

Rating Methodology – Banks

[In supersession of “CARE Rating’s Methodology – Banks” Issued in [October, 2018](#)]

Background

Performance of banks is highly dependent on the overall economic environment prevailing in the country of operation. The Indian banks have witnessed challenging times over the few years with sharp rise in non-performing assets (NPAs), hurting profitability and creating capital constraints which in turn has led to deceleration in credit growth. The government has stepped in to support the public sector banks (PSBs) through sizeable capital infusion and has pushed forward with mega bank mergers in order to strengthen the overall banking system. The Indian banks are the largest provider of credit in the formal financial sector in India with gross bank credit outstanding at ~Rs.95 trillion as at March 2019. The sector is classified broadly into public sector banks, private banks and foreign banks. CARE's rating on banks are an opinion on the relative ability and willingness of these banks to make timely payments on the specific debt obligations over the life of the instrument. The key factors considered by CARE while rating debt instruments of banks 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 as breaching of such benchmarks may 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 analyses capital raising track record of individual bank which indicates the financial flexibility of the bank. CARE Ratings also 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

Rating Methodology for Banks

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-wise exposures of the bank to assess existing and potential level of stress.

The bank's experience of loan losses and write off/provisions and 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.

An analysis of the restructured assets as well as quantum of identified weak assets in banks total exposure are also taken into account to arrive at the potential NPAs of the bank.

c) Resources

Raising deposits, which is the major resource for banks, at competitive cost is the core of banking business. Resource base of the bank is analysed in terms of cost and composition. CARE does an analysis of the franchise built by the bank over the years which helps a bank garner deposits as well as granularity of the depositor base. Proportion of low cost deposits in total deposits and retail-wholesale deposit mix is examined. Deposit growth rates and their rollover rates which indicate stability of the funding profile of a bank are also analysed.

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 liquidity coverage ratio (LCR). 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 analyses 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

Rating Methodology for Banks

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 scenario is critical. In case of public sector banks, the willingness of the government to provide capital support is an important consideration. Level of governance is an important consideration in case of both public and private banks.

b) Management Quality

The composition of the board, frequency of change in the top management team 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 approach towards risk is gauged by understanding their stance in terms of product segments/sectors the bank intends to target and the rate at which it intends to grow such segments.

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.

Rating Methodology for Banks

CARE Ratings focuses on the modern banking practices and systems, degree of digitalisation, 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 established franchise of a bank provides it with a deposit base and reach through its branch network and can have a bearing on the bank's competitive position. Large banks with established franchise tend to gain competitive advantage in terms of access to a stable base of low cost funds and greater geographical reach, whereas small banks typically would either be geographically restricted or would have challenges in ramping up their deposit base necessitating a different approach to its business model.

Various financial ratios considered while analysing banks can be found in the "Financial Ratios – Financial Sector" paper on CARE's website viz. www.careratings.com.

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. 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 hinges on thorough analysis of the bank's position over the term of the instrument with regard to business fundamentals.

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CARE Ratings Limited

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

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