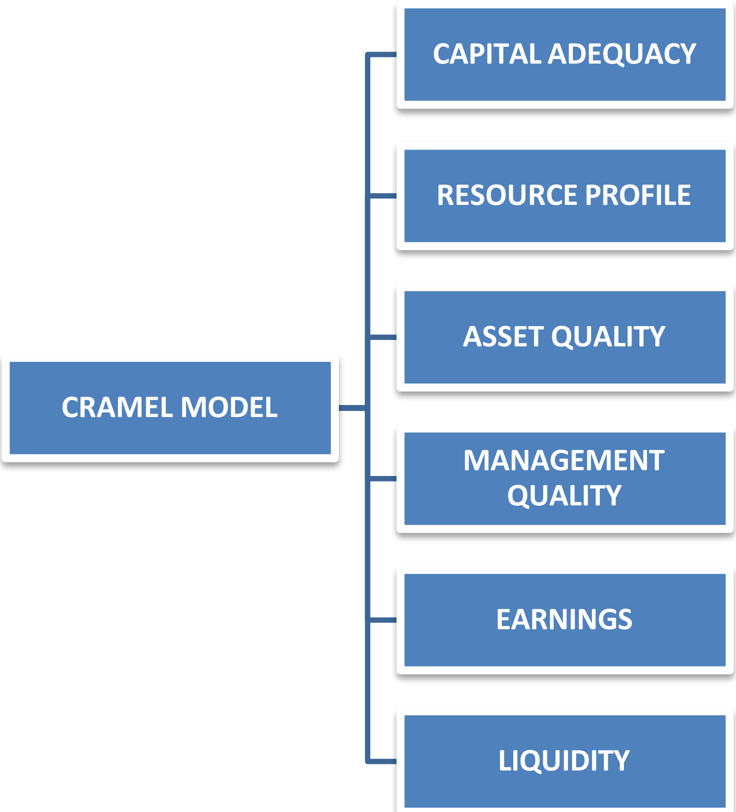
Rating Criteria for Banks and Financial Institutions

Brickwork Ratings (BWR) 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. The banking sector forms an integral part of the economy, hence BWR's analysis integrates a review of the overall economy, financial sector and industry. Banking analysis and rating is performed while considering the evolving regulatory framework.

BWR's Risk assessment is based on the analysis of both quantitative and qualitative factors. This includes comparisons with peers and industry standards, as well as an operating environment. 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.

BWR adopts the CRAMEL model for the rating process. The methodology would mainly focus on evaluating the financial strength of the entity and is carried out based on past audited financials and projection of potential asset quality issues and capital raising plans.



- Capital Adequacy
- Resource Profile
- Asset Quality
- Management Quality
- Earnings
- Liquidity

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 www.brickworkratings.com

Capital Adequacy

The Capital Adequacy Ratio (CAR) regulatory requirement on the minimum capital required to be maintained by Banks and FIs, indicates the ability of Banks and FIs to optimally and effectively cover its risk from operations and undertake additional business. The primary goal of capital adequacy is to ensure that banks have enough capital to absorb losses in the event of financial stress or downturns, protecting depositors, the financial system, and the economy as a whole. It is a measure of the financial strength of a Bank or an FI in terms of its ability to withstand operational and abnormal losses.

The size of the capital provides financial flexibility for Banks and FIs, and their ability to withstand the changing economic/competitive environment. Hence, capitalization 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.

Capital Adequacy Ratio (CAR) = (Bank's Capital/ Risk-Weighted Assets) × 100

Where:

- Bank's Capital includes both Tier 1 (core capital) and Tier 2 (supplementary capital).
- Risk-Weighted Assets are the total assets of the bank, weighted by the level of risk they carry.

A higher CAR indicates a more stable bank, while a lower CAR may signal that the bank is at higher risk of insolvency in the event of financial losses.

CRAMEL Model BWR considers the following ratios while rating the Banks and Financial Institutions. Capital adequacy ratios is analyzed w.r.t the regulatory requirements (as required by BASEL framework), however BWR may look into the other parameters like ability to raise capital in future, risk appetite vs. internal generation of capital while rating an entity.

Capital Adequacy	Common Equity Tier 1
	Tier1
	Total Capital Adequacy Ratio

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 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 (Current Account and Saving Account deposits) 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.

BWR considers the below ratios while rating Banks and Financial Institutions. However other factors like granularity, diversification and concentration of deposit base are also viewed while analyzing the resource profile of an entity. BWR also considers reliance on market borrowing or wholesale funding while reviewing the resource profile

Resources Profile	CASA
	Concentration on Resource profile
	Credit Deposit ratio

Asset Quality

Asset quality has a direct impact on the financial performance of a Bank or Financial institution. The asset quality is measured mainly on GNPA (Gross Non- [performing Assets) however 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.

Banks' diversity of risk profiles while lending is considered and the nature of assets 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 is also considered while reviewing the risk profile. 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.

Asset Quality	Gross Non-Performing Assets
	Asset Growth Rates
	Provisioning Coverage Ratio

- NPA Ratio = (Non-Performing Assets / Total Loans) × 100

  This ratio shows the proportion of loans that are not being repaid on time, providing insight into credit risk.
- Provision Coverage Ratio = (Loan Loss Provisions/ Non-Performing Loans) ×100 These measures how well the bank's provisions cover its non-performing loans.

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

While analysing the bank/FI that has strong, experienced, and prudent management, they are likely to implement better credit policies, ensure better loan monitoring, and take timely action to reduce loan defaults. This can lead to better asset quality (fewer non-performing loans, better loan classification, higher provisions) while affecting profitability and internal generation of capita hence may positively influence the rating of an entity

Conversely, if the bank has weak or poor management or aggressively driven that fails to adequately assess and manage credit risk, make prudent lending decisions, or monitor the loan portfolio effectively, asset quality could deteriorate. High levels of non-performing loans or risky loans could arise from poor judgment, inadequate risk assessments, or mismanagement while negatively affecting other vital parameters; this may in turn lead to rating negatively getting affected

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 earnings, coupled with the costs, impacts 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), Return on Equity (RoE) 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. BWR also considers cost to income and credit cost while analysing the earning capacity of the entity.

ROA= Net Income/Average Total Assets ROE=Net Income/Shareholders Equity

Earnings	Net Interest Margins
	Return on Assets
	Return on Equity

Liquidity/ Asset Liability Management

Liquidity refers to an ability to meet its short-term financial obligations and maintain adequate cash flow to support its operations, especially during times of financial stress. A Bank or Financial institution must 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 it is very critical for a Bank or an FI to remain as a going concern. 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.

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 on 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.

Key Aspects of Liquidity:

Liquid Assets:

- Cash and Cash Equivalents: The most liquid assets, including cash on hand, reserves, and short-term investments that can be quickly converted into cash.
- Marketable Securities: Short-term investments, such as government bonds or other highly liquid securities, that can be sold easily in the market.

Funding Sources:

- A bank/FI's liquidity is partly determined by its ability to raise funds from different sources, such as customer deposits, interbank borrowings, or the capital markets.
- A strong and stable deposit base provides a steady and reliable source of liquidity. Banks that are heavily reliant on short-term, volatile funding sources may be more vulnerable to liquidity risk.

Liquidity Ratios:

- **Liquidity Coverage Ratio (LCR)**: Measures the bank's ability to meet short-term obligations (usually 30 days) using its high-quality liquid assets.
- **LCR= HQLA/Net Cash Flow over 30-day period**
- Loan-to-Deposit Ratio (LDR): Compares the bank's total loans to its total deposits. A lower ratio suggests better liquidity because it indicates that the bank is not overly reliant on loans to fund its activities.

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-v1.1_p.pdf

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