Ratings

CRISIL
An S&P Global Company

Rating criteria for banks and financial institutions

December 2016

Criteria contacts

Pawan Agrawal
Chief Analytical Officer – CRISIL Ratings
Email: pawan.agrawal@crisil.com

Somasekhar Vemuri
Senior Director – Rating Criteria and Product Development
Email: somasekhar.vemuri@crisil.com

In case of any feedback or queries, you may write to us at Criteria.feedback@crisil.com

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 interest obligations and principal payments 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. Banks have become increasingly predominant, and financial institutions have developed a sector-specific focus. This transformation is evident both on the asset and the liability side. On the asset side, banks have shifted from the historical business model of providing working capital finance to corporates to aggressively 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 liability side, the transformation has been from a passive retail strategy to an active retail thrust to attract and retain customers and increase deposit base. Banks have also resorted to raising short-term bulk deposits, although recently they have reduced some of their bulk deposits. These changes have resulted in a lengthening of the asset maturities coupled with shortening of liability maturities. The entry of new private sector banks and the marketing strategy adopted by them are factors that have hastened the transformation.

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 asset and liability sides to both retail and wholesale customers. Before the entry of new private sector banks, retail assets were considered the primary domain of non-banking finance companies. Most banks, therefore, did not offer the full range of products to customers even though they had the required distribution infrastructure and retail client base.

The advent of differentiated entities such as small finance banks and payments banks will provide a new dimension to the banking landscape. This, along with the digital technology advancement, could be a game changer in the way financial services companies do business. Also, the implementation of the Basel III capital framework for banks is likely to significantly influence the sector in terms of the minimum capital required on an ongoing basis and the growth that can be pursued while complying with these requirements.

An entity-specific analysis of the risk profile is done through a qualitative and 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 peers, are evaluated. CRISIL also evaluates the market position of the bank or financial institution (FI) being rated, and the strategy it adopts to cope with 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 large size enables an entity to withstand systemic shocks and determines the extent of systemic support the entity 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 considered in isolation. All these six factors are viewed in conjunction when 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 over the medium to long term. This assessment is significantly influenced by the perception of relative profitability, the entity'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 current level 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 capital adequacy of a bank. 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, an entity with a high absolute capital is viewed favorably.

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

An entity can enhance its Tier I capital base either through internal accruals or by raising fresh equity capital or by raising 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. 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 favorably. Other factors considered when assessing the sustainability of capital ratios are dividend policy, likely capital commitments to subsidiaries, shareholding in subsidiaries and ability of the bank to dilute its 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 of a bank or FI's capital. 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 (such as 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 a study of the Tier I capital coverage for unprovided weak assets (Weak assets = Gross NPAs + 40% of outstanding restructured standard advances (excluding state power utilities) + 75% of security receipts (from loans sold to asset reconstruction companies) + 15% of loans structured under the 5:25 scheme (flexible structuring of long-term loans)

Growth plans

CRISIL also factors in the growth plans of the bank or FI when analysing capital adequacy. Capital adequacy (even if at high levels) would be regarded unsustainable if the entity pursues a high- growth strategy. Also, the segments in which the incremental growth is targeted is considered as different loan segments would have varying level of capital requirement.

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. 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 the 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 favorably.

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. 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 cost of deposits.

Cost of deposits

Cost of deposits is a function of the 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 for banks.

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 (GoI) 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 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 larger number of 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 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.

Industry exposure and single-risk concentration is monitored by the Reserve Bank of India (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 the credit concentration in the advances portfolio, CRISIL reviews the rated bank's largest 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 the top 100 or 200 corporate exposures in the asset portfolio of a bank to make a judgment on portfolio quality. 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 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 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 the segment-wise non-performing asset (NPA) levels of the portfolio, revealing the performance of the bank in each segment. This helps gauge the bank's relative strength in each of its loan segments.

In recent times, banks and FIs have begun to focus increasingly 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.

Weak asset 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. A weak asset level helps benchmark the 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 weak asset level net of provisioning is 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. The present weak asset numbers are thus not a true indicator of the inherent credit quality of a bank's asset portfolio. Therefore, weak 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 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 for the 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 its geographical presence or diluting credit criteria.

Management and systems evaluation

CRISIL believes that the quality of management is 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 form a view on its management's vision. The bank's 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 the bank's managements on their policy with regard to diversification, asset growth, 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 the analysis of risk monitoring systems and the periodicity and quality of 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 digitalisation and interconnectivity between branches within a bank is 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 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 management's attitude towards risk and growth. An analysis of the strength of systems and processes put in place by the management to strengthen the structures within a financial institution/banks are also undertaking to assess the management risk appetite. 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 on risks is viewed cautiously.

Competence and Integrity

Assessment of the competence and integrity levels of management is a key analytical driver of the management evaluation. This delves into the past track record of the management to identify positive and negative attributes of both these areas.

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 by the bank. The level of earnings of a bank is looked at in conjunction with its risk appetite. Purely from the viewpoint of size, the absolute profit levels registered by a bank are also germane to the earnings profile of a bank.

Earnings of banks/FIs 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 while analysing the earnings position of a bank/FI. Banks relying on short-term, non-repetitive income sources such as bill financing and trading income are viewed less favorably than banks with long-term credit relationships with companies through cash credit or term loan exposures. CRISIL also analyses the composition of non-interest income while evaluating a bank/FI's earnings: this includes income from trading activities, which tend 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 in the bank/FI. CRISIL looks at salary expenses and total non-interest expenses as a proportion of average assets to bench mark bank / FIs on efficiency parameters.

Liquidity/ asset liability management

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

Liquidity risk

The liquidity risk rating factors in the bank's resource strength and the liquidity support available to it 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, Export Import Bank of India, etc. Banks are the primary channel of retail savings into the economy. Most public sector banks with 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 attendant liquidity support available to them due to this large deposit base.

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, liquid mutual funds and other short term fixed income instruments in an entity's books to its total assets. This can also be derived from the credit- deposit ratio.

Liquidity Coverage Ratio (LCR)

As per the Basel III framework on liquidity standards, all scheduled commercial banks are required to maintain 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 10 million 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 schemes like 5:25 restructuring. 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 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.

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 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. 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 Opinion piece titled 'Criteria for Notching up Stand Alone Ratings of Entities Based on Government Support'.

About CRISIL Limited

CRISIL is a global analytical company providing ratings, research, and risk and policy advisory services. We are India's leading ratings agency. We are also the foremost provider of high-end research to the world's largest banks and leading corporations.

CRISIL 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 95,000 MSMEs have been rated by us.

CRISIL Privacy Notice

CRISIL respects your privacy. We use your contact information, such as your name, address, and email id, to fulfil your request and service your account and to provide you with additional information from CRISIL and other parts of S&P Global Inc. and its subsidiaries (collectively, the "Company") you may find of interest.

For further information, or to let us know your preferences with respect to receiving marketing materials, please visit www.crisil.com/privacy. You can view the Company's Customer Privacy at https://www.spglobal.com/privacy

Last updated: April 2016