Rating criteria for banks and financial institutions

November 2020
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Executive summary

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

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 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, CRISIL factors in the market position of the entity. The criteria have been further refined to make them more robust and comprehensive in terms of assessment of various risks related to banking. The concepts explained in this criteria document would broadly apply to FIs as well.

The performance of banks/FIs is assessed by their asset quality, capitalisation, earnings and resource profile, which are now considered core parameters by CRISIL in its assessment of credit risk profiles of these entities. 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 ensure growth.

Deterioration 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 these core parameters. Other parameters, such as market position, liquidity and management are considered as supplementary and may have limited influence on uplifting the rating compared with core parameters, but may constrain the rating in certain situations.

Scope

This criteria document\(^1\) highlights CRISIL’s approach in assessing the credit quality of banks and all-India financial institutions (AIFIs). CRISIL uses the CRAMEL framework to rate banks and FIs, as for 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 may notch up the standalone rating for support from government. The extent of notch-up is driven by CRISIL’s criteria for notching up standalone ratings of entities based on government support, which can be found on the CRISIL website, www.crisil.com.

\(^1\) The previous version of the criteria that was published in February 2019 can be accessed here: https://www.crisil.com/content/dam/crisil/criteria_methodology/financials/archive/Rating-criteria-for-banks-and-financial-institution-feb2019.pdf
Methodology

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

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

Core parameters

CRISIL considers asset quality, capitalisation, earnings and resource profile as the core parameters that drive the 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 rating will be typically anchored around the assessment on these parameters.

Asset quality

Deterioration in asset quality could lead to higher credit costs that can impact returns, and also eat into 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 residing in the standard book. Write-offs and recoveries are also considered.

Banks lend to a wide range of asset classes that display variations in their risk profiles. For instance, retail loans have traditionally displayed lower delinquency profiles and volatility, and are considered less risky compared with agricultural (agri) loans or loans to micro, small, medium enterprises (MSME).
Hence, CRISIL analyses the asset quality of different asset classes to which banks / FIs extend credit – namely, retail, agriculture entities, MSMEs, and corporates to get a comprehensive understanding of the portfolio quality.

Any expected improvement or deterioration in the asset quality based on the economic environment and underwriting policies is also factored in the assessment. CRISIL also evaluates the diversification of the loan book across asset classes, volatility in GNPs, and geographic and borrower concentration.

Corporate loan book
The asset quality assessment of the corporate loan book takes into account the NPA levels in corporate loans, as well as stressed assets in the standard book. While the reported NPAs indicate the past track record of asset quality in the corporate loan book, the stressed assets in the standard book indicate the outlook on asset quality, in terms of potential slippages to NPAs in the medium term.

The 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. The track record of slippages, provision coverage ratio (PCR), and recovery prospects are also considered.

Retail, agriculture and MSME loans
The asset quality assessments of such loans are primarily driven by the GNPA levels. Within retail loans, CRISIL analyses the various segments—home loans, secured loans (such as vehicle and gold loans), and unsecured loans (such as credit card loans and personal loan)—to have a wholesome view of the asset quality, as each of these asset classes can have different credit risk profiles.

The asset quality assessment takes into account the typical delinquency levels, volatility in GNPA levels and potential recoveries from these asset classes. As asset quality indicators can be distorted by growth, CRISIL analyses NPA levels on a lagged basis.

Capital adequacy
Capital provides the cushion to withstand credit and other risks in business. Adequate capitalisation enables tiding over asset quality stress and maintaining credit growth. While assigning a rating, CRISIL 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 (CET 1) as required under the Basel III framework is a key input in CRISIL’s assessment of capital adequacy. 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.

A forward-looking view is taken on the sustainability of capital, based on profitability, growth plans, asset quality, and flexibility to raise capital. CRISIL also considers the 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. This indicates the ability to price anticipated risk. Earnings also directly influence the ability to attract capital.

CRISIL considers return on assets (RoA) as a critical indicator of the earnings profile. 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 RoA are also considered in the assessment. The trend in profitability at the gross profit level over the past years is examined to form a view on the sustainability of earnings. The level of pre-provisioning operating profits 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 that the provisioning may be insufficient 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 when compared with retail deposits, due to higher concentration risks and greater probability of run-off during stress scenarios than retail funding. These risks (especially stability of resources) are mitigated by the ability of AIFIs to mobilise resources from provident funds and insurance, which have access to long-tenure funds.

Unlike FIs, retail deposits form an important source of funding for banks. The 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 and savings account) deposits. CRISIL also considers the reliance on capital market borrowings by banks.
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.

Some leading FIs regularly raise bonds and deposits from retail investors, which impart stability to the funding mix. The trend of raising funds from retail resources is 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 its resource profile favourably.

**Supplementary parameters**

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

**Market position**

Market position assesses the predictability of business volumes 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 also provides avenues for cross selling and diversification.

The key factors on which market position is assessed is the market share of the bank/FI in the overall 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.

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 considered while assessing market position.

**Management**

CRISIL's analysis of the quality of a bank's/FI's management, its business strategies, and ability and track record in responding to changes in market conditions, risk appetite and competency forms a key input in credit assessment. Evaluation of the management entails understanding the goals, philosophies, and strategies 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.

All banks are expected to meet the minimum LCR requirement set by RBI. CRISIL 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 management (ALM) of the bank. CRISIL also considers any regulatory relaxations provided by RBI from time to time.
Liquidity assessment of FIs takes into account the ALM profile, including the cumulative mismatches in various maturity buckets. CRISIL also factors the size of liquid assets maintained by the FI, and its financial flexibility.

**Government support**

CRISIL 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. In CRISIL’s opinion, 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 channelling savings and the government uses the system as a vehicle to fulfil 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 the support to public sector banks would unquestionably be of a higher order as demonstrated by capital infusion over the years.

The assets of public sector banks represent close to two-third of the assets and deposits 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 distress.

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

**Conclusion**

CRISIL’s ratings on banks/FIs are based on the CRAMEL framework in addition to an assessment of market position. 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. Other 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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