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A CAMEL Model Analysis of Laxmi Vilas Bank: Causes of Failure and Lessons for the Indian Banking Sector

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ABSTRACT:

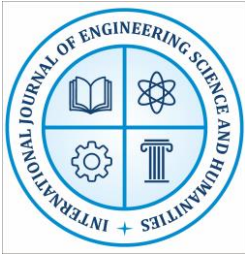
The banking sector forms the backbone of the Indian financial system and plays a vital role in ensuring economic stability. However, in recent decades, the Indian banking industry has faced several crises, with institutions like IL&FS, DHFL, PMC Bank, Yes Bank and Laxmi Vilas Bank (LVB) collapsing due to mounting non-performing assets (NPAs), liquidity shortages and poor governance practices. This paper analyzes the downfall of LVB using the CAMEL model framework (Capital Adequacy, Asset Quality, Management Efficiency, Earnings, Liquidity). The study highlights that weak asset quality, liquidity crunch, erosion of net worth, governance failures and risky lending strategies to large corporates were the primary causes of the bank's collapse. The findings emphasize the importance of sound governance, strict NPA monitoring and timely regulatory intervention in preventing bank failures. The merger of LVB with DBS Bank India in 2020 marked the first merger of an Indian private sector bank with a foreign bank, signaling a historic shift in India's banking landscape.

KEYWORDS: Banking Sector, CAMEL Model, Laxmi Vilas Bank, RBI, NPAs, Liquidity Crisis, Corporate Governance, Bank Mergers.

INTRODUCTION

The banking sector is the core sector of the Indian financial system and it is the most significant pillar since it serves to the financial requirements of all segments of society. As a result, an efficient and solid financial system serves as the foundation for a robust economy. In India, the Reserve Bank of India (RBI) has the authority to examine the health of banks on a regular basis. However, the banking industry has been in a crisis phase in recent years, particularly with the failures of The Infrastructure Leasing and Financial Services Limited (IL&FS), The Diwan Housing Finance Corporation (DHFL), The Punjab and Maharashtra Cooperative Bank (PMC) and Yes Bank. When one of these banks fails, it sets off a chain reaction that results in liquidity shortages and defaults. The failure of these institutions raises questions about the overall security and safety of the financial system.

To keep banks from failing, the RBI is reviving weak and inefficient banks in India through mergers and acquisitions. The Reserve Bank of India (RBI) has merged a greater number of weak public sector banks (PSBs) with stronger ones without thoroughly investigating the ground facts (Krishnamurthy, 2017). In 1993, the problem-plagued The New Bank of India was absorbed by



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one of the profitable PSBs, Punjab National Bank. Global Trust Bank and Oriental Bank of Commerce merged in 2004 and now Oriental Bank of Commerce and United Bank of India have merged with The Punjab National Bank. Similar to the United Western Bank, debt-ridden private banks followed the same pattern and the United Western Bank was bought and merged with IDBI Bank in 2006 and the Vijay and Dena banks were merged into Bank of Baroda in 2009.

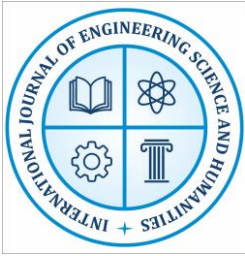
In India it has become a ritual to merge weak and inefficient public sector banks with stronger ones to manage the problem of bad loans. On April 1, 2020, the RBI consolidated six banks into four major banks. The Andhra Bank, Corporation Bank, Oriental Bank of Commerce, United Bank of India, Syndicate Bank and Allahabad Bank were merged into Canara Bank. Punjab National Bank, Union Bank and Indian Bank. The Andhra and Corporation Bank were merged into Union Bank, Oriental Bank of Commerce and United Bank of India merged with Punjab National Bank, Syndicate Bank merged with Canara Bank and Allahabad Bank merged with Indian Bank. In India, there are now 12 nationalized banks in operation. The collapse of banks in India is not confined to nationalized banks as it equally affected the so-called efficient and market-oriented private sector banks such as YES bank and LVB.

The collapse of Laxmi Vilas Bank (LVB)

The LVB is a Chennai-based Private Sector Bank with a market value of 257.59 crore with 569 branches, including seven Commercial Bank branches and one satellite bank. In 1926, VSN Ramalingan Chettiar and seven other enterprises established this bank to meet the financial demands of Karur's businessmen. On June 19, 1958, the firm was founded as a bank and on August 11, 1958, it was upgraded to the status of a scheduled commercial bank. By 1974, this bank had expanded its services into many Indian States and in 1976, it became an authorized currency broker. The bank took advantage of this chance to expand its business into the retail, mid-market and wholesale industries.

The LVB crisis began in 2016-17, when the bank changed its lending approach to major corporate houses rather than small enterprises, resulting in a Rs 720 crore bad debt owned by Malvinder and Shivendar Singh, the owners of Ranbaxy and Fortis health care. As a result of this incident, the RBI placed LVB bank under urgent corrective action in September 2019, limiting the bank's capacity to make new loans and operate new branches. All shareholders were dissatisfied with the increase in bad loans and voted against MD and CEO Shyam Sundar at the bank's 93rd annual meeting on November 17, 2020 and T. N. Manoharan was appointed as administrator to protect depositors' interests, the RBI imposed a moratorium under Section 45 Sub Sec (2) and the bank was not permitted to make payments to creditors in excess of \$25,000 per unsecured creditor.

The LVB Bank's financial position has deteriorated noticeably as a result of repeated losses, falling from 585 crore in 2017-18 to 836.04 crore in 2019-20. A reported loss of 397cr in the September quarter of FY 2021 exacerbated the situation. The increasing value of banks' gross NPAs over the



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previous three years was 10%, 15% and 25% in 2018, 2019 and 2020, respectively, indicating decreasing asset quality and therefore lowering bank profitability. The bank's Capital Adequacy Ratio was 1.12 percent in March 2020, compared to the statutory ceiling of 9 percent, indicating that it was undercapitalized to withstand unexpected losses.

The RBI created a proposal to merge LVB with Development Bank of India Ltd. (DBIL), a subsidiary of Development Bank of Singapore, after assessing the bank's financial position (DBS). The merger will encompass both actual and intangible assets, enterprises, estates, rights and titles, among other things. The DBS was chosen to revive Laxmi Bank because it has a solid balance sheet and this would alleviate the problem of liquidity constraints in LVB bank since Rs. 2500 crore will be invested into the bank. This is the first time an Indian bank has merged with a foreign bank in the banking history.

This paper crafted a comprehensive fiasco of Laxmi Vilas Bank along with its reasons for the deteriorating financial performance.

REVIEW OF LITERATURE:

Banking failures are not unique to the Indian banking system. India witnessed bank failures even after the nationalization of banks in 1960, when extensive control was in government hands. The literature of this study emphasized studies related to banking failures and their mergers across the globe. Mergers reduce the overall risk in the banking system, but evidence suggests that greater merger activities increase the higher rate of bank failures (Paroush, 1995). Banks assessed the various parameters relevant for the management of credit risk in a bank and its impact on the bank's financial position. The study revealed that among all the identified parameters, default risk is the most pertinent factor affecting the financial position of the bank. (Musyoki & Kadubo, 2012). The wave of mergers is not only limited to the Indian financial system but to the Asian countries, particularly Malaysia, followed by the Asian financial crisis in 1997. The merger was done to make the banking system more resilient and robust, but this goal cannot be achieved solely through a merger (Shanmugam & Nair, 2004). Cheshti & Khan (2019) analysed the impact of the global financial crisis on the efficiency of public sector banks in India using DEA analysis. The results concluded that the Indian public sector banks were resilient to the shocks and the efficiency of banks remained unaffected before and after the crisis period due to reforms initiated in the economy. In the context of Indian banking, a similar kind of failure happened with YES Bank and it was discovered that poor performance of the stock of Yes Bank, adverse asset quality, increased withdrawals, losses to investors and losses from operating activities were the financial factors that led to the downfall of Yes Bank. The RBI revival plan for Yes Bank proved to have a positive impact on investors and thus share prices rose up to 40.4 on 16.3.2020. (Kaur & Topno, 2020). Ballooning NPA and poor governance practice were the main reasons behind the failure of the banks and it adversely impacted the stakeholders of YES Bank. (Sarkar, 2020). Punjab and



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Maharashtra Bank (PMC) were in the same boat and underreported their lending operations, financial irregularities and a failure of their internal control system were the major loopholes that landed PMC in the category of failed bank (Singhal and Chauhan, 2002). The importance of corporate governance in the financial sector was highlighted and explained that a series of mistakes by the top level management in Laxmi Vilas Bank led to a high level of NPA in the bank and continuous losses from 2019. (Ganapathy et al., 2020).

OBJECTIVES OF STUDY:

- To analyze the financial performance of Laxmi Vilas Bank using CAMEL Model.
- To find out the reasons that led to the downfall of Laxmi Vilas Bank.

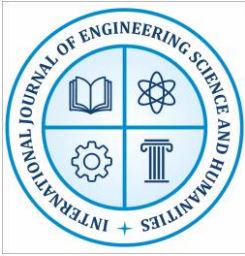
RESEARCH METHODOLOGY:

The study is based on secondary data primarily culled out from annual reports of LVB and some other vital figures from the financial website, i.e., money control. To scrutinize the financial performance of the bank, CAMEL model has been used and further data has been analyzed with help of graphs. The study has been carried out for a period of 5 years from 2015-2020.

CAMEL Model

The “Uniform Financial Institution Rating System” (UFIRS) established a methodology, namely the CAMEL model, in 1979 to assess bank's financial soundness. These characteristics are used to assess banks and financial institutions on a scale of 1 to 5, with 1 being the best and 5 being the worst. In 1996, a new component, "Sensitivity to Market Risk", was introduced to the grading system, giving rise to the CAMELS model. Indian banks were evaluated on the basis of the CAMELS component, whereas international banks were ranked on capital adequacy, liquidity, asset quality, compliance, systems and controls (in which liquidity was later added to the list). A-E composite ranks represent the soundness and strength of banks in descending order, as stated in the High Level Steering Committee Report on the Review of Supervisory Processes for Commercial Banks, 1995.

Capital adequacy is an indicator of bank financial performance. It checks whether the banks have an adequate amount of capital or not to meet the unexpected losses and is calculated using different ratios like the Capital Adequacy Ratio, the Debt to Equity Ratio and the Government Securities to Total Investments Ratio. Asset Quality is an indicator to gauge the financial strength and earnings of a bank by taking into the account the loan quality of the bank. It is calculated using following ratios: Net NPAs to Net Advances, Net NPA to total assets, Total investment to total assets ratio, percentage change in NPA. Managerial Efficiency makes sure that the banks must adhere to the prescribed norms and takes crucial decisions on the management quality of banks. Total Advances to Total Deposit Ratio, Profit per Employee, Business per Employee and Return on net worth are some of the indicators used to measure the managerial efficiency of a bank. Earning Quality reflect the bank's ability to earn profits, which further impacts the growth of the business. Operating profit



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to total assets, spread or Net Interest Margin (NIM) to total assets and interest income to total income are some of the key indicators of the earning capacity of banks. Liquidity is an indispensable component as it takes into account the bank's ability to meet its financial obligations. High cash ratio implies that the bank is affluent and is able to meet the depositor's demand for cash. Liquidity can be expressed as a ratio of liquid assets to total assets or a ratio of liquid assets to total deposits. Sensitivity to market risk is a risk associated with changes in market conditions, such as fluctuations in interest rates, foreign exchange rates and equity prices, which have an impact on bank earnings. It is measured by the price earnings ratio and total securities to total asset ratio.

Analysis of Financial Performance of Laxmi Vilas Bank

The performance of the LVB was analyzed using the CAMELS model and the data for this was gathered from the annual report of the Laxmi Vilas bank. Each component got a rating from 1 to 5 on the basis of the criterion mentioned in table 2.

COMPONENT RATING ANALYSIS:

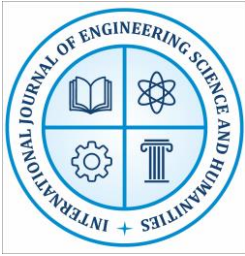
The individual rates attributed to the various components indicate the LVB's health and soundness, as discussed below.

Capital adequacy, as assessed by the Capital Adequacy Ratio (CAR), indicates how much capital a bank must maintain as a percentage of its hazardous assets. The Reserve Bank of India has set a minimum capital requirement of 9%, which banks must adhere to in order to remain capital sound. The LVB was able to maintain this ratio till 2017-18 and after that there was a dip in value from 7.72 in 2018-19 to 1.12 in 2019-20. This sudden plunge in the value clearly reflects the incompliance with the RBI norms and the deteriorating health of the bank. On the basis of the ratio, the component rating falls from 3 to 5.

Asset quality (A) is a matter of concern for banks as it directly affects the profitability of banks by way of higher provisions for non-performing assets. Asset Quality is calculated on the basis of the Net NPA to Net Advances ratio and the higher the ratio, the lower the asset quality. A whopping increase in asset quality from 1 in 2015-16 to 10.04 in 2019-20 shows the deteriorating asset quality of the bank. Rating 1 implies that banks are efficient in managing their bad loans, while rating 5 means that the ratio of problem assets has increased and immediate action is required to be taken by the regulatory authorities.

Total Advances to Total Deposits is a ratio that indicates how well a bank's management (M) is performing. The better the bank's management, higher the ratio. The dwindling ratio, reflected by a rating of 5, shows the bank's weaknesses in the area of management and the urgent need to revise the board members in order to protect the bank from being solvent.

Earnings (E) are depicted by the Return on Asset (ROA) and Return on Equity (ROE) of the banks. The higher the value, better the performance of banks. However, in the case of Laxmi Vilas



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Bank, both metrics were not only dropping but also turning negative during the research period, with a Return on Assets of 1.57 in 2017-18 and a Return on Equity of 46.35. Deteriorating ratings from 3 to 5 depict the same picture of banks' declining earning capacity.

Liquidity (L) as assessed by the Total Investment to Total Deposit ratio indicates a mixed trend, but the bank's performance was fairly decent, thus the rating 1 during the period of the study.

The bank's **sensitivity to market risk (S)** was rated 1 based on the total securities to total asset ratio, indicating a better responsiveness to market risk.

COMPOSITE RATING ANALYSIS:

On the basis of the component ratings mentioned in table 2, the composite rating of the bank has been calculated by the weighted average of all the component ratings. Assigning weights to the different components of the model is a subjective approach which varies across different institutions. The Report of the RBI on the "High Level Steering Committee for Review of Supervisory Processes for Commercial Banks" mentioned the following rates which have been used in the study.

Based on the composite range listed in the table above, Laxmi Vilas Bank was graded as Fair in 2015-16 and 2016-17. In 2017-18, it was demoted to the Marginal Category, indicating that the bank is not financially sound and requires prompt supervision and close monitoring by financial authorities. As a result, the RBI took immediate corrective action in 2019 and Laxmi Vilas Bank will be placed in the Unsatisfactory Category after 2019-20, suggesting that the bank is no longer viable and that the RBI will take control of administration. Laxmi Vilas Bank was merged into the Development Bank of India Ltd as a result (DBIL).

The above data clearly shows that the Laxmi Vilas Bank's condition has been steadily deteriorating and that the financial year 2017-18 marked a turning point in the bank's operations, as their performance deteriorated thereafter and that, despite the clear picture painted by the financial statements of banks, no concrete action was taken by RBI at the appropriate time to protect these banks.

FINDINGS OF THE STUDY:

Following the CAMELS model's assessment, the following reasons for the LVB's failure were identified, as detailed below.

- 1. Rising NPA:** The rise of nonperforming assets (NPA) poses a serious threat to the banking industry as a whole. For the previous three years, LVB's gross NPA has been steadily increasing, rising from 17.3 percent in June 2019 to 25.4 percent in June 2020 as mentioned in **Figure 1**. It is also expected that NPA will increase further as a result of the country's pandemic situation, which has had a negative impact on customers' income. A quarter of all bank advances ended up as problematic loans.



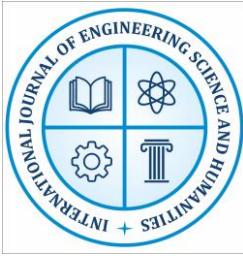
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2. **Liquidity crunch** – LVB has been coping with a liquidity issue, as evidenced by the fact that the bank lacked sufficient capital to carry out its routine operations. Customers were also withdrawing their funds at a rapid rate (As shown in Figure 2), with deposits falling by 26.76 percent (from 29279.44 lakh in 2019 to 21443.19 lakh in 2020). In addition, withdrawals are bigger than deposits, which lead to liquidity crunches in the LVB.
3. **Eroding net worth** – a bank's net worth is the difference between its net assets and net liabilities. Bad asset quality was the reason for falling net worth. Also, LVB has been at a huge loss for the past 3 years. The net loss for the year, after provisions and taxes, was 836.04 crore, compared to 894.10 crore in the previous year, which contributed to the drop in their net worth.
4. **Governance issues-** To govern the operations of their banks, banks must adhere to a set of regulations and guidelines. This entails striking a balance between the interests of shareholders, top executives and customers. LVB was confronted with a number of governance challenges. For instance, shareholders were so disheartened by allegations of mismanagement, poor governance, an increase in bad loans and a drop in the value of bank shares that on September 25, 2020, they chose to dismiss 7 members of the top management, including S.Sundar, the bank's interim MD and CEO.
5. **Shift in Strategy-** The LVB got inspired by reputed and big private sector banks like Axis and ICICI banks to provide loans to big corporate houses. This shift in their strategy resulted in the distribution of loans of 2000 crore to borrowers like Religare Enterprises Limited, Jet Airways, Cox and Kings, Nirav Modi Group, Coffee Day, Reliance Housing Finance, etc., which resulted in the multiplication of bad loans.

RECOMMENDATIONS AND CONCLUSION:

The case of Laxmi Vilas Bank demonstrates how poor governance, high-risk lending and the neglect of asset quality can push a century-old institution into collapse. The CAMEL model analysis revealed severe weaknesses in capital adequacy, asset quality, managerial efficiency and earnings quality, despite relatively stable liquidity and market sensitivity indicators. LVB's failure was primarily driven by five factors: the steep rise in NPAs, liquidity crunch, erosion of net worth, governance lapses and an unsustainable shift in strategy toward lending to large corporates. The regulatory response of merging LVB with DBS Bank India was unprecedented and provided short-term relief by safeguarding depositors' interests. However, the case raises larger concerns about the effectiveness of RBI's supervisory mechanisms, since early warning signals were visible years before the collapse. The lessons from this study underscore the need for: Strengthened credit appraisal systems to avoid risky corporate lending. Stricter governance frameworks ensuring accountability of top management. Proactive regulatory oversight by RBI to prevent crises before they escalate. Balanced growth strategies where banks do not abandon their core customer base



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for short-term profit motives. In conclusion, while mergers and acquisitions may provide temporary solutions, they cannot replace the need for strong corporate governance, prudent risk management and regulatory vigilance. The LVB fiasco serves as a warning for India's banking sector to prioritize financial discipline and transparency to restore public trust in the system.

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