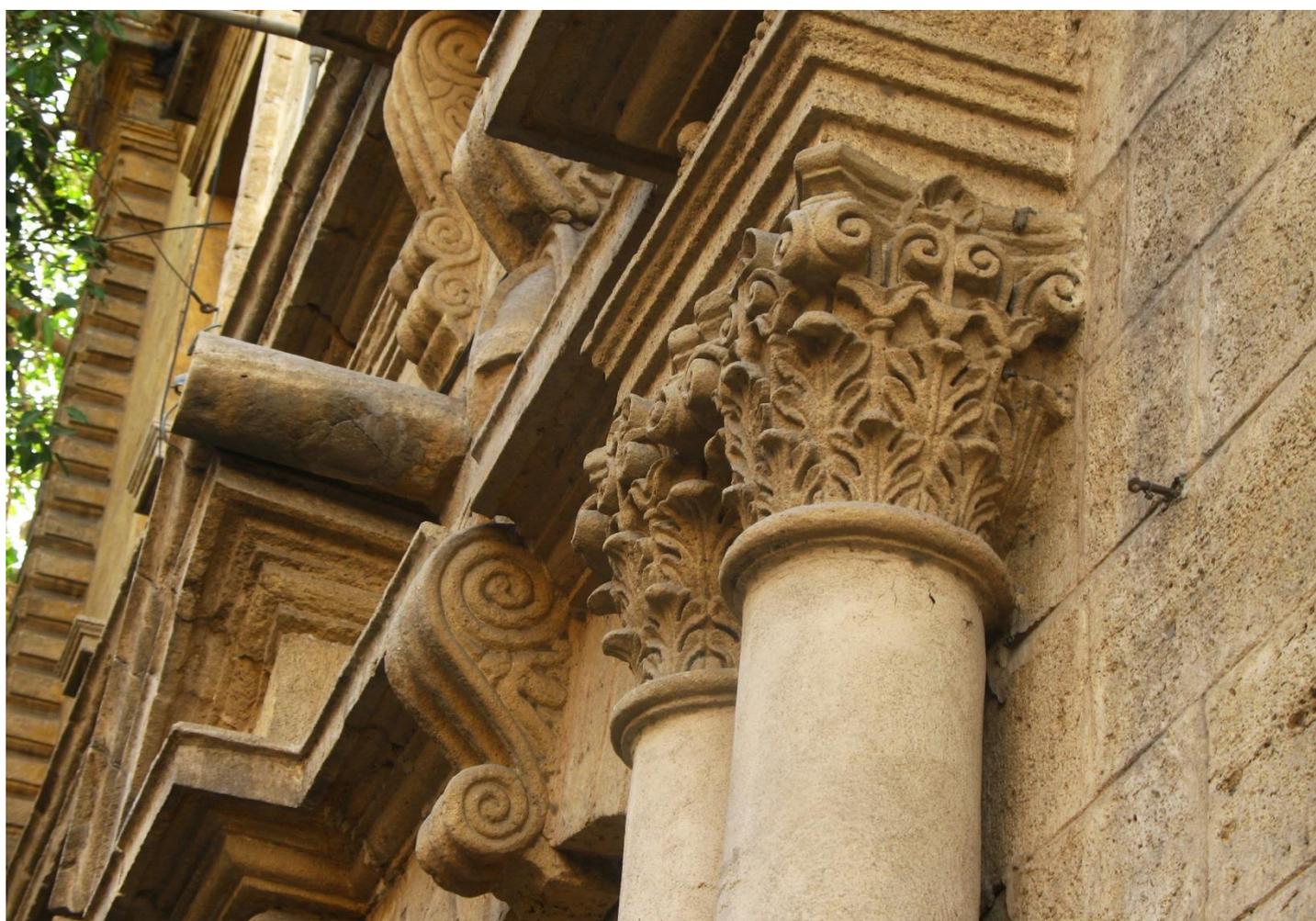


Rating criteria for banks and financial institutions

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Executive summary

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

This exercise incorporates a review of the economy and the financial and banking sectors. CRISIL also analyses the changing regulatory environment and increased competition arising out of the private sector's push into the financial services space.

The financial sector has been going through a phase of transformation and convergence. While banks continue to be predominant, other financial institutions have also developed a sector-specific focus. This transformation is evident on both the assets and the liabilities side.

On the assets side, banks are focusing on long-term assets such as infrastructure finance and residential housing loans, and other retail assets such as automobiles and commercial vehicles. On the liabilities side, the retail strategy has changed from passive to a proactive one to attract and retain customers and increase the deposit base. Retail deposits increased also because reliance on high-cost bulk deposits reduced.

Rising market share of new private sector banks, the marketing strategies adopted by them, and the advent of differentiated banks have hastened these changes.

Banks have also been going through a phase of convergence. Almost all of them now offer the entire gamut of products and services on the assets and liabilities sides to both retail and wholesale customers. Before the entry of new private sector banks, retail assets were considered the domain of non-banking finance companies. Most banks, therefore, did not offer the full suite of products even though they had the distribution network heft and retail client base.

The advent of small finance banks and payments banks is expected to add another dimension to India's banking landscape. That, along with advances in digital technology, should change the way financial services companies do business.

Also, the implementation of the Basel III capital framework for banks will have a big bearing on the minimum capital required on an ongoing basis, and the growth that can be pursued when complying with such a requirement.

An entity-specific analysis of the risk profile is conducted through a qualitative and quantitative approach following a structured methodology called 'CRAMEL'. Based on rating criteria, the strengths and weaknesses of each bank/FI compared with peers, are evaluated. CRISIL also evaluates the market position of the financial institutions being rated, and the strategy it adopts to cope with the emerging competitive scenario.

Market position

CRISIL factors in the size of a bank/FI and its positioning in the industry. A large size enables it to withstand systemic shocks and helps determine the extent of systemic support it can expect. CRISIL also factors in the diversity in product portfolio, business lines and customer base.

The 'CRAMEL' model comprises

Capital adequacy

Resource-raising ability

Asset quality

Management and systems evaluation

Earnings potential

Liquidity/asset liability management

No single factor is of overriding importance, or is considered in isolation. All six factors are viewed in conjunction when assigning a rating.

Capital adequacy

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

Adherence to capital adequacy requirements as per Basel III regulatory norms

The adequacy of Common Equity Tier I (CET 1), Tier I and Total Capital Ratio as required under the Basel III framework is a key input in CRISIL's assessment of the capital adequacy of a bank/FI. A material cushion over the minimum capital requirement should enable the bank to better support future credit growth.

Size of capital

The absolute size of capital imparts flexibility to a bank/FI to withstand shocks. Therefore, a bank/FI with high absolute capital is viewed favourably.

Sustainability of capital ratios and flexibility to raise Tier I and hybrid capital

A bank/FI can enhance its Tier I capital base either through internal accrual or by raising fresh equity or hybrid capital. CRISIL, therefore, evaluates 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. The ability of a bank/FI 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 accrual without impairing capital adequacy is viewed favourably. Other factors considered when assessing the sustainability of capital ratios are dividend policy, likely capital commitments to subsidiaries, shareholding in subsidiaries and the ability to dilute stake in them.

Quality of capital (Tier I capital)

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

CRISIL also analyses other issues such as the presence of hidden reserves (for example, unrealised gains on investment portfolio) and the percentage of the investment portfolio that is marked to market. These issues help streamline accounting policy differentials across entities and have a bearing on the capital's quality. A key element in CRISIL's capital adequacy analysis is the study of Tier I capital coverage for net non-performing assets (NPA).

Growth plans

CRISIL also factors in the growth plans of the bank/FI when analysing capital adequacy. Capital adequacy (even if at high levels) would be regarded unsustainable if an entity pursues a high-growth strategy. Also, segments where incremental growth is targeted would require varying levels of capital.

Resource-raising ability

CRISIL analyses the resource 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 a bank is very different from that of an FI. Banks are significantly deposit-funded whereas FIs depend on wholesale funds. Some FIs do raise retail funds, though. However, compared with the banking sector, they are at a natural disadvantage when raising retail liabilities owing to restrictions on minimum tenure and interest rates, the absence of cheque-issuing facility, and relatively smaller branch network. In general, 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 sector. Such resources have a retail origin.

Given this basic distinction in funding profiles, the funding risk profile of banks and FIs are also evaluated separately.

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 number of small deposits, geographical spread and optimal rural/urban mix lends stability to the resource 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 spread 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 current and savings 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. The proportion of wholesale or bulk deposit is assessed to form a view on stability and cost of borrowing.

Growth in deposits

Accretion to deposits (especially low-cost retail deposits) is the main source of funding asset growth and managing liquidity risks in banks. CRISIL compares a bank's growth in deposits with industry trends to make relative judgments on the cost of deposits.

Cost of deposits

Cost of deposits is a function of a bank's deposit mix, its region of operations and ability to attract deposits at lower rates. Banks with low-cost resources not only benefit from higher profitability but also have greater flexibility to increase deposit rates in order to maintain their resource positions. CRISIL analyses the all-inclusive funding cost of a bank. This factors in the operating cost involved in mobilising deposits and the negative carry incurred due to the mandatory statutory liquidity ratio (SLR) and cash reserve ratio (CRR) norms.

The relevant issues when 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 than those that have a large investor base.

Funding mix and cost of funds

Traditionally, FIs enjoyed concessional funding from the Government of India in the form of 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 over the near term.

The 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 default on a foreign currency payment obligations and thus, expose themselves to increased currency risk. This risk assumes greater significance at times when the economy is slowing down or if there are many corporate defaults. Any sovereign support to cover adverse fluctuations in the foreign exchange rate will be viewed favorably in the analysis of the entity's resource profile.

Retail penetration and tax benefits

Some leading FIs regularly raise bonds and deposits from retail investors. These funds impart stability to the funding mix and the trends in raising retail resources are favourably factored into CRISIL's risk evaluation. Any sustainable form of tax-related or regulatory benefits that are accorded by the sovereign to the entity's bond programme will influence the entity's resource profile favourably.

Asset quality

A bank/FI's asset quality is a measure of its ability to manage credit risks. In recent years, asset quality of banks have been under stress mainly due to the deterioration of credit quality of corporates. The Reserve Bank of India (RBI), along with the government, has been taking appropriate measures to address the challenge and also to strengthen credit and risk practices. Some of the RBI's tools to support banks to manage asset quality includes restructuring of loans under CDR, structuring of stress assets under schemes such as 5:25, Strategic Debt Restructuring, and the Scheme for Sustainable Solution of Stressed Assets. The government has also amended the Banking Regulation Act to operationalise the Insolvency and Bankruptcy Code (IBC) for effective resolution of stressed assets.

Besides studying a bank's credit appraisal mechanism, portfolio monitoring procedure, and 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.

Industry exposure and single-risk concentration is monitored by the RBI through exposure guidelines. However, some banks/FIs show a high degree of exposure to certain industries, leaving themselves vulnerable to downturns in those industries. To ascertain credit concentration, CRISIL reviews the rated entity's largest exposures.

Client profile of the corporate asset portfolio

The credit quality of a bank/FI's corporate portfolio (funded as well as non-funded) is an important input in analysing asset quality. CRISIL analyses the profile of the top 100 or 200 corporate exposures in the asset portfolio of a bank to make a judgment on portfolio quality. CRISIL also analysis banks' exposure to various sectors across economic cycles. The ability of a bank/FI to attract clients with a better credit quality is an important indicator of its own future credit quality. The size (of capital) of a financial sector entity lends considerable flexibility in attracting clients with a better credit quality, given its ability to take on large exposures on its balance sheet. Also, a bank/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 are obliged to lend a portion of their funds to the priority sector that primarily includes agriculture and small-scale industries. To that extent, FIs are better placed than banks because they do not have any such obligations.

CRISIL analyses the credit quality of the non-industrial portfolio in judging the overall asset quality of a bank. The credit quality of the asset portfolio is also indicated by segment-wise non-performing asset (NPA) levels in the portfolio, which reveals the performance in each segment. This helps gauge a bank's relative strength in each loan segment.

In recent times, banks and FIs have begun to sharpen focus on retail consumer loans – primarily vehicle and housing loans. CRISIL looks at the quality of retail consumer credit growth, and the underwriting standards and recovery mechanisms to arrive at the asset quality implications of the retail foray.

Level of stressed assets

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 level of stressed assets helps benchmark a bank/FI's ability to manage its asset portfolio on a relative scale. It is also an indicator of the inherent quality of the entity's asset portfolio and thus, of its credit appraisal capabilities. A stressed asset level net of provisioning indicates balance sheet strength, the proportion of earning assets held by it and the potential credit loss. The proportion of earning assets and 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. Therefore, the stressed asset 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 write-offs and provisioning, which would further affect the bank's earnings capability.

Growth in advances

High growth rates in the financial sector engender risks associated with the establishment of collection systems, tracking of asset quality, and lack of seasoning in loan portfolios. 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 asset quality. An entity that has grown by attracting good quality clients would be viewed more favourably than one that has grown just by increasing geographical presence or diluting credit criteria.

Management and systems evaluation

Quality of management is an important differentiating factor in the future performance of a bank/FI. Managements are evaluated on the following parameters:

Goals and strategies

A bank/FI's future goals and strategies are evaluated to form a view on its management's vision. The ability to adapt to the changing environment and 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 managements regarding their policy on diversification, asset growth, maintenance of capital, provisioning, and liquidity levels.

Systems and monitoring

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

CRISIL attaches significance to operating systems for data capture and MIS reporting. A balance sheet that has a large volume of transactions pending reconciliation reflects lack of adequate operating systems and is viewed negatively. Expenses made on technology during the recent period and the strategy of using technology effectively as a delivery platform to reduce costs and improve service levels are also assessed.

Appetite for risk

CRISIL also analyses the management's attitude towards risk and growth. An analysis of the strength of systems and processes put in place by the management to strengthen structures within a bank/FI are also undertaken to assess the management risk appetite. A high-risk propensity typically reflects in higher earnings volatility in both fund-based and fee-based businesses. A management with a higher propensity to take on risks is viewed cautiously.

Competence and integrity

Assessment of the competence and integrity levels is a key analytical driver of management evaluation. This entails delving into the track record of the management to identify positive and negative attributes.

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 net profitability margin (NPM) provides the bank/FI with a cushion for its debt servicing and also increases its ability to cover its asset risk. NPM is a function of interest spreads, expense levels, and fee-based income earned. The level of earnings is looked at in conjunction with risk appetite. Purely from the viewpoint of size, absolute profit levels are also germane to the earnings profile.

Earnings can be significantly affected due to volatility in interest rates. Thus, the trend in profitability at gross profit levels over the past years is examined to form a view on the sustainability of earnings. The various elements leading to profitability, such as interest spreads, fee levels, expense levels and provisioning levels are also analysed to form a view on profitability trends and the sustainability of profits.

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 such as industries, trade and retail. Banks also diversify their income streams through non-interest, or fee, income such as guarantees, cash management facility, service charges from 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 when analysing the earnings position. Those relying on short-term, non-repetitive income sources such as bill financing and trading income are viewed less favourably than those with long-term credit relationships with companies through cash credit or term loan exposures. The composition of non-interest income is also analysed when evaluating earnings. This includes income from trading activities, which tends to be volatile. A closer analysis of the composition of revenue streams helps form an opinion on the sustainability of earnings.

Efficiency measures

CRISIL looks at the level and trend of operating expenses and degree of automation. Salary expenses and total non-interest expenses as a proportion of average assets is used to benchmark efficiencies.

Liquidity/ asset liability management

CRISIL assesses the quantum and quality of liquid assets available, reliance on short-term funding and the asset-liability maturity profile to form an opinion on the liquidity and interest rate risks. The policy on asset and liability management is also analysed.

Liquidity risk

The liquidity risk rating factors in resource strength and liquidity support available in the form of access to call/repo borrowings and the extent of refinance available from various institutions such as the RBI, the National Bank for Agriculture and Rural Development, the National Housing Bank, and the Export Import Bank of India.

Banks are the primary channel of retail savings in India. Most public sector banks with wide branch network act as conduits of mobilisation. CRISIL views most public sector banks favourably on this parameter due to stable accretion of deposits and the liquidity support available because of the large deposit base.

An FI's liquidity position is a function of its management's policy of maintaining treasury portfolios to meet the liquidity demands of the assets and liabilities sides. However, on account of their significance to the domestic financial sector, FIs enjoy a high degree of financial flexibility, which 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, liquid mutual funds and other short-term, fixed-income instruments in total assets. This can also be derived from the credit-deposit ratio.

Liquidity coverage ratio

As per the Basel III framework on liquidity standards, all scheduled commercial banks are required to maintain a liquidity coverage ratio (LCR) in a phased manner starting with a minimum requirement of 60% from January 1, 2015, and increasing by 10% each year to reach a minimum 100% on January 1, 2019.

Proportion of small deposits

CRISIL looks at the proportion of deposits below Rs 1 crore in 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 or the shape of the yield curve. 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 maturity profiles of the assets and liabilities have an inherent mismatch despite the introduction of longer-dated infrastructure bonds and restructuring schemes such as 5:25.

The floating rate advances portfolio (linked to marginal cost of funds based lending rate) and the relatively long duration investment portfolio are funded largely through short to medium tenure liabilities, which exposes an entity to 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.

Government support

CRISIL positively factors in government support for specialised entities in the financial sector, which have a policy role to play in the 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 public sector banking system plays in the economy. Banks are the primary agencies for channeling savings and the government uses 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 as demonstrated by different leg of capital infusion across years. The assets of public sector banks represent close to 70% of the assets 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.

For details, refer to an opinion piece titled 'Criteria for notching up standalone ratings of entities based on government support'.

For accessing the previous published document on 'Rating criteria for banks and financial institutions', kindly refer to the following link: https://www.crisil.com/content/dam/crisil/criteria_methodology/financials/CRISIL-Ratings-criteria-banks-fis_2007.pdf

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We are 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.

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