Rating criteria for banks and financial institutions

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Executive summary

The financial sector in India continues to be dominated by banks, despite inroads made by non-banking financial companies. They account for the bulk of lending, as reflected in their diversified loan books catering to households and corporates. On the liabilities side, banks attract low-cost deposits from retail customers and have built large branch networks to cater to retail clients.

Banks are highly regulated and fall under the purview of the Reserve Bank of India (RBI). Credit growth and transmission of policy rates are highly dependent on the performance of the banking system.

CRISIL Ratings follows the CRAMEL framework for analysis of banks and financial institutions (FIs), which entails the assessment of capital adequacy, resource profile, asset quality, management, earnings and liquidity. In addition, market position is also factored. The concepts explained in this criteria document broadly apply to FIs as well.

Asset quality, capitalisation, earnings and resource profile are considered the core parameters for the assessment of credit risk profiles of banks/FIs. Asset quality indicates the risk levels at which a bank /FI operates, while capitalisation indicates the cushion available to absorb potential losses that may arise due to the risks taken, and to ensure growth.

Weakening in asset quality can eat into the earnings and, thereby, the capital cushion available to absorb losses, while adequate capitalisation can help absorb losses and ensure sustainable loan growth.

Earnings indicate the ability to appropriately price risks and generate risk-adjusted returns and augment the capital base. Resource profile is determined by the cost and stability of funds, which are key to smooth functioning and maintaining operational stability.

The ratings are typically anchored around the assessment of core parameters. Other aspects such as market position, liquidity and management are considered supplementary and may have limited influence on uplifting the ratings compared with core parameters but may constrain the ratings in certain situations.

CRISIL Ratings believes managing environmental, social, and governance (ESG) risks and opportunities will have a bearing on the credit risk profile of an issuer. Based on materiality and adequacy of data on ESG factors, CRISIL Ratings will assess and suitably factor in the ESG profile of banks and FIs in its credit risk analysis.

Scope

This criteria document[1] highlights the CRISIL Ratings approach to assessing the credit quality of banks (including Small Finance Banks) and all-India financial institutions (AIFIs). CRISIL Ratings uses the CRAMEL framework to rate banks and FIs, as well as other financial companies.

The methodology outlined in this document is used to arrive at the standalone rating of a bank/FI. For public sector banks and AIFIs, CRISIL Ratings may notch up the standalone rating for support from the government. The extent

[1] *The previous version of the criteria that was published in January 2022 can be accessed here:* https://www.crisilratings.com/content/dam/crisil/criteria_methodology/financials/archive/Rating-criteria-for-banks-and-financial-institution-jan2022.pdf

of notch-up is driven by the criteria for notching up standalone ratings of entities based on government support, which can be found on the CRISIL Ratings website, www.crisilratings.com. The document also covers CRISIL Ratings' approach to financial ratios used for analysing banks and AIFIs, including adjustments it carries to the reported metrics in the financial statements.

Methodology

The CRISIL Ratings approach to rating banks and FIs involves a comprehensive assessment of several parameters. Some core parameters have a high influence on the credit quality while others are considered supplementary.

Core parameters (High influence on credit risk profile of a bank/FI)			
Asset quality	**Capitalisation**	**Earnings**	**Resource profile**

Supplementary parameters (Degree of influence lower than core parameters to uplift the rating, but may constrain the rating)		
Market position	**Liquidity**	**Management profile**

CRISIL Ratings takes a forward-looking view on the performance of an entity on these parameters while evaluating its rating.

Core parameters

CRISIL Ratings considers asset quality, capitalisation, earnings and resource risk profile as the core parameters that drive the standalone credit risk profile of a bank /FI. The interplay of these parameters determines the ability to underwrite, price and manage risks, maintain adequate capital to absorb losses during times of stress, and ensure profitable growth. The standalone credit risk profile will be typically anchored to the assessment on these parameters.

Asset quality

Weakening in asset quality could lead to higher credit costs, which can impact returns and erode the headroom available in the capital structure to absorb losses. Eventually, these can impact growth prospects and affect solvency.

The asset quality assessment is driven by the level of gross non-performing assets (GNPAs) and the potential stress in the standard book (restructured advances and other potentially weaker credits). Write-offs and recoveries are also considered.

GNPA refers to the value of on-balance sheet loans or advances that have not been paid by the borrower for at least 90 days. Restructured advances refer to value of on-balance sheet loans or advances that have undergone modification of terms like alteration of payment period or payable amount or the amount of instalments or rate of interest; or have experienced roll over of credit facilities; sanction of additional credit facility/ release of additional funds for an account in default to aid curing of default or enhancement of existing credit limits; as well as compromise settlements where time for payment of settlement amount exceeds three months.

GNPA% = GNPAs / Gross advances

Restructured advances% = Restructured advances / Gross advances

Banks lend to a wide range of asset classes with varying risk profiles. For instance, retail loans have traditionally displayed lower delinquency profiles and volatility and are considered less risky compared with agricultural loans or loans to micro, small and medium enterprises (MSMEs).

Hence, CRISIL Ratings analyses the asset quality of the asset classes to which banks/FIs extend credit—retail, agriculture entities, MSMEs, and corporates—for a comprehensive understanding of the portfolio quality.

Any expected improvement or weakening in the asset quality based on the economic environment and underwriting policies is also factored in the assessment. Diversification of the loan book across asset classes, volatility in GNPAs, and geographic and borrower concentration are also considered.

Corporate loan book

Asset quality assessment of the corporate loan book takes into account NPAs in corporate loans and stressed assets in the standard book. While the reported NPAs indicate the track record of asset quality in the corporate loan book, stressed assets in the standard book reflect the outlook on asset quality, in terms of potential slippages to NPAs over the medium term.

Assessment of stressed assets in the standard book is based on the credit risk profiles of the top exposures, and the rating and sectoral distribution of the loan book. Track record of slippages, provision coverage ratio (PCR) and recovery prospects are also considered.

Retail, agriculture and MSME loans

Asset quality assessment of such loans are driven by GNPAs. Within retail loans, various segments—home loans, secured loans (such as vehicle and gold loans), and unsecured loans (such as credit card loans and personal loans)—are analysed for a wholesome view of the asset quality, as each of these asset classes can have different credit risk profiles.

The assessment factors in typical delinquency levels, volatility in GNPAs and potential recoveries from these asset classes. As asset quality indicators can be distorted by growth, NPAs are studied on a lagged basis.

Capital adequacy

Capital provides the cushion to withstand credit and other risks in business. Adequate capitalisation helps in tiding over asset-quality stress and maintaining credit growth. While rating banks/FIs, CRISIL Ratings analyses the capital adequacy and its sustainability over the medium-to-long term.

Capital adequacy is viewed relative to regulatory requirement of capital. For instance, the adequacy of Common Equity Tier I capital (as required under the Basel III framework) is a key input in the assessment of capital adequacy. CET1 ratio compares company's Common equity Tier 1 capital to the risk-weighted assets. A cushion over the minimum regulatory capital requirement can enable the bank/FI to better support credit growth and is considered in the capitalisation assessment.

CET 1 = CET 1 capital / Risk weighted assets

Overall Capital Adequacy Ratio (CAR) ratio is also looked at during capital adequacy assessment of banks. Capital adequacy ratio (CAR), also known as capital to risk-weighted assets ratio (CRAR), is an indicator of how well a bank can meet its obligations. CAR is critical to ensure that the financial institution has large enough cushion to absorb losses before they become insolvent. CAR compares both company's Tier 1 and Tier 2 capital to the risk-weighted assets.

Overall CAR = (Tier 1 capital + Tier 2 capital) / Risk weighted assets

CRISIL Ratings also shall assess net worth to NNPA ratio, which indicates capital cover available in relation to un-provided weak assets. Un-provided weak asset refers to quantum of weak assets not provided for by provision cover. The ratio indicates the headroom available to absorb unexpected losses over and above weak assets already covered through provisioning.

Net worth to NNPA = Net worth / NNPA

A forward-looking view is taken on the sustainability of capital, based on profitability, growth plans, asset quality and flexibility to raise capital. CRISIL Ratings also considers adherence to other regulatory capital norms: Tier 1 capitalisation, overall capital requirement and the leverage ratio.

Earnings

Earnings are key to augmenting the capital required to support growth and absorb losses and indicate the ability to price anticipated risk. Earnings also directly influence the ability to attract capital.

CRISIL Ratings considers return on assets (RoA) as a critical indicator of earnings. This indicates the returns generated by a bank / FI on its assets.

RoA = PAT / average total assets

This ratio encompasses all the building blocks of profitability that indicate how efficient the bank/FI is in managing its:

- Pricing (as indicated by yield on assets)
- Operations (operating expenses)
- Asset quality (credit costs)
- Fund raising (cost of funds)

Stability and sustainability of the RoA are also factored in the assessment. The trend in profitability at the gross profit level is examined to form a view on the sustainability of earnings. The level of pre-provisioning operating profit is considered to gauge the ability to absorb credit costs.

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 such as industries, trade and retail. Banks also diversify their income streams through non-interest or fee income, such as guarantees, cash management facilities, service charges from retail customers, and trading income. Fee income provides a cushion to profitability, especially in times of pressure on interest spreads.

The impact of PCR on future profitability is gauged. For instance, low PCR would indicate insufficient provisioning to cover potential losses from NPAs, which can affect profitability.

Resource profile

Resource profile indicates the ability to mobilise stable funds at competitive rates to operate the business. The resource composition of a bank is very different from that of an FI. Banks are significantly deposit-funded whereas FIs depend on wholesale funds. While some FIs do raise retail funds, they are at a natural disadvantage compared with the banking sector, because of restrictions on minimum tenure and interest rates, the absence of cheque-issuing facility, and relatively small branch network.

In general, dependence on wholesale funding attaches a degree of risk to the funding profile of FIs. High reliance on such funding is considered disadvantageous compared with retail deposits, due to higher concentration risks and greater probability of run-off during stress scenarios in comparison to retail funding. These risks (especially stability of resources) are mitigated by the ability of AIFIs to mobilise resources from provident funds and insurance companies, which have access to long-tenure funds.

Unlike FIs, retail deposits form an important source of funding for banks. Assessment of the resource profile is centred on the ability of the bank to access stable funding (indicated by retail deposit franchise) and funding at competitive costs (indicated by CASA [current account and savings account] deposits). Reliance on capital market borrowings is also considered.

CASA deposits represent cheap source of funding for the banking system. For this reason, banks with higher proportion of CASA deposits are expected to reduce the cost of overall borrowings which shall positively impact the bank's overall performance.

CASA ratio = CASA deposits / total deposits

Retail deposits represent stable and economical source of funding vis-à-vis market borrowing and wholesale deposits. As a stable source of funding such banks with high retail deposit reliance are expected to be resilient during the times of liquidity stress.

Retail deposits ratio = Retail deposits (savings + retail term) / total deposits

Given that FIs are predominantly wholesale-funded, the diversity in investors (both domestic and international) may mitigate resource risks. FIs that are dependent on a few investors are viewed less favourably than those that have a large investor base.

If FIs can regularly raise bonds and deposits from retail investors, it will impart stability to the funding mix. The trend of raising funds from retail resources is favourably factored into the risk evaluation. Any sustainable form of tax-related or regulatory benefits that are accorded by the sovereign to the entity's bond programme will also influence its resource profile favourably.

The growing importance of ESG risks and opportunities

The past few years have seen the emergence of ESG-led investments globally. ESG investments account for about a third of global assets under management and are expected to grow more than 2.5 times to ~$100 trillion by 2030. Investments in emerging markets, pegged at ~15% in these global funds, are likely to reflect a similar trend, thereby significantly improving access to funds for ESG-focused entities. While ESG-led investing is at a nascent stage in India, its adoption is steadily picking pace. CRISIL Ratings believes ESG readiness will, in time, become an important distinguishing feature for banks and FIs to diversify their resource profile.

Banks and FIs have limited direct environmental impact and have a reasonable social impact because of their substantial employee and customer base, and their key role in promoting financial inclusion. Given the nature of the sector, strong governance is pivotal in this sector for long-term sustainable operations and is a key determinant of the credit rating. Furthermore, the lending decisions could have a bearing on environmental factors and hence affect their overall ESG profile.

Non-financial disclosures are still evolving. Some of the large corporates have been early adopters, voluntarily tracking and disclosing their ESG-related parameters and policies. Disclosure levels in India are, however, expected to improve—the Securities and Exchange Board of India (SEBI) circular on Business Responsibility and Sustainability Reporting dated May 10, 2021, requires the top 1,000 listed corporates to disclose significant non-financial information on a voluntary basis in fiscal 2022 and compulsorily from fiscal 2023. Improving data availability and ability to benchmark non-financial parameters will help suitably factor in ESG risks in credit assessment and other investment decisions.

Factoring the impact of ESG in credit ratings

As investors begin to screen investments through the ESG lens, CRISIL Ratings believes the ability of an issuer to manage ESG related risks will have a bearing on its resource profile. This will specifically hold true for issuers that are accessing the global pool of capital to meet their funding needs. Based on materiality, CRISIL Ratings will assess the impact of the ESG risk of issuers, subject to availability of information. Parameters such as proportion of foreign investment holding and reliance on external market borrowings will be considered in assessing the materiality of ESG for an issuer.

CRISIL Ratings will assess parameters, such as emissions and energy consumption, water usage, waste management for assessment of the environmental impact. In addition, the sectors to which banks and FIs lend will also be assessed as such lending can have an indirect bearing on the environment. Under social assessment, information pertaining to human capital, product and customer management, vendor management and community engagement will be evaluated. Under governance, the board performance, ownership concentration, shareholder relations, and disclosures and financial statements will be assessed. CRISIL Ratings may look at a specific combination of these parameters based on the materiality and availability of information.

CRISIL Ratings believes improvement in non-financial disclosures will be critical to increase the scope of integrating ESG into credit risk assessment.

Supplementary parameters

CRISIL Ratings considers market position, management and liquidity as supplementary parameters; these have limited ability to uplift the rating based on the core parameters but can constrain the rating in certain situations.

Market position

Market position assesses the predictability of business volume in the face of potential economic and market fluctuations. A strong market position provides benefit in terms of operating leverage and pricing power. The ability to tap a vast consumer base enables a bank to continuously replenish its portfolio and provides avenues for cross selling and diversification.

The key factor on which market position is assessed is the market share of the bank /FI in the industry. In addition to the market share in assets, the share in deposits is also considered to factor in the strength of the liabilities franchise of a bank.

Market share in assets = Total reported assets / Total banking sector assets

Market share in deposits = Total deposits / Total banking sector deposits

Other parameters such as sustainability of market share assessed through brand and franchise strength, scalability in terms of size, business outlook and growth potential, and diversification across the spectrum of financial services are also considered.

Management

Analysis of the quality of the management, its business strategies, and ability and track record in responding to changes in market conditions, risk appetite and competency form key inputs in the credit risk assessment. Evaluation of the management entails understanding the goals, philosophies, and strategies of the management that drive the business and financial performances.

Liquidity

Banks are required to maintain a minimum liquidity coverage ratio (LCR), in line with RBI regulations. LCR measures the ability to meet any net funding run-off by using high-quality liquid assets over a 30-day period of stress.

LCR = High Quality Liquid Assets (HQLA) / 30-day outflows - inflows

CRISIL Ratings considers the cushion over the regulatory LCR requirement in its assessment of a bank's liquidity. If the LCR is close to the regulatory minimum, the LCR calculations are sensitised, if required, based on asset liability maturity (ALM) management of the bank. Any regulatory relaxations provided by RBI from time to time are also considered.

Liquidity assessment of FIs factors in the ALM profile, including the cumulative mismatches in various maturity buckets. The quantum of liquid assets maintained by the FI and its financial flexibility are also considered.

Small Finance Banks (SFBs)

SFBs were set-up with the objective to serve the unserved and underserved sections. As a result, the asset side of SFBs differs from universal banks in terms of the target lending segment and loan ticket size. For instance, SFBs are required to extend 75% of its Adjusted Net Bank Credit (ANBC) to the sectors eligible for classification as priority sector lending (PSL) by RBI, as against PSL prescription of 40% of ANBC in the case of universal banks.

The relatively higher risk in asset side is counterbalanced by SFBs through higher capital cushion and pricing. SFBs are required to maintain minimum overall capital adequacy ratio (CAR) at 15% of risk weighted assets (RWA), on the other hand CAR requirement for universal banks stands at 11.5% of RWA (including 2.5% capital conservation buffer (CCB)). Also, SFBs have track record of relatively higher return on assets than a universal bank primarily due to difference in the target lending segment.

SFBs also have number of similarities with universal banks. SFBs are in direct competition with universal banks for expanding their deposit franchise. Large SFBs are steadily increasing their retail deposits and their resource profile ratios are moving closer to universal banks. Also, SFBs have access to liquidity adjustment facility from RBI and have same liquidity norms as universal banks. Also, SFBs become eligible to apply for universal banking license after five years of operations, thereby placing them at the same level as that of other universal banks.

While the analytical approach for SFBs is similar to that of universal banks, CRISIL Ratings' assessment accounts for nuances specific to SFBs. These nuances factors for the differences in target lending segment, scale, profitability, and capital requirements of SFBs vis-à-vis universal banks.

Government support

CRISIL Ratings positively factors in government support for FIs that have a policy role to play in the economy. Furthermore, public sector banks benefit from the high likelihood of support arising from government ownership. The likelihood of government support is underpinned by strong policy and moral imperatives, given the role that the public sector banking system plays in the economy.

Banks are the primary agencies for channeling savings and the government uses the banking system to fulfil its economic and social agenda through priority-sector lending. While the government has stepped in to rescue troubled private sector banks in the past, the support to public sector banks would unquestionably be of a higher order as demonstrated by capital infusion over the years.

Assets of public sector banks constitute close to two-third of the assets and deposits in 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 distress.

For details, refer to 'Criteria for notching up standalone ratings of entities based on government support' available on www.crisilratings.com.

Conclusion

CRISIL Ratings uses the CRAMEL framework to rate banks/FIs. Asset quality, capitalisation, earnings and resource profile are considered core parameters that drive the ratings. These parameters significantly determine the ability to underwrite, price and manage risks, while maintaining adequate capitalisation to absorb losses and ensure credit growth. The supplementary parameters considered are market position, liquidity and management.

About CRISIL Limited

CRISIL is a leading, agile and innovative global analytics company driven by its mission of making markets function better. It is India's foremost provider of ratings, data, research, analytics and solutions, with a strong track record of growth, culture of innovation and global footprint.

It has delivered independent opinions, actionable insights, and efficient solutions to over 100,000 customers.

It is majority owned by S&P Global Inc, a leading provider of transparent and independent ratings, benchmarks, analytics and data to the capital and commodity markets worldwide.

About CRISIL Ratings

CRISIL Ratings is part of CRISIL Limited ("CRISIL"). We pioneered the concept of credit rating in India in 1987. CRISIL is registered in India as a credit rating agency with the Securities and Exchange Board of India ("SEBI"). With a tradition of independence, analytical rigour and innovation, CRISIL sets the standards in the credit rating business. We rate the entire range of debt instruments, such as, bank loans, certificates of deposit, commercial paper, non-convertible / convertible / partially convertible bonds and debentures, perpetual bonds, bank hybrid capital instruments, asset-backed and mortgage-backed securities, partial guarantees and other structured debt instruments. We have rated over 24,500 large and mid-scale corporates and financial institutions. CRISIL has also instituted several innovations in India in the rating business, including rating municipal bonds, partially guaranteed instruments and microfinance institutions. We also pioneered a globally unique rating service for Micro, Small and Medium Enterprises (MSMEs) and significantly extended the accessibility to rating services to a wider market. Over 1,10,000 MSMEs have been rated by us.

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