CHAPTER THREE

RESEARCH METHODOLOGY

This chapter discusses the methodology employed to carry out the research. The research methodology consists of the CAMEL rating framework to evaluate the relative performance of commercial banks, finance companies and merchant banks, data collection and techniques of data analysis. The CAMEL rating framework was formulated based on an extensive literature so as to arrive at a common understanding of the theories used by practitioners and researchers. Secondary data was gathered from the BNM's - Monthly, Quarterly, and Annually reports for the period 1990 to 1998. Supplementary data from the BNM Web-site was also used. The analysis and discussion presented in the subsequent chapters are based on the data and information collected.

3.1   Capital Adequacy Indicator

The risk-weighted capital ratio (RWCR) is the indicator for the capital adequacy analysis. To compute the RWCR, the capital base of banking institutions is divided by assets weighted against the relevant risk weights. The risk weights are assigned based on the risk of default of the counter-party. The maturity structure and the importance of collateral in influencing the risk of loss are also taken into account in certain circumstances.

There are five broad risk weights categories, that is, 0 per cent, 10 per cent, 20 per cent, 50 per cent and 100 per cent. For each category of asset held, a risk weight is ascribed to reflect the inherent risk of loss. The different

types of assets have different risks of non-payment and are ranked accordingly. For example, if a bank invests all its deposits in cash or places them with the BNM, the risk will be 0 per cent. If it lends to a statutory body, the loan is subjected to a 20 per cent weighting, in the case of a housing loan it is 50 per cent. However, if it is a claim from an enterprise operating on a commercial basis, the risk is at 100 per cent.

3.2   Asset Quality Indicator

The non-performing loan (NPL) is the indicator for the asset quality analysis. The level of NPLs is a key indicator of the magnitude of a bank's difficulties. A bank fails because of bad loans, so the most basic trend to watch is the rising NPLs. A loan is classified as non-performing when the principal or interest is due and unpaid for six months or more from the first day of default.

3.3   Management Competency Indicator

The operating efficiency is the indicator for the management competency analysis based on the staff cost plus overheads to total assets. The operating efficiency is also a key determinant of bank profitability.

3.4   Earnings Performance Indicator

The return-on-asset (ROA) is the indicator for the earnings performance analysis. The ROA is defined as net income to total assets. This ratio is a good measure of the overall profitability and managerial efficiency. By relating profit to assets rather than shareholders' funds, the ROA shows the effectiveness of operations and capital deployment. A high ROA indicates an ability to utilize resources well and control operating costs. Genay (1998) found that there is a positive relationship between profitability and operating

efficiency. The ROA reflects how well an institution performs relative to its size. This ratio also provides a measure for the comparison between institutions.

3.5   Liquidity Position Indicator

The liquidity ratio is the indicator for the liquidity position analysis. The ratio is expressed as a percentage of eligible liabilities of banking institutions. The eligible liabilities base comprises all deposits including negotiable certificates of deposit and repurchase agreements and net interbank borrowings.