed to limit the risks associated with credit extensions in order to minimise the possibility of banks incurring substantial losses arising from default. Defaults jeopardise the safety of the funds placed by depositors and investors. While the rule allows for banks and other institutions engaged in banking business to absorb some losses, a high level of diligence on the part of their administrators is required in monitoring the institution's exposure to bad debts, and in their assessment of the level of credit risk posed by each potential borrower prior to extending credit.

- iii. **Management Soundness** – Sound management is one of the most important pre-requisites for the strength and growth of any financial institution. The availability of sound procedures to limit and respond to the institution’s exposure to risk, proper internal controls and audit systems as well as competent staff and management are among the key indicators of management quality.

- iv. **Earnings** – A financial institution, which has consistently demonstrated strong earnings and profitability, provides a good indication of its ability to support present and future operations. Furthermore, its earnings and profitability determine its capacity to absorb losses, finance its expansion and pay adequate dividends to shareholders. In the financial industry, the most widely used indicator of earnings and profitability is the Return on Assets (ROA).

- v. **Liquidity** – Banks in their normal course of business must hold a portion of their assets in liquid form in order to meet the withdrawal demands of their customers. Tight (low) liquidity is usually an indicator of poor funds management. Presently all institutions licensed to engage in banking business in the Eastern Caribbean Currency Union are subject to a statutory liquidity requirement.

The ECCB conducts inspections to ensure that banks and other financial institutions engaged in banking business adhere to these requirements. Application of CAMEL ratings allows the ECCB to examine the financial soundness of these institutions. A financial institution in receipt of a less than satisfactory CAMEL rating is closely monitored by the ECCB. The ECCB may then enter into a Letter of Commitment or a Memorandum of Understanding with the institution, specifying targets that need to be achieved over a period of time in order to improve its financial soundness.