

## Rating Criteria for Banks and Financial Institutions

The objective of CRISIL's analysis is to form an opinion on the types of risks that may affect the relative ability of banks and financial institutions (FIs) to service the interest and principal payments on the rated instrument in a timely manner.

This exercise incorporates a review of the overall economy, the financial sector and the banking industry. CRISIL also analyses the changing regulatory environment and increased competition arising out of liberalisation. Over the past decade, the Indian economy has been liberalised and the financial sector, deregulated. Both the opening up of the economy and the gradual lowering of tariff barriers has exposed the corporate sector to risks of foreign competition. Some of these risks have manifested in certain sectors where the domestic industry has been rendered uncompetitive.

The financial sector is going through a phase of transformation and convergence, and there has been an increasing blurring of boundaries between the role of banks and financial institutions, which is likely to step up competitive pressures in future. This transformation is evident on both the assets and the liability side. On the asset side, banks are shifting from their historical business model of providing finance to corporates to aggressively focus on financing retail assets such as housing, automobiles and commercial vehicles. This is driven both by the weak demand from corporates as well as the paucity of clients with good credit quality. On the liability side, the transformation is from a passive retail strategy to a very active retail thrust to attract and retain customers and increase the deposit base. The entry of the newer private sector banks and the marketing strategy adopted by them has precipitated this transformation.

Apart from this transformation, banks are also going through a phase of convergence wherein almost all banks are offering the entire gamut of products and services on the asset and liability side to both retail as well as wholesale customers. Hitherto, retail assets were primarily the domain of non-banking finance companies and most banks did not actively offer the full range of products to their customers even though they had the required distribution infrastructure and retail client base.

This transformation, dismantling of the consortium lending system and the deregulation in interest rates have further presented associated challenges of managing credit risks and asset liability profiles. The move to enhance the mark to market principle in the banking system in a scenario of volatile interest rates has introduced instability in the earnings of the banking system. CRISIL monitors all these trends closely and analyses their impact on entities in the financial sector.

An entity-specific analysis of the risk profile is done through a qualitative cum quantitative approach following a structured methodology called the 'CRAMEL' model. Based on the rating criteria, the relative strengths and weaknesses of each entity in comparison to its peer group are evaluated. Apart from the CRAMEL model, CRISIL also evaluates the market position of the bank/FI being rated and its strategy in the emerging competitive scenario.

## ■ Market position

CRISIL factors in the size of an entity in the financial sector and looks at its positioning in the industry. A larger size enables the entity to withstand systemic shocks and determines the extent of system support that can be expected for the entity. Diversity in product portfolio, business lines and customer base are also positively factored in by CRISIL.

The ‘CRAMEL’ model comprises the following:

- Capital adequacy
- Resource-raising ability
- Asset quality
- Management and systems evaluation
- Earnings potential
- Liquidity/Asset liability management

No one factor has an overriding importance or is considered in isolation and all the six factors are viewed in conjunction before assigning a rating.

## ■ Capital adequacy

An entity’s capital provides it with the necessary cushion to withstand credit risks and other risks in its business. While assigning a rating, CRISIL analyses the capital adequacy level and its sustainability in the medium to long term. This assessment is significantly influenced by the perception of relative profitability, the entity’s risk profile and its asset quality. The analysis encompasses the following factors:

### ***Size of capital***

The absolute size of capital imparts flexibility to a bank/FI to withstand shocks and thus, an entity with higher absolute capital is viewed favourably.

### ***Quality of capital (Tier I capital)***

The proportion of Tier-I capital or core capital is the primary indicator of the quality of a bank or FI’s capital. The level of Tier-I capital is given primary importance when assigning a rating on the capital adequacy parameter. Although the presence of Tier II capital does provide some cushion in the short to medium term, such capital needs to be periodically replenished.

CRISIL also analyses other issues, like the presence of hidden reserves and the percentage of the investment portfolio that is marked to market. These issues help in streamlining accounting policy differentials across various entities and have a bearing on the capital’s quality.

### ***Sustainability of capital ratios and flexibility to raise Tier I capital***

An entity has the flexibility to raise Tier I capital either through internal accruals or through the capital markets. The rated entity’s ability to access the capital markets to meet its Tier I capital needs and its ability to service the increased capital base is considered while evaluating its flexibility to raise such capital. A bank or FI’s ability to support the increased asset base through earnings is an important parameter in assessing the sustainability of its capital adequacy. An entity that is able to sustain asset growth through internal generation without impairing capital adequacy is viewed favourably.

### ***Growth plans***

CRISIL factors the rated bank or FI’s future growth plans while analyzing its capital adequacy. Its capital adequacy (even if it is at high levels currently) would be regarded as unsustainable if the entity pursues a high-growth strategy.

## ■ Resource-raising ability

CRISIL analyses the resources position of the bank/FI in terms of its ability to maintain a low-cost, stable resource base. In the domestic context, the resource composition of banks and FIs is very different. Banks are significantly deposit-funded whereas FIs have to depend on wholesale funds. Although some FIs do raise retail funds, compared to the banking sector, they are at a natural disadvantage while raising retail deposits in terms of the restrictions on the minimum tenure and interest rates, the absence of a cheque-issuing facility and a relatively smaller branch network. In general, the dependence on wholesale funding attaches a degree of risk to the funding profile of FIs. These risks (especially stability of resources) are partly mitigated by the access that the All India Financial Institutions (AIFIs) have to resources from provident funds and the insurance sectors. Such resources have a retail origin.

Given this basic distinction in their funding profiles, the funding risk profile of banks and FIs too are evaluated distinctively.

***The following issues are considered while analyzing the resources position of a bank:***

***Size of deposit base***

A large deposit base provides stability to a bank's resources position by diversifying the depositor base and ensuring a continuous stable source of funds.

***Diversity in deposit base and the geographical spread***

The diversity of the deposit base in terms of the number of small deposits, the geographical spread and the optimal rural/urban mix lends stability to the resources position of a bank. The number of branches and their geographical spread lend diversity to its deposit base. Thus, a bank with a large number of branches dispersed all over India and with an optimal rural/urban mix is viewed favourably.

***Deposit mix***

A bank's deposit mix has an impact on its cost of deposits. A high proportion of savings and current deposits leads to a low-cost resource base. CRISIL also analyses the trends in deposit mix to form an opinion on future stability and costs.

***Growth in deposits***

Accretion to deposits is the main source of funding asset growth and managing liquidity risks in banks. CRISIL compares the growth in deposits of a bank with industry trends to make relative judgements.

***Cost of deposits***

Cost of deposits is a function of the bank's deposit mix, its region of operations and its ability to attract deposits at lower rates. Banks that have a low cost of resources not only benefit through higher profitability but also have greater flexibility to increase deposit rates in order to maintain their resources position.

***The relevant issues while analysing the resource position of an FI are:***

***Diversity of investor base***

Given that FIs are predominantly wholesale funded, the diversity of the investor population (both domestic and

international) does mitigate an FI's risk profile to some extent. FIs that are dependent on a few investors are viewed less favourably.

***Funding mix and cost of funds***

Traditionally FIs enjoyed concessional funding from the government of India in the form of statutory liquidity ratio (SLR) bonds or subsidised loans. This facility has been progressively withdrawn and FIs have been increasingly accessing market borrowings over the past few years. FIs that still carry a significant proportion of concessional funds on their books will tend to enjoy a cost of funds advantage in the near term.

The funding mix between domestic and foreign currency funding is also examined to determine an FI's overall risk profile. FIs that tend to have a higher proportion of foreign currency funding carry the risk of a foreign currency borrower defaulting on payment obligations and thus, exposing the FI to increased currency risk. This risk assumes greater significance at times when the economy is slowing down or there is a greater instance of corporate defaults.

***Retail penetration***

Some of the leading FIs have started tapping the retail market for bonds and deposits. These funds do impart stability to the funding mix and the trends in raising retail resources are favourably factored into CRISIL's risk evaluation.

**■ Asset quality**

A bank or FI's asset quality is a measure of its ability to manage credit risks. Besides studying the bank's credit appraisal mechanisms, portfolio monitoring procedures and problem asset resolution strategies, CRISIL analyses asset quality on the basis of the following parameters:

***Geographical diversity and diversity across industries***

Geographical diversity of asset base and diversity across industries, along with single risk concentration limits, are important inputs in determining the asset quality of banks/FIs. Regional banks with limited operations and branch network have lesser flexibility to diversify their advances portfolio than banks with a national presence and are thus susceptible to adverse economic conditions in a particular region.

The industry exposure and single risk concentration is monitored by the central bank, that is the Reserve Bank of India (RBI), through exposure guidelines. However, some banks/FIs show a high degree of exposure to certain industries, making themselves vulnerable to downturns in those industries. To ascertain the importance of individual borrowers, CRISIL reviews the rated bank's largest credit exposures.

### ***Client profile of the corporate asset portfolio***

The credit quality of a bank's corporate portfolio (funded as well as non-funded) is an important input in analysing asset quality. CRISIL analyses the profile of clients in the asset portfolio to make a judgement on portfolio quality. The ability of a bank/FI to attract better credit quality clients is an important indicator of its future credit quality. The size (of capital) of a financial sector entity lends considerable flexibility in attracting larger and better quality clients given its sheer ability to take on larger exposures on its balance sheet. Also, a bank or FI's ability to attract and retain good quality clients by providing value-added services would enhance asset quality in future.

### ***Quality of non-industrial lending***

Banks in India have an obligation to lend a proportion of their funds to the priority sector that primarily encompasses agriculture and small-scale industries. To this extent, FIs are better placed than banks because they do not have any such obligations. CRISIL analyses the credit quality of this non-industrial portfolio in arriving at a judgement on the overall asset quality of a bank. The credit quality of the asset portfolio is also indicated by the segment-wise non-performing asset (NPA) levels of the portfolio, revealing the performance of the bank in each segment. This helps in gauging the bank's relative strength in each of its loan segments.

In recent times, banks as well as FIs are increasingly focusing on retail consumer loans, primarily vehicle and housing loans. CRISIL looks at the quality of retail consumer credit growth, the underwriting standards and recovery mechanisms to arrive at the asset quality implications of the retail foray.

### ***NPA levels***

The asset quality of a bank depends not only on the credit quality of its clients but also on its ability to manage its asset portfolio. The gross NPA level helps to benchmark the bank/FI's ability to manage its asset portfolio on a

relative scale. Gross NPA levels are an indicator of the inherent quality of the entity's asset portfolio and thus, of its credit appraisal capabilities. Net NPA levels are an indicator of the balance-sheet strength of the bank, the proportion of earning assets held by it and the potential credit loss. The proportion of earning assets and the potential credit loss would have a bearing on the bank's future earnings capability.

### ***Movement of provisions and write-offs***

Some banks/FIs follow a practice of writing off a large portion of their bad loans in order to clean up their balance sheets. Thus, the present NPA numbers are not a true indicator of the inherent credit quality of a bank's asset portfolio. Hence, NPA levels alone cannot be a criterion to assess a bank's future asset quality. Average provisioning, including write-offs, over a five-year timeframe is an indicator of the level of cleaning up done by a bank over a period of time. This average provisioning level and its movement is an indicator of the portfolio's credit risk and the expected future write-offs and provisioning, which would further affect the bank's earnings capability.

### ***Growth in advances***

High growth rates in the financial sector bring the risks associated with the establishment of collection systems, tracking of asset quality and lack of seasoning of the lending portfolio. CRISIL closely analyses the pattern and nature of such growth, studying entities with higher growth rates more carefully to look at the nature of the growth, the reasons for it and its implications on the asset quality. An entity that has grown by attracting good quality clients from its competitors would be viewed more favourably than one that has grown just by increasing its geographical presence or diluting credit criteria.

## **■ Management and systems evaluation**

CRISIL believes that the quality of management can be an important differentiating factor in the future performance of a bank/FI. The management is evaluated on the following parameters:

### ***Goals and strategies***

A bank's future goals and strategies are evaluated to take a view on its management's vision. The bank's ability to adapt to the changing environment and its ability to manage credit and market risks, especially in a scenario of increasing deregulation of the financial markets, assumes critical importance. CRISIL also has

extensive discussions with the banks' managements on their philosophy with regards to diversification, asset growth and maintenance of capital, provisioning and liquidity levels.

### **Systems and monitoring**

CRISIL studies credit appraisal systems and the systems for managing and controlling credit and market risks at a portfolio level. Significant emphasis is laid on risk monitoring systems and the periodicity and quality of such monitoring. Most Indian banks face the challenges of enhancing the coverage and quality of their information systems and reporting. The degree of acceptance of new systems and procedures in the bank, data monitoring systems and the extent of computerisation within a bank is given significant importance. The level of computerisation is gauged on the basis of the extent of business covered by computerisation, computerisation in branches and of the money market and foreign exchange desks.

CRISIL attaches significance to the operating systems for data capturing and MIS reporting in a bank. A bank's balance sheet that has a large volume of transactions pending reconciliation reflects its lack of operating systems and is viewed negatively. CRISIL also analyses expenses made on technology during the recent period and the bank's strategy of using technology effectively as a delivery platform to reduce costs and improve service levels.

### **Appetite for risk**

CRISIL also analyses the bank management's attitude towards risk and the level of interest rate, foreign exchange and equity risks in the balance sheet. A high-risk propensity typically reflects in higher volatility in earnings in both the fund-based and the fee businesses. A management with a higher propensity to take risks is viewed cautiously.

### **Motivation levels of the staff**

Employee motivation levels could be a function of remuneration, management involvement and job satisfaction. Such motivation levels would directly affect a bank's service levels, which is a key success factor in a market-driven environment.

## **■ Earnings potential**

CRISIL analyses a bank/FI's earnings on the basis of the level, diversity and stability of earnings.

### **Level of earnings**

The level of earnings as measured by the return on total assets (ROTA) provides the bank/FI a cushion for its debt servicing and also increases its ability to cover its asset risk. ROTA is a function of interest spreads, expense levels, provisioning levels and the non-interest income earned by the bank. The size of net profit is also factored in while rating the entity's earnings.

Earnings of banks/FIs have been affected due to volatility in interest rates. Thus, the trend in profitability at gross profit levels is examined over the past years to take a view on the sustainability of earnings. The various elements leading to profitability like interest spreads, fee levels, expense levels and provisioning levels are also analysed to take a view on the profitability trend and the sustainability of profits in the future.

### **Diversity of income sources**

Diversity of income sources is an important input in analysing the stability of earnings. Diversity in fund-based income is achieved by focusing on different borrower segments like industries, trade and retail. Banks also diversify their income streams through non-interest or fee income like guarantees, cash management facility, service charges from its retail customers and trading income. Fee income provides a cushion to profitability, especially in times of pressure on interest spreads.

CRISIL also views the composition of interest revenue streams while analysing the earnings position of a bank/FI. Banks relying on short-term, non-repetitive income sources like bills financing and trading income are viewed less favourably than banks with long-term credit relationships with companies through cash credit or term loan exposures and the like. CRISIL also analyses the composition of the non-interest income while evaluating a bank/FI's earnings. Non-interest income also includes income from trading activities, which tend to be volatile. A closer analysis of the composition of revenue streams helps in forming an opinion on the sustainability of the earnings.

### **Efficiency measures**

CRISIL looks at the level and trend of operating expenses and degree of automation in the bank/FI. CRISIL looks at salary expenses and total non-interest expenses as a proportion of total income and average assets.

## ■ Liquidity/ Asset liability management

CRISIL assesses the asset liability maturity profile of the rated entity to form an opinion on the liquidity risk as well as the interest rate risk. The entity's general philosophy of asset and liability management is discussed.

### **Liquidity risk**

The liquidity risk rating factors in the bank's resources strength and the liquidity support available to it in the form of access to call/repo borrowings and the extent of refinance available from the RBI. Banks are the primary channelisers of retail savings into the economy. Most public sector banks having a widespread branch network act as conduits for mobilising retail savings. CRISIL views most of the public sector banks favourably on this parameter due to the stable accretion to deposits and the liquidity support available to them.

An FI's liquidity position is a function of its management's policy of maintaining treasury portfolios to meet asset and liability side liquidity demands. However, on account of their significance to the domestic financial sector, FIs enjoy a high degree of financial flexibility that reduces liquidity risks to fairly low levels.

The specific liquidity parameters analysed by CRISIL are:

### **Liquid assets/ Total assets**

To arrive at this ratio, CRISIL looks at the percentage of sovereign investments in an entity's books to its total assets. This can also be roughly derived from the credit-deposit ratio.

### **Proportion of small deposits**

CRISIL looks at the proportion of deposits below Rs. 150 million to the bank's total deposit base. These small sized retail deposits tend to be inherently more stable.

### **Interest rate risk**

The rating factors in the volatility of the bank/FI's earnings to interest rate changes. CRISIL analyses the entity's asset liability maturity profile to judge the level

of interest rate risk carried by it. In the Indian banking system, the interest rate and maturity profile of the assets and liabilities have an inherent mismatch. The floating rate advances portfolio (linked to prime lending rates) and the relatively long duration investment portfolio are funded through short to medium tenure liabilities, which exposes the bank to an element of interest rate risk.

FIs score over banks in this regard due to the wholesale nature of their operations and policies that link the nature of borrowing (fixed/floating) with correspondingly matched lending. On an overall basis, FIs carry relatively fewer interest rate risks compared to banks.

## ■ Government support

CRISIL positively factors in government support for specialised entities in the financial sector, which have a policy role to play in the national economy. Further, public sector banks benefit from the high likelihood of support arising from government ownership. In CRISIL's opinion, the likelihood of support is underpinned by strong economic and moral imperatives to provide assistance, given the role that the banking system plays in the Indian economy. Banks are the primary agencies for channeling of savings in the economy and the government has used the banking system as a vehicle to fulfill its economic and social agenda through priority sector lending.

While the authorities have stepped in to rescue troubled private sector banks in the past, CRISIL believes that the support to public sector banks would unquestionably be of a higher order. The assets of public sector banks represent 80% of the banking system. Moreover, government ownership and control of banks is a politically sensitive issue and the government will find it difficult to deny support to public sector banks in the event of difficulty. In fact, the government has made substantial capital infusions into banks during the 1990s. This is evident from the fact that the government not only made substantial capital infusions into banks during the 1990s but it also continues to have a capitalisation programme for some weak banks.