

**A Review on CAMELS+(S): (S) Shariah Rating
For- Islamic Banks****Dr. Priya Rao**

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Abstract:

In the globalized economic scenario for economic development of an economy, the role and importance, of judicious banking system cannot be underestimated. The performance of banking sector is considered, as an effective measure to examine the financial health of an economy. With the swift and vibrant changes in the globalization of the economy, the world tends to see the growth of Islamic banks especially in the Middle East region. Muslim customers establish relationships with Islamic banks because they trust that Islamic banks are Shariah compliant.

CAMELS rating is widely used for evaluating performance of financial institutions, especially to banks. CAMELS is an early warning system for the financial institutions. This paper is an attempt to put forth the importance of one more "S"- Shariah Rating: in the CAMELS for the Islamic banks .

Paper Type: Article**Key Terms:** CAMELS Rating, Shariah law, Islamic Bank, Islamic Finance**Introduction**

Banking sector which is an important component of financial system is considered as the lifeline of an economy and its people. Banking has facilitated in developing the crucial sectors of the economy and usher in a new dawn of progress on the Indian horizon. The banking sector has translated the hopes and aspirations of millions of people into reality by providing loans and advances. The role and importance of banking and the monetary mechanism cannot be underestimated in the economic development of a nation. Hence the banks and financial institutions play significant and crucial role by contributing in economic planning such as laying down of specific goals and allocating particular amount of resources that constitute the economic policy of the government. Assessment of financial performance of the banking sector is an efficient measure and indicator to judge the strength of financial system of an economy. The banking sector's performance is acknowledged as the carbon copy of economic activities performed in an economy.

In 1979, the bank regulatory agencies created the Uniform Financial Institutions Rating System (U.F.I.R.S). Under the original UFIRS a bank was assigned ratings based on performance in five areas: the adequacy of (C) Capital, the quality of (A) Assets, the capability of (M) Management, the quality and level of (E) Earnings and the adequacy of (L) Liquidity.

Bank supervisors assigned a 1 through 5 rating for each of these components and a composite rating for the bank. This 1 through 5 composite rating was known primarily by the acronym CAMEL. A bank that received a CAMEL of 1 was considered sound in every respect and generally had component ratings of 1 or 2 while a bank with a CAMEL of 5 exhibited unsafe and unsound practices or conditions, critically deficient performance and was of the greatest supervisory concern.

The UFIRS was revised at year-end 1996 and CAMEL became CAMELS with the addition of a component grade for the Sensitivity of the bank to market risk (that is, the degree to which changes in market prices such as interest rates adversely affect a financial institution).

Shariah Law

Shariah law is the legislative framework that regulates all aspects of life both private and public and accordingly Islamic finance means that all financial transactions are conducted in accordance with the *Shariah* law. The advancement of Islamic finance has gone through three phases: a) the fledging years (1975-1991); the globalization era (1991-2001) and post September 11, 2001. The Islamic banking and finance discipline is nearly four decades old. The conceptual developments of Islamic banking took cognizance in late 1940s. The growth of Islamic finance has been accelerating ever since, in terms of the number of countries in which it operates. In recent years, the industry has attracted a number of Western multinational financial institutions.

Islamic finance is fundamentally different from the conventional banking models as it is based on a profit and loss structure and the prohibition of *riba'* (interest). This structure requires that the financial institution invest with the client in order to finance the client's transaction rather than lend money to the client.

Due to the inherent risk involved in any investment, the financial institution is entitled to profit from the financial transaction. This is a stark contrast to modern finance in which interest is one of the key methods by which banks make money through their products, such as mortgages and personal loans. Despite its differences to its western counterparts, Islamic banking has the same purpose as conventional banking except that it operates in accordance with the rules of *shariah*, known as *fiqh al-muamalat* (Islamic rules on transactions). Unlike ordinary commercial banks whose operations are based on interest, Islamic banks operate an interest-free system and are guided by the common principle that depositors, instead of receiving a fixed return in the form of interest, share the risk of investment and take part of the resulting profits or bear part of the losses.

The Islamic banking industry has grown rapidly in recent years and has become an important part of the financial system in many countries. Islamic banking is projected to continue to grow faster than conventional banking for the foreseeable future given its low base, low level of penetration, substantial market potential, and the strong demand in many Islamic countries for Shariah-compliant products.

Islamic banking and Islamic finance are distinct and separate from conventional banking and finance. ***They are based on compliance with the legal framework referred to as Shariah Law.***

Islamic banks and Islamic banking are largely merchant and investment banking oriented, as they typically relate to or involve the real economy, especially trade and investment.

Shariah Law imposes a set of ethics that militates against exploitation, and prohibits involvement in activities that are considered morally distasteful, such as drugs, alcohol, prostitution, and games of chance. The use of instruments based on interest is forbidden. Furthermore, pure financing such as derivative transactions and hedging instruments is not permitted, which can benefit financial stability and constrain leverage. Also, real economic activity is promoted through the requirement that only real assets should be financed and a return should be derived from exposure to (proprietary) risk taking, and not merely from financial risk taking.

Literature Review:

Much of the research work has been carried on CAMELS rating system but the limited work is available, when the same is added with the Shari'ah Law Compliance or Shariah rating

Goldstein (1998) and Corsetti, Pesenti, and Roubini (1999) proclaimed that the pre-crisis was due to weak regulations and lack of supervision by respective authorities, ratios were in low capital adequacy, deposit insurance schemes were lacking in terms of incentive-compatible, there were insufficient expertise and authorities in regulatory institutions, outright corrupt lending practices and inefficient credit allocation to the non-market criteria. All of these criteria were the beginning of the creation of growing numbers of non-performing loans which had led to the 1997 financial crisis.

On contrary, Islamic banks are less risky and more stable compared to conventional banks because the former prohibits the involvement of interest rate pertaining to monetary transactions. Previous case study by **Ali (2007)**, during the 2001-2002, one Islamic bank named IhlasFinans House had collapsed due to the financial crisis in the banking sector in Turkey. Based on the study, **Ali (2007)**

found that the collapse of Ihlafinans House were due to several causes and reasons such as the license of the bank had been cancelled by the regulatory authorities because the bank was unable to keep its promises and obligations towards their respective customers. Furthermore,

the bank experienced a form of weak internal management, imprudent financing or fraud behavior within the group and last but not least management had poor strategy in handling the crisis.

Wirnkar&Tanko(2008)Bank's performance or rather solvency or insolvency has been given much attention both at the local and international level. Financial ratios are often used to measure the overall financial soundness of a bank and the quality of its management

Kunt and Huizinga (2000)andChazi and Syed (2010) found thatfinancial ratios (profitability and liquidity) are the most common used ratios in evaluating the efficiency of performance in banks.

According to **Gonzalez (2009)**, the determinants of the efficiency of banks are importantbecause the market structure of banks is not only competitive for the banking system but also companies' access to fund their investment and the result conveyed that efficient banks have more access into the capital market and thus have a large market concentration by the potential investors.

Sahut&Mili, 2011; Bongini, Claessens, &Ferri, 2001 found that CAMEL ratings system also has been used widely to predict failures and closures of banking institutions.

Reza Djojogugito (2008) Islamic banks face risks stemming from legal structure chosen due to the differences between principles of Shariah and law. While compliance to Shariah is paramount for Islamic banks, the law governing Islamic banking transactions may not necessarily give any consideration to Shariah.

Sufian and Noor (2009) stated that initially, Islamic banks were developed to cater the needs of Muslims but nowadays the number of Islamic financial institutions have raised to over 300 in more than 75 countries including western countries (Europe and USA) where the biggest hubs are located in Bahrain and Malaysia .

The Shariah Board has become the most important component of the Shariah governance system in Islamic finance that has a deep influence on the day-to-day practice of Islamic finance in Financial System.**(Hassan, 2010)**.

Actually CAMELS rating is a common phenomenon for all banking system all over the world. It is used in all over the country in the world. It is mainly used to measure a ranking position of a bank on the basis of few criteria **(Datta, 2012)**.

Muslim Amin,Zaidi Isa and Rodrigue Fontaine (2013) concluded that Muslim customers establish relationships with Islamic banks because they trust that Islamic banks are Shariah compliant. Therefore, providing secure banking products that are fully compliant with Islamic principles are necessary.

Shariah Rating- Shariah Supervisory Board

Islamic financial institutions that offer products and services conforming to Islamic principles must, therefore, be governed by a religious board that act as an independent Shari'ah Supervisory Board comprising of at least three Shari'ah scholars with specialised knowledge of the Islamic laws for transacting, fiqh al mu`amalat, in addition to knowledge of modern business, finance and economics.

As for Shari'ah Compliance , it is utmost required that all Islamic banks comply with the Shari'ah requirements and regulations. This is because Shari'ah principles act as fundamentals to the Islamic banks as to show that all Islamic financial products and services are in accordance with the Holy Quran and as-Sunnah.

Top Ten Countries with Largest Muslim Population (2015)

Rank	Country	Population
1.	Indonesia	209,120,000
2.	Pakistan	176,190,000
3.	India	167,410,000
4.	Bangladesh	133,540,000
5.	Egypt	77,300,000
6.	Nigeria	76,990,000
7.	Iran	73,570,000
8.	Turkey	71,330,000
9.	Algeria	34,730,000
10.	Morocco	31,940,000

Source: <http://www.mapsofworld.com/world-top-ten/world-top-ten-countries-with-largest-muslim-populations-map.html>

Looking at the growth of Muslim population all over the world, it's quite a high time to realize the importance of Shariah Rating (S) with CAMELS rating system in Islamic Banks or the banks with Islamic window.

The role of Shari'ah Supervisory Board members is to review the banking operations, supervise its development of Islamic insurance products, and determine the Shari'ah compliance of these products and the investments. The Shari'ah Supervisory Board have to carry their own independent audit and certify that nothing relating to any of the operations involve any element that is prohibited by Shari'ah.

Islamic financial institutions must adhere to the best practices of corporate governance however they have one extra layer of supervision in the form of religious boards. The religious boards have both supervisory and consultative functions. Since the Shari'h scholars on the religious boards carry great responsibility, it is important that only high calibre scholars are appointed to the religious boards. An Islamic financial institution is required to establish operating procedures to ensure that no form of investment or business activity is undertaken that has not been approved in advance by the religious board. The management is also required to periodically report and certify to the religious board that the actual investments and business activities undertaken by the institution conform to forms previously approved by the religious board. They are responsible primarily to give approval that banking and other financial products and services offered comply with the Shari'ah and subsequent verification that of the operations and activities of the financial institutions have complied with the Shari'ah principles (a form of post Shari'ah audit). The Shari'ah Supervisory Board is required to issue independently a certificate of Shari'ah compliance.

The day-to-day application of Shari'ah by the Shari'ah Supervisory Boards is two-fold. First, in the increasingly complex and sophisticated world of modern finance they endeavours to answer the question on whether or not proposals for new transactions or products conform to the Shari'ah. Second, they act to a large extent in an investigatory role in reviewing the operations of the financial institution to ensure that they comply with the Shari'ah. The concept of collective decision-making, in other words, decisions made by more than one scholar, is especially important. Shari'ah Supervisory Boards function is to ensure that decisions are not unilateral, and that difficult issues of finance receive adequate consideration by a number of qualified people.

Shaikh Yusuf TalalDeLorenzo, Islamic scholar, strongly recommends that unless a financial product or service is certified as Shari'ah compliant by a competent Shari'ah supervisory board, that product's authenticity is dubious. At that point, it will be the responsibility of the individual investor or

consumer to determine on his or her own that the product complies with the principles and precepts of the Shari'ah.

Conclusion

Banking crisis are destructive for the economy and unfavorable to the health of financial sector. The real cost of a banking crisis is the deadweight loss and the consequent diversion in macroeconomic policy forced by the crisis. There is the resilient need for an efficient Shariah supervisory system for promoting the stability of the Islamic financial sector. With this aspiration, corporate governance in banks has to set institutional arrangements to supervise the Shariah-compliant aspects of their activities. One of the most powerful institutional arrangements is known as the Shariah Board which plays a crucial role in all Shariah aspects of the banks: supervision, monitoring, auditing and issuing rules and fatwa.

For the *Shari'ah* compliance, the Shariah rating should be assessed. This CAMELS+S rating is essential to assess overall soundness of the Islamic banks, and identify and/or predict different risk factors that may contribute to turn the banks into a problem or failed banks. Specially for the **Islamic banks it is highly recommended to go for CAMELSS that is CAMELS+S i.e (S) "Shari'ah Rating"**.

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