Rating Criteria for Banks and Financial Institutions

Brickwork Ratings' (BWR's) rating process involves a comprehensive quantitative and qualitative analysis of the balance sheet strength of a Bank or an FI (Financial Institutions), along with the operating performance and business profile. This includes comparisons with peers and industry standards, as well as the assessment of the operating plans, philosophy and management.

BWR's analysis integrates a review of the overall economy, financial sector and industry. BWR also analyses the increased competition while considering the evolving regulatory framework. BWR's Risk assessment is based on the analysis of both quantitative and qualitative factors. BWR adopts the CRAMEL model for the rating process. Quantitative factors such as the Capital Adequacy, Resource profile, Asset size, Asset quality, Net Worth, Liquidity, Earnings quality and Profitability of the Banks and FIs, and Qualitative factors such as the Business risk, Management quality, People and Operating environment are analysed. The analysis also considers the market position of the Banks and FIs and comparisons with peers. Based on these parameters, the relative strength and weakness of each entity are evaluated.

Rating Factors

An analysis of the operating environment of the Banks and FIs includes both macro and micro factors, along with the market factors, market position and financial flexibility. The methodology would mainly focus on evaluating the financial strength of the entity based on the entity's cash generation and debt servicing abilities. The analysis is carried out based on the past audited financials and projection of potential asset quality issues and capital raising plans.

BWR uses the CRAMEL model for the rating process:

- **C**apital Adequacy
- **R**esource Profile
- **A**sset Quality
- **M**anagement
- **E**arnings Quality
- **L**iquidity/Asset Liability Management

While the CRAMEL model is used to assess the standalone credit profile of the Bank/FI, the rating also considers the ownership structure of Banks and FIs through a notch-up model based on government support or support from a parent/group. The criteria for these can be found on the BWR website.

Capital Adequacy

Capital Adequacy is a measure of the financial strength of a Bank or an FI in terms of its ability to withstand operational and abnormal losses. Furthermore, considering the regulatory requirement on the minimum capital required to be maintained by Banks and FIs, the Capital Adequacy Ratio (CAR) also indicates the ability of Banks and FIs to undertake additional business. BWR examines the adequacy and quality of capital, gearing and adjusted gearing, and the ability to raise capital to maintain the gearing. The size of the capital provides financial flexibility for Banks and FIs, and their ability to withstand the changing economic/competitive environment. Hence, capitalisation is also assessed against the asset quality of the Bank or FI to assess the cover that the capital provides against possible losses due to defaults in underlying assets.

Resource Profile

Resources are the key raw materials for Banks and FIs, and their ability to garner resources from diverse sources and garner low-cost resources is an important determinant of the quality of assets that they will be able to build in their portfolio and will also be a key driver of their profitability. The diversity of resources is also important to ensure that they will be able to get resources during a liquidity squeeze in the economy. Banks are assessed for the percentage of low-cost CASA that they have and the cost of overall funds, and FIs are assessed for the diversity of the resources, along with the cost of funds.

Asset Quality

Asset quality has a direct impact on the financial performance of a Bank or Financial institution. The GNPA is the measure of the asset quality, but it does not provide full information in isolation. One-year lagged GNPAs are used to adjust for entities growing at a faster pace than the industry. The nature of assets is also used as a proxy for future asset quality assessment with secured products such as home loans on the one end of the spectrum and unsecured loans on the other. Other factors such as the vintage of the portfolio, concentration risk, yields and LTVs of portfolios are considered where appropriate. The experience of the Banks or Financial Institutions with respect to the loan loss, provision/write-off, loan recovery rate, ability to reduce NPAs and extent of weak assets is also factored. For wholesale lenders, the quality of the stressed assets and top 50/100 assets is considered to assess potential asset quality issues in future.

Management Quality

The quality of the management will determine the success of a Bank or Financial institution. The performance of a Bank or an FI is largely dependent on the vision, competence and integrity, and risk appetite of the management. The analysis of the quality of management is based on the experience of the management and their track record in terms of their vision and competence in running the Banks and FIs. The analysis of the management also factors in the overall corporate governance standards in the Bank/ FI. The risk appetite in terms of the exposure to various categories of assets, adoption of technology and responsiveness to competition and growth strategy impacts the performance of a Bank/FI, and this is considered during the analysis for the rating. BWR considers factors related to the adoption of risk management practices and adherence to Basel norms and any observations by the regulators on the bank/FI. Adverse regulatory actions (such as Caution and Penalties, among others) and other developments affecting the Reputation Risk of the Bank/FI also will be factored.

Earnings Quality

The quality of earnings of a Bank or Financial institution determines the ability of the entity to meet debt obligations, and its loan book growth and reserves. BWR factors the composition between fee-based and fund-based activities. The quality of earning, coupled with the costs, impacts the profitability. BWR analyses the track record of the profits, profit margins, growth rate of earnings and components of income and expenses of a Bank/FI. While the Return on Assets (RoA) or Return on Managed Assets (RoMA) is considered for assessment, the trend in the RoA/RoMA and provisioning coverage vis-à-vis peers are important indicators of variability in earnings that can be expected.

Liquidity/ Asset Liability Management

The quality of earnings is also affected by the extent of asset liability mismatch and the resultant volatility in earnings due to changes in the interest rate. A Bank or Financial institution has to be sufficiently liquid to meet payment obligations to depositors and creditors. This calls for sound Asset Liability Management by the Banks & FIs. A liquidity analysis considers the ability of the Banks and FIs to meet their obligations and is very critical for a Bank or an FI to remain as a going concern. The absence of liquidity can lead to the failure of a Bank or FI. BWR examines the mismatch in the tenor of the Banks' or FIs' assets and liabilities. BWR identifies the risk of concentration of the funds, liability structure and future cash flow projections. The extent of deposits, especially the low-cost CASA, and the resultant dependence of a Bank or an FI on market borrowings impacts the liquidity and also the profitability of a Bank or Financial Institution. The liquidity maintained by the Bank/FI during normal times, unutilised committed lines available and quality of securitisable assets provide further liquidity comfort.

In addition to the above factors, the Assets Under Management (AUM) and diversity of product offerings are considered in assessing the ability of the bank/FI to withstand stress in the economy.

These criteria outline the methodology to arrive at the standalone rating of a bank/FI. The rating further considers any support that the bank/FI can get from its parent or group or can be expected to provide to other entities in its group. Additionally, Public sector banks and FIs are assessed for the support they enjoy from the government. In such cases, the standalone rating of the bank/FI gets notched-up, and the extent of the notch-up is driven by BWR's criteria for notching-up the standalone ratings of entities based on parent/group/government support, which can be found on the BWR website.

The rating of the bank/FI detailed here is for senior instruments issued by them. Criteria for rating subordinated/hybrid instruments issued by them in the form of Tier 1 or Tier 2 capital can be found on the BWR website.

The previous version of this document can be found in
https://www.brickworkratings.com/download/Criteria-BanksFinancialInstitutions.pdf

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