Rating Methodology - Banks

[In supersession of "CARE's Rating Methodology - Banks" issued in June 2017]

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 Ratings 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:

a) Capital Adequacy

Capital Adequacy is a measure of the degree to which the bank's capital is available to absorb possible losses. It also indicates the ability of the bank to undertake additional business. Maintaining capital adequacy ratios above the prescribed regulatory threshold is critical for a bank. Breaching capital ratios can lead to regulatory action including putting banks under 'Prompt Corrective Action' (PCA) framework, whereby restrictions are put on lending as well as operations of a bank. CARE Ratings examines the conformity of the bank to the regulatory guidelines on capital adequacy ratio. Higher proportion of Tier I (core capital) in the overall capital is viewed favourably. Further, CARE Ratings works out the 'stressed capital adequacy' on the basis of expected erosion of capital arising as a result of factors such as:

- Additional provisioning for NPAs
- Possible losses from restructured assets
- Possible losses from other weak assets

b) Asset Quality

Asset Quality review begins with the examination of the bank’s credit risk management framework. The overall asset quality is assessed by evaluating the sector by sector loan and guarantee exposures. The bank's experience of loan losses and write off/provisions are studied carefully. The percentage of assets classified into standard, substandard, doubtful or loss and the track record of recoveries of the bank is examined closely. The portfolio diversification and exposure to troubled industries/areas is evaluated to arrive at the level of weak assets. Restructured assets in banks total exposure are also taken into account to arrive at the potential NPAs of the bank.

c) Resources

Resource base of the bank is analyzed in terms of cost and composition. Deposits form the core funding source of a bank. Proportion of low cost deposits in total deposits and retail-wholesale deposit mix is examined. Deposit growth rates and their rollover rates are also analyzed. Average as well as incremental cost of funds is examined in the context of prevailing interest rate regime. Ability of the bank to raise additional resources at competitive rates is examined critically.

d) Liquidity

Lack of liquidity can lead to a bank’s failure, while, strong liquidity can help even an otherwise weak institution to remain adequately funded during difficult times. CARE Ratings evaluates the internal and external sources of funds to meet the bank's requirements. The liquidity risk is evaluated by examining the assets liabilities maturity (ALM) profile, deposit renewal rates, proportion of liquid assets to total assets and the degree to which core assets (those that are relatively 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 along with CRR and SLR investments are important sources of reserve liquidity.

e) **Earnings Quality**

CARE Ratings analyzes the composition of income of the bank by segregating it into those generated from fee based and fund based activities. Core earnings are also identified by excluding non-recurring income from total income. Each business area that contributes to the core earnings is assessed for risks as well as for its earnings prospects and growth rate.

Profitable operations are essential for banks to operate as an ongoing concern. Yield on business assets as also on investments are viewed in conjunction with cost of funds to arrive at the spreads earned by the bank. Operating efficiency is also examined in terms of expense ratios. Quality of bank's earnings is also influenced by the level of interest rate and foreign exchange rate risks that the bank is exposed to.

Finally, the overall profitability is reviewed in terms of return on assets and return on shareholders' funds.

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 RATINGS also compares the bank's performance on each of the above discussed parameters with its peers. Detailed inter-bank 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:

a) **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.

b) 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 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 RATINGS 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.

c) Risk Management

The management stance on risk and the risk management framework is examined. Credit risk management is evaluated by examining the appraisal, monitoring and recovery systems and the 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 RATINGS 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 are also analysed.

d) Compliance with statutory requirements

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

e) 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.

f) Size and Market Presence

The fund base and branch network of the bank may have a bearing on the bank's competitive position. While both large and small banks have successfully co-existed in India, in the rapid changing competitive banking environment, the niche strategy of smaller banks against the scale advantages of larger banks would be carefully examined to understand the business model of each bank.

g) Rating of Upper Tier II Bonds and the Perpetual Bonds (under Basel II) and Basel III Compliant Tier-I Perpetual Bonds

The Upper Tier II Bonds and the Perpetual Bonds (under Basel II) are rated at least one notch lower than the Tier II Bonds in view of their increased sensitivity to the bank's Capital Adequacy Ratio (CAR), capital-raising ability and profitability during the long tenure of the instruments. The ratings for these hybrid instruments factor in the additional risk arising due to the existence of the 'lock-in' clause in these instruments. Any delay in payment of interest/principal (as the case may be) following the invocation of the lock-in clause, would constitute an event of default as per CARE's definition of default and as such, these instruments may exhibit a somewhat sharper migration of the rating compared with conventional subordinated debt instruments.

The rating for Basel III Compliant Tier-I Perpetual Bonds is assessed after taking into consideration its key features as below:

- The bank has full discretion at all times to cancel coupon payments.
- The coupon is to be paid out of current year profits. However, if the current year's profits are not sufficient, coupon payment may be paid subject to availability of (i) Profits brought forward from previous years, and/or (ii) Reserves representing appropriation of net profits, including statutory reserves, and excluding share premium,

revaluation reserve, foreign currency translation reserve, investment reserve and reserves created on amalgamation. The accumulated losses and deferred revenue expenditure, if any, shall be netted off from (i) and (ii) to arrive at the available balances for payment of coupon.

- However, payment of coupons on PDIs from the reserves is subject to the issuing bank meeting minimum regulatory requirements for CET1, Tier 1 and Total Capital ratios including the additional capital requirements for Domestic Systemically Important Banks at all times and subject to the restrictions under the capital buffer frameworks
- The instrument may be written-down upon CET I breaching the pre-specified trigger of 5.5% before March 31, 2019, and 6.125% on and after March 31, 2019, or written-off on occurrence of trigger event called point of non-viability (PONV). The PONV trigger shall be determined by RBI.

Any delay in the payment of interest/principal (as the case may be) due to invocation of any of the features mentioned above would constitute as an event of default as per CARE's definition of default.

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.

[Last updated on October 8, 2018. Next review due in September-October 2019]

Disclaimer

CARE's ratings are opinions on credit quality and are not recommendations to sanction, renew, disburse or recall the concerned bank facilities or to buy, sell or hold any security. CARE has based its ratings/outlooks on information obtained from sources believed by it to be accurate and reliable.

CARE does not, however, guarantee the accuracy, adequacy or completeness of any information and is not responsible for any errors or omissions or for the results obtained from the use of such information. Most entities whose bank facilities/instruments are rated by CARE have paid a credit rating fee, based on the amount and type of bank facilities/instruments.

HEAD OFFICE

CARE Ratings Limited

(Formerly known as Credit Analysis & Research Ltd.)

4th Floor, Godrej Coliseum, Somaiya Hospital Road, Off Eastern Express Highway, Sion (East), Mumbai - 400 022.

Tel: +91-22-6754 3456, Fax: +91-22- 6754 3457, E-mail: care@careratings.com

REGIONAL OFFICE

AHMEDABAD 32, Titanium, Prahaladnagar Corporate Road, Satellite, Ahmedabad - 380 015 Tel: +91-79-40265656 Fax: +91-79-40265657	**KOLKATA** 3rd Floor, Prasad Chambers, (Shagun Mall Bldg.) 10A, Shakespeare Sarani, Kolkata - 700 071. Tel: +91-33- 40181600 / 02 Fax: +91-33-40181603
BENGALURU Unit No. 1101-1102, 11th Floor, Prestige Meridian II, No. 30, M.G. Road, Bangalore - 560 001. Tel: +91-80-46625555 / 46625544	**JAIPUR** 304, Pashupati Akshat Heights, Plot No. D-91,Madho Singh Road, Near Collectorate Circle, Bani Park, Jaipur - 302 016. Tel: +91-141-402 0213 / 14
CHANDIGARH SCF No. 54-55, First Floor, Phase 11, Sector 65, Mohali 160062. Tel No. +91-172-4904000	**HYDERABAD** 401, Ashoka Scintilla, 3-6-502, Himayat Nagar, Hyderabad - 500 029. Tel: +91-40-69000500 - 522 Fax: +91-40-40020131
CHENNAI Unit No. O-509/C, Spencer Plaza, 5th Floor, No. 769, Anna Salai, Chennai - 600 002. Tel: +91-44-2849 7812 / 2849 0811 Fax: +91-44-28490876	**NEW DELHI** 13th Floor, E-1 Block, Videocon Tower, Jhandewalan Extension, New Delhi - 110 055. Tel: +91-11-4533 3200 Fax: +91-11-45333238
COIMBATORE T-3, 3rd Floor, Manchester Square Puliakulam Road, Coimbatore - 641 037. Tel: +91-422-4332399 / 4502399	**PUNE** 9th Floor, Pride Kumar Senate, Bhamburda, Senapati Bapat Road, Shivaji Nagar, Pune - 411 015. Tel: +91-20- 4000 9000