METHODOLOGY FOR RATING BANKS

CARE’s ratings are an opinion on the relative ability and willingness of an issuer to make timely payments on the specific debt obligations over the life of the instrument. CARE has developed a comprehensive methodology for credit rating of debt instruments issued by banks.

Some of the factors considered in CARE’s rating analysis are described below:

QUANTITATIVE FACTORS

The starting point in reaching a rating decision is a detailed review of key measures of financial performance and stability:

Capital Adequacy

Capital Adequacy is a measure of the degree to which the bank’s capital is available to absorb possible losses. CARE examines the conformity of the bank to the RBI guidelines on capital adequacy ratio. The extent of possible Government support to subscribe to the capital of weak banks to improve the capital adequacy ratio is examined.

Asset Quality

Asset Quality review assesses the quality of the bank’s overall loan portfolio and includes a sector by sector analysis of the loan and guarantee portfolio, as well as inter-bank exposures. The historical recovery rate of annual demands of principal and interest and the bank’s experience of loan losses and write-off/provisions are studied. The percentage of assets classified into standard, substandard, doubtful or loss is examined closely. The portfolio diversification and exposure to troubled industries/areas is evaluated to determine the extent of potential losses. In addition, the bank’s own credit risk norms are examined.

Funding and leverage

The funding mix determines the leverage and the cost of capital. One of CARE’s principal aims in bank analysis is to assess the institution’s ability to finance itself in times of stress. CARE examines the composition of deposits in terms of short term or long term, domestic or foreign currency and also the composition of currencies. The volatility, growth and shift in the composition of the funding pattern is also studied. Overall gearing, interest coverage and their trends are taken as measures of financial risk arising as a result of funding decision.

Liquidity

Liquidity is often the proximate cause of bank failure, while, strong liquidity can help even an otherwise weak institution to remain adequately funded during difficult times. CARE determines the maximum stress which the bank is likely to face and evaluates the internal and external sources available to meet this. Factors examined are the credit deposit ratio, the maturity matching of assets and liabilities, proportion of liquid assets to total assets and the degree to which core assets that are illiquid are funded by core liabilities. The short term external funding sources in the form of refinance facilities from RBI and the inter-bank borrowing limits available are considered. The bank’s CRR and SLR investments are important sources of reserve liquidity.

Earnings quality

Earnings quality reviews cover the performance and risk assessment of each business area; the loan portfolio, guarantees and forex & treasury operations, and ‘non fund based’ activities such as merchant banking and advisory services. CARE focuses on the strength of each major business and its earning prospects. The main indicators used to measure profitability are return on assets, spreads, the expense ratios and the earnings growth rate.

Evaluation of quantitative factors is done, not only of the absolute numbers and ratios, but their volatility and trends as well. The attempt is to determine core, recurring measures of performance. CARE also examines how the bank's performance on each of the above discussed parameters is, compared to its peers. Detailed inter-firm analysis is done to determine the relative strengths and weaknesses of the bank in its present operating environment and any impact on it, in future.

QUALITATIVE FACTORS

Some of the qualitative factors that are deemed critical in the rating process are:

Ownership

An assessment of ownership pattern and shareholder support in a crisis is significant. In case of public sector banks, the willingness of the government to support the bank is an important consideration.

Management quality

The composition of the board, frequency of change of CEO and the organisational structure of the bank are considered. The bank's strategic objectives and initiatives in the context of resources available, its ability to identify opportunities and track record in managing stress situations are taken as indicators of managerial competence. The management's response to the deregulation in the financial sector in terms of setting up specialised subsidiaries and branches to cater to different business segments is studied.

CARE analyses the bank's budgeting process and cost control in terms of their effectiveness. The adequacy of the information systems used by the management is evaluated in terms of quality and timeliness of the information made available to bank managers. The extent of frauds committed in the bank is taken as an indication of the imperfections of the control systems. CARE focuses on the modern banking practices and systems, degree of computerisation, capabilities of senior management, personnel policies and extent of delegation of powers. The track record of labour relations is also examined.

Risk Management

Credit risk management is evaluated through the appraisal, monitoring and recovery systems and the internal prudential lending norms of the bank. The bank's balance sheet is examined from the perspective of interest rate sensitivity and foreign exchange rate risk. Interest rate risk arises due to differing maturity of assets and liabilities and mismatch between the floating and fixed rate assets and liabilities. CARE also assesses the extent to which the bank has assets denominated in one currency with liabilities denominated in another currency. The derivatives and other risk management products used in the past and implication of these deals is also analysed.

Compliance with statutory requirements

CARE examines the track record of the bank in complying with SLR/CRR and priority sector lending norms as specified by the RBI.

Accounting Quality

Rating relies heavily on audited data. Policies for income recognition, provisioning and valuation of investments are examined. Suitable adjustments to reported figures are made for consistency of evaluation and meaningful interpretation.

Size and Market Presence

The fund base and branch network of the bank are taken as important indicators of strength. In a fast changing environment, a bigger bank can meet the competitive challenges from other financial intermediaries due to its economies of scale and wider reach. Also if the bank represents a substantial percentage of the banking sector, its failure would cause severe disruptions for the country as a whole and it is thus likely to obtain government support in times of distress.

All relevant quantitative and qualitative factors are considered together, as relative weakness in one area of the bank's performance may be more than adequately compensated for by strengths elsewhere. However, the weights assigned to the factors are different for short term ratings and long term ratings. The intention of long term ratings is to look over a business cycle and not adjust ratings frequently for what appear to be short term performance aberrations. The quality of the management and the competitiveness of the bank are of greater importance in long term rating decisions.

The rating process is ultimately a search for the fundamentals and the probabilities for change in the fundamentals. The assessment of management quality, the bank's operating environment and its role in the nation's financial system are used to interpret current data and to forecast how well the bank is positioned in the future. The final rating decision is made by the Rating Committee after a thorough analysis of the bank's position over the term of the instrument with regard to business fundamentals.

For Further details please contact at :

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