RATING CRITERIA — BANKS AND FINANCIAL INSTITUTIONS

Introduction: The objective of CRISIL's analysis is to form an opinion as to the types of risks that may affect the relative ability of banks /financial Institutions (FIs) to service interest and repayment of principal on the rated instrument in a timely manner.

The exercise incorporates a review of the strength of the economy, the financial sector and the banking industry. CRISIL also analyses the changing regulatory environment and increased competition arising out of liberalisation. Over the past years, there have been trends of increased liberalisation in the domestic economy and increased deregulation in the financial sector. The opening of the economy and the gradual lowering of tariff barriers have exposed the corporate sector to risks of foreign competition. Some of these risks have been manifested in certain sectors where the domestic industry has been rendered uncompetitive. There has been an increasing blurring of boundaries between the role of banks and financial institutions which is likely to step up competitive pressures in the future. The dismantling of the consortium lending system and the deregulation in the interest rates have presented associated challenges of managing credit risks and asset liability profiles to the domestic financial sector. The move towards enhancing the mark to market for the banking system in a scenario of volatile interest rates has introduced volatility in the earnings of the banking system. CRISIL monitors these trends closely and analyses the impact of these trends on the credit quality of entities in the domestic financial sector.

The entity specific analysis of the riskprofile is done through a qualitative cum quantitative approach, following a structured methodology called 'CRAMEL' model. The relative strengths and weaknesses of each entity as compared to its peer group are evaluated, based on the rating criteria.

The 'CRAMEL' model comprises the following :

⇒ **Capital Adequacy**
⇒ **Resource raising ability**
⇒ **Asset Quality**
⇒ **Management & systems evaluation**
⇒ **Earnings potential**
⇒ **Liquidity/Asset Liability Management**

No one factor has an overriding importance or is considered in isolation. All these six factors are viewed in conjunction before assigning a rating. <u>In addition to the factors which constitute the CRAMEL, the size of the financial entity is also an important parameter.</u> The size of an entity in the financial sector, imparts it the ability to withstand systemic shocks, determine the extent of system support that can be expected for the entity.

CAPITAL ADEQUACY Capital adequacy of an entity provides the necessary capital cushion to withstand credit risks. While assigning a rating, CRISIL analyses the capital adequacy level and its sustainability in the medium to long term. The analysis of capital adequacy encompasses the following factors :

Size of capital: The absolute size of capital imparts flexibility to a bank/FI to withstand shocks and thus, an entity with higher absolute capital is viewed favourably.

Quality of capital (Tier I capital): The proportion of Tier-I capital or core capital of a bank/FI is the primary indicator of the quality of capital. The level of Tier-I capital is given primary importance when assigning rating for capital adequacy. Although, the presence of Tier II capital does provide some cushion in the short to medium term, the Tier II capital needs to be periodically replenished. CRISIL also analyses other issues, like the presence of hidden reserves and the percentage of the investment portfolio marked to market. These issues help in streamlining accounting policy differentials across various entities and have a bearing on the quality of capital..

Flexibility to raise Tier I capital: An entity has the flexibility to raise Tier I capital either through internal accruals or through the capital markets. The ability of the entity to access the capital markets to meet its Tier I capital needs and its ability to service the increased capital base is considered while evaluating the flexibility of a bank to raise Tier I capital. The ability of a bank/FI to support the increased asset base through earnings is an important parameter in assessing sustainability of capital adequacy. An entity which is able to sustain asset growth through internal generation without impairing capital adequacy is viewed favourably.

Growth plans : CRISIL factors the future growth plans of a bank/FI while analysing capital adequacy. The capital adequacy of the entity (although at currently high levels) would be regarded as unsustainable, if it is pursuing a strategy of high growth.

RESOURCE RAISING ABILITY: CRISIL analyses the resources position of the bank/FI in terms of its ability to maintain a low cost, stable resource base. In the domestic context, the resource (funding) composition of banks and FIs is very different. Banks are significantly deposit funded whereas the FIs have to depend on wholesale funds. Although some FIs do raise retail funds, they are at a natural disadvantage (in raising retail deposits) as compared to the banking sector in terms of the restrictions on the minimum tenure and interest rates, the absence of a cheque issuing facility and a relatively smaller branch network. Some of the FIs do have access to significant concessional funding from the government if they are playing a role which is of policy importance to the country. However, in general, the 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 funds from provident funds and insurance sectors; these funds are of a retail origin. Given this basic distinction in funding profiles between banks/FIs, the funding risk profile of banks/FIs is discussed separately.

The following issues are considered while analysing the resources position of a bank:

Size of deposit base: A large deposit base provides stability to the resources position of a bank. The size of deposit base, provides the bank, a critical mass for effectively managing its cash flows and adds considerably to the diversity (in terms of the number of deposits) of the deposit base.

Diversity in deposit base & the geographical spread: The diversity of the deposit base in terms of large numbers of small ticket size deposits, the geographical spread and the optimal rural/urban mix, lend stability to the resources position of a bank. The number of branches and their geographical spread lend diversity to the deposit base of a bank. Thus, a bank with large number of branches, dispersed all over India, and an optimal rural/urban mix is viewed favourably.

Deposit mix: The deposit mix of a bank has an impact on the cost of deposits. A high proportion of savings and current deposits, signify a well entrenched deposit base and lead to a stable and low cost resource base. CRISIL also analyses the trends in deposit mix to form an opinion on the future stability and costs.

Growth in deposits: Accretion to deposits is the main source of funding asset growth, and managing liquidity risk, in banks. CRISIL compares the growth in deposits of a bank with industry trends to make relative judgements.

Cost of deposits: Cost of deposits is a function of deposit mix of the bank, its region of operation and the ability of the bank to attract deposits at lower rates. Banks which have a low cost of resources, not only benefit through higher profitability, but also have a higher flexibility to increase deposit rates, in order to maintain their resources position, in the face of increasing competition.

The relevant issues while analysing the resource position of an FI are :

Diversity of investor base **:** Given the fact that the FIs are predominantly wholesale funded, the diversity of the investor population (both domestic and international) does mitigate the risk profile to a certain extent. FIs which are dependent on a few investors are viewed less favourably.

Funding mix and cost of funds **:** Traditionally, all the FIs enjoyed concessional funding from the Government in the form of SLR bonds. This facility has been progressively withdrawn from the institutions and they have been increasingly accessing market borrowings over the past few years. The mix of funds between the Government and market borrowed funds, is an important determinant of the overall cost of funds for an FI. FIs which still carry a significant proportion of concessional funds on their books will tend to enjoy a cost of funds advantage in the near term.

The funding mix between domestic and foreign currency funding is also examined to determine the overall risk profile. FIs which tend to have a higher proportion of foreign currency funding carry the risk of a foreign currency borrower defaulting on payment obligation and thus exposing the FI to currency risk. This risk assumes significance in the current context, when the economy is slowing down and there is a greater instance of corporate defaults. In case of FIs which have been significantly dependent on foreign currency multilateral funds, the recently imposed economic sanctions would affect their resource raising capabilities.

Retail penetration **:** Some of the leading FIs have started tapping the retail market for bonds and deposits. These funds do impart stability to the funding mix and the trends in raising retail resources are factored favourably into CRISIL's risk evaluation.

ASSET QUALITY: Asset quality of a bank/FI is a measure of the ability of the bank to manage credit risks. CRISIL analyses the 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. Industrial development of the states in the western region, like Maharashtra and Gujarat is relatively higher. Thus, the amount of credit extended in this region is higher than that of other regions. So, even entities with all India presence, tend to show a higher concentration of advances in the western region. However, the banks/FIs with an all India presence have the additional flexibility, due to their widespread branch network, to enhance their exposure to other regions, in case of adverse economic developments in these states. However, the regional banks with limited operations and branch network have lesser flexibility to diversify their advances portfolio and are thus susceptible to adverse economic conditions in a particular region.

Diversity across industries is largely a function of the geographical presence of the banks/FIs and management policy. The industry exposure and single risk concentration is monitored by the Central Bank through exposure guidelines. However, some banks/FIs show a high degree of exposure to certain industries thus making themselves vulnerable to downturns in those industries.

Client profile of the corporate asset portfolio: Credit quality of the corporate portfolio of the bank is an important input in the analysis of asset quality. CRISIL analyses the profile of clients in the asset portfolio to make a judgement on portfolio quality. The ability of a bank/FI to attract better credit quality clients is an important indicator of future credit quality, especially after the dismantling of consortium lending. The size (of capital) of a financial sector entity lends considerable flexibility to the entity to attract larger and better quality clients given its sheer ability to take on larger exposures in its balance sheet. Also, the ability of the entities to attract and retain good quality clients by providing value added services would enhance asset quality in the future.

Quality of Non-industrial lending: Banks in India have an obligation to lend a proportion of their funds to the priority sector which primarily encompasses agriculture and small scale industries. To this extent, FIs are better placed than banks because they do not have any such obligations. CRISIL analyses the credit quality of this non industrial portfolio in arriving at a judgement on the overall asset quality of a bank. The credit quality of the asset portfolio is also indicated by the segment wise NPA levels of the portfolio, indicates the performance of the bank in each segment. This helps in gauging the relative strength of the bank in each of the loan segments. Some of the banks have a higher level of exposure to the trading. These advances provide a comparitively higher yield and also provide diversity due to their small ticket size. The Indian banks have to compulsorily lend 40% of their total advances to the priority sector. Loans to the agricultural sector, small business segments, small road transport operators and small individual housing loans constitute the priority sector. The break-up of the loans within these sectors is an important indicator of the health of the portfolio. The regionwise break-up of these advances is also a good indicator of the quality of the portfolio. e.g. An agricultural loan in an agriculturally prosperous state of Punjab would have a better probability of being repaid as compared to other agriculturally weak states.

Retail consumer loans (primarily vehicle and housing loans) still do not constitute a major portion of the asset profiles of banks and FIs. However, some large banks/FI are strategising towards a Universal Bank strategy and propose to expand significantly in this segment. CRISIL looks at the quality of retail consumer credit growth and its asset quality implications in its final analysis.

NPA levels: The asset quality of a bank depends not only on the credit quality of its clients, but also on the ability of the bank to manage its asset portfolio. The NPA figures at gross and net levels helps in benchmarking the bank/FIs ability to manage their asset portfolio, on a relative scale. While the gross NPA levels are an indicator of the inherent quality of the asset portfolio of the entity and thus the credit appraisal capabilities, the net NPA levels are an indicator of the balance-sheet strength of the bank, The NPA levels also indicate the proportion of earning assets of the bank and the potential credit loss of bank. The proportion of earning assets and the potential credit loss would have a bearing on the future earnings capability of the bank.

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. Thus, the present NPA numbers are not a true indicator of the inherent credit quality of the bank's asset portfolio. Hence, NPA levels alone, cannot be a criteria to assess future asset quality of the bank. Average provisioning including write-offs, over a five year time frame is an indicator of the level of cleaning up done by the banks, over the years, in order to reduce its NPA levels. The amount of provisioning done is also an indicator of the inherent credit quality of the asset portfolio. The average provisioning level and its movement serve as indicators of the credit risk of the portfolio and the expected future write-offs and provisioning, which would further affect the earnings capability of a bank.

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 low seasoning of the lending portfolio. CRISIL closely analyses the pattern and nature of growth. CRISIL studies the entities with higher growth rates more carefully to look at the nature of growth, reasons for growth and its implications on the asset quality. An entity which has grown by attracting good quality clients from its competitors would be viewed more favourably as compared to one which has grown just by increasing its geographical presence or diluting credit criteria.

MANAGEMENT AND SYSTEMS EVALUATION : CRISIL believes that the quality of management can be an important differentiating factor in the future performance of a bank/FI. The analysis of the management is carried out on the following parameters:

Goals & strategies : The future goals and strategies of a bank are evaluated to take a view on the vision of the bank management. The ability of the banks to adapt to the changing environment and their ability to manage credit and market risks, especially in a scenario of increasing deregulation of the financial markets assumes critical importance.

Systems & monitoring: CRISIL studies the credit appraisal systems and risk management systems for managing and controlling credit and market risks at a portfolio level. Significant emphasis is laid on the risk monitoring systems and the periodicity and quality of such montitoring. Most Indian banks face the challenges of enhancing their information systems and quality of information reporting. The degree of acceptance of new systems and procedures in the bank, data monitoring systems and the extent of computerisation within the bank is given significant importance. The level of computerisation is gauged on the basis of the extent of business covered by computerisation, the computerisation in branches and computerisation of money market and forex market desks. CRISIL attaches significance to the operating systems for data capture and MIS reporting in a bank. A bank balance-sheet with a large volume of transactions pending reconciliation, reflects the lack of operating systems in the banks, and is viewed negatively.

Appetite for risks: CRISIL also analyses the bank management's attitude towards risk. A high risk propensity of a management, typically reflects in the higher volatility in earnings in both fund-based as well as non-fund based business. A management with a higher propensity to take risk is viewed cautiously.

Motivation levels of the staff: Employee motivation levels could be a function of remuneration, management involvement and job satisfaction. The motivation level of employees would directly affect the service levels of the bank which is a key success factor in a market driven environment.

EARNINGS POTENTIAL : CRISIL analyses earnings of a bank/FI on the basis of the level, diversity and stability of earnings.

Level of earnings : The level of earnings as measured by return on total assets (ROTA) provides the bank/FI a cushion for its debt service, and also increases the ability of the bank to cover its asset risk. The ROTA is a function of interest spreads, expenses levels, provisioning levels and the non-interest income earned by the bank. The size of net profit is also factored while rating the earnings of the entity.

Earnings of banks/FIs, have been affected due to the volatility in interest rates. Thus, the trends in profitability at gross profit levels is examined over the past years to take a view on the sustainability of earnings. The various elements leading to the profitability like net interest income, non-interest income, expense levels and the provisioning levels are also analysed to take a view on the profitability trends and the sustainability of profits in the future.

Diversity of income sources: Diversity of income sources is an important input in analysing the stability of earnings. Diversity of income sources between various categories of fund based income like industrial portfolio, trade portfolio, retail portfolio, etc. lends stability to the income sources. The banks also diversify their income streams through non-interest income like guarantees, service charges from its retail customers, trading income, etc. The non-interest income provides cushion to the profitability, especially in times of unexpected volatility in interest spreads. Thus, entities which have the capability to provide better value-added services would be in a better placed to improve their fee based income.

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 like bills financing and trading income are viewed less favourably than banks with long term credit relationships with corporates, like cash-credit or demand loan exposures, etc. CRISIL also analyses the composition of the non-interest income, while evaluating the earnings of a bank/FI. The non-interest income also includes income from trading activities, which tend to be volatile. A closer analysis the composition of the revenue streams, helps in taking a view regarding the sustainability of the earnings.

LIQUIDITY / ASSET LIABILITY MANAGEMENT : CRISIL assesses the asset liability maturity profile of the entity to form an opinion on the liquidity risk as well as the interest rate risk.

Liquidity risk: The liquidity risk rating factors the resource strength of the bank and the liquidity support available to a bank in the form of access to call borrowings and the extent of refinance available from RBI. The banks are the primary channel through which retail savings are channeled back into the economy. Thus, the most of the public sector banks having a widespread branch network act as conduits for mobilisation of retail savings. CRISIL views most of the public sector banks favourably on this parameter due to the stable accretion to deposits and the liquidity support available to banks in the form of call money and RBI refinance.

The liquidity position of an FI, is a function of the management policy of maintaining treasury portfolios to meet asset and liability side liquidity demands. However, on account of their significance to the domestic financial sector and their government ownership, FIs enjoy a high degree of financial flexibility which reduces liquidity risks to fairly low levels.

Interest rate risk: The rating factors the volatility of bank/FIs earnings to interest rate changes. CRISIL analyses the asset liability maturity profile of an entity to judge the level of interest rate risk carried by the entity. In the Indian banking system, the interest rate and maturity profile of the assets and liabilities have an inherent mismatch. The floating rate advances portfolio (linked to prime lending rates) and the relatively long duration investment portfolio are funded through short to medium tenure liabilities which exposes the bank to an element of interest rate risk.

FIs do score over banks in this regard due to the wholesale nature of their operations and policies which link the nature of borrowing (fixed/floating) with correspondingly matched lending. On an overall basis, FIs carry relatively lesser interest rate risks as compared to the banks.

Parent support: CRISIL factors the parentage of an entity in the final rating decision. The extent of support factored is a function of the relative size of the two entities, the credit quality of the parent and the strategic importance of the subsidiary to the parent. CRISIL positively factors the systems support for specialised entities in the financial sector, which have a policy role in the national economy.