



Criteria for Rating of Banks and Financial Institutions

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BANK

Executive Summary

Banks are systemically essential entities having a unique risk profile. Acuité follows an exhaustive CRAMELO framework to assess the credit facility of banks. The broad parameters of this framework are:

- Capital Adequacy
- Risk-Weighted Assets
- Asset Quality
- Management Risk
- Earnings Quality
- Liquidity
- Operational Environment

This process of assigning credit ratings to banks based on the CRAMELO framework involves assessment of banking operations and taking into consideration the financial profile of the bank, along with other qualitative factors. This is followed by a structural analysis which typically includes an analysis of the asset-liability management, sensitivity of the bank to the external environment and the overall approach of the bank towards mitigating risks. Based on the CRAMELO framework, the risk of a bank comprises the following:

Capital Adequacy

All banks, under the Basel II and Basel III norms, are required to maintain a minimum level of regulatory capital (comprised of Tier I and Tier II capital) as a proportion of the Risk Weighted Assets. Higher levels of capitalisation - especially Tier I enable a bank to better absorb losses and provide stability in banking operations. Thus, apart from the Capital Adequacy Ratio, Acuité evaluates the Tier 1 capital to Risk Weighted Assets (RWA) Ratio and the quantum of Capital Conservation Buffer Maintained by the bank. Acuité also evaluates the indebtedness of a bank vis-à-vis its own funds, with higher indebtedness meaning that the incremental growth in the loan book would have to be supported by increasing reliance on equity as a means of finance. While assessing a bank's capital levels and adequacy of the same, Acuité also evaluates the expected growth trajectory, outlook on asset quality, and ability of the bank to raise additional capital (Tier I and Tier II) in the short/ medium term.

Risk-Weighted Assets

While a bank's asset quality indicators measure its existing delinquency profile, the Risk Weighted Assets measure the propensity of such delinquency occurring in the first place. Acuité evaluates the Risk Weighted Assets to Total Exposure (all fund and non-fund-based exposures) ratio. This indicates the average risk weight associated with the bank's assets and off-balance sheet exposures, enabling to ascertain the quality of assets which are yet to default.

Asset Quality

A study of the delinquency levels in the bank's asset portfolio, composition of assets into standard, sub-standard are some of the parameters that help evaluate a bank's ability to manage credit risk. It is also important to study the relationship between growth in assets and NPAs to ascertain whether the reduction in the GNPA ratio is due to an actual reduction in GNPA or higher growth in assets. Acuité also evaluates the levels of geographical and sectoral diversification in the loan books to ascertain the degree of risk a bank would be susceptible to in case of adverse economic or regulatory changes in a sector or region. Further evaluates the segment-wise NPA and advances levels to understand the composition and performance (revenue/profit) of the loan segments based on size, sector, geography, especially for public sector banks that are required to lend to priority sectors areas. To understand the quality of lending to the corporate sector, Acuité takes into account the credit quality of the top loan exposures, along with concentration in the loan portfolio. A bank's ability to attract and retain high credit quality corporate borrowers is key to ensuring stable and healthy asset quality going forward. Acuité also evaluates a bank's provisioning and write-off policies, risk management practices.

Further, to develop a holistic view of the asset quality of the bank, Acuité believes that the rate of migration in the asset quality is an indispensable parameter to be evaluated. To this end, Acuité evaluates the Slippage Ratio of the bank's assets, defined as a ratio of Fresh Accretions to the Gross NPA divided by the total standard assets at the beginning of the year.

Acuité evaluates the quantum of priority sector exposure by factoring in the risk diversification strategies adopted to mitigate high credit risk.

Management

Management Risk is evaluated at two levels. Firstly, it is a function of the competence and integrity of the top management. Secondly, it is a function of the checks and balances put in place to account for fraud prevention, supervision and oversight within the bank. Acuité appraises the management of the bank on the following parameters:

- Competence

Competency of the management is assessed based on the management's credentials, organisation structure, performance track record, strategies employed in response to environment changes and finally impact of the strategy implemented on the performance of the company.

- Integrity

Integrity of the management is assessed based on the track record of the management in adhering to statutory requirements, level of disclosures, transparency in reporting and analysis, litigation and related matters. Management, for this purpose, includes senior management of the company, directors and promoters.

- Risk Appetite

Risk appetite of the management is an important parameter in the evaluation of management risk. It is ascertained based on the tendency of the management to enter riskier/ newer business segments, exposure to risky segments in the past and management philosophy for mergers, acquisitions and aggressive growth plans.

- Corporate Governance Structure

Acuité also believes that quality corporate governance is the key towards effective management of a financial institution. It facilitates compliance and enables the bank to better identify frauds, misappropriations and other personnel-related operational issues.

- Accounting Quality

Acuité lays much emphasis on accounting quality. The auditor's report, changes in auditors, accounting policies, periods as also comments of auditors are considered while arriving at the rating.

- Systems & Procedures

Acuité believes that adherence to the laid-down procedures and carrying out the transactions in line with the procedures and systems is an important aspect governing the operations of a bank. Accordingly, the control and monitoring mechanisms of the bank are also factored in while arriving at/ assigning the rating.

- Regulatory Compliance

Despite liberalisation, the banking sector continues to be a highly regulated industry. Thus, the level of compliance with RBI guidelines, maintaining daily and fortnightly balances in the form of Cash Reserve Ratio, Statutory Liquidity Ratio and meeting other regulatory requirements are parameters that are evaluated by Acuité.

Earnings

Earnings is a function of the operating efficiency. Evaluation of the quality of earnings is not only treated as a return variable but also evaluated as a cost variable. Acuité adopts a three-pronged approach to understanding the Earnings Quality of a bank:

- Profitability and return ratios

These ratios measure the efficiency and loan pricing ability of the bank and compute the pace and yield that help generate returns. Acuité analyses several ratios, including Net Interest Income (NII), Net Interest Margins (NIM), Interest Spreads, Return of Assets etc., to ascertain profitability and return levels.

- Operating Expenses as a Proportion of Total Assets

This ratio measures the operating efficiency of the bank by analysing the trend in operating expenses with a rise or fall in AUM. In well-managed banks with an increase in scale of operations, the ratio should ideally decline with the realisation of economies of scale.

- Ratio of Non-Interest Income to the Total Income

This ratio is aimed at measuring the fee-based income as a proportion of the total income generated by a bank. Typically, fee-based income is less risky than interest income for a bank, as the former is generated without the fund outflow for the purpose. Nevertheless, it is important to consider the amount of development as a proportion to average non-fund-based commitments. Acuité also evaluates the investment income to total income ratio. This ratio is aimed at understanding the proportion of earnings from investments after accounting for mark-to-market adjustments. A higher ratio, to a limited extent, may indicate the risk appetite and business development efforts of the bank.

Liquidity

Acuité assesses the liquidity profile of financial sector entities based on the mismatches in the asset liability maturity profile, availability of steady state liquid assets, and the management's philosophy regarding its liquidity management.

Banks have a highly stable liquidity profile given the steady access to retail deposits. Most banks in India have a sizeable proportion of low-cost current account and savings account deposits as well as retail term deposits, which are highly granular and relatively sticky in nature. Hence, the assessment of the deposit profile is a critical aspect of its credit risk assessment. In addition, the assessment takes into account various liquidity support mechanisms for the banking sector, such as access to liquidity through call money/repo markets, refinance limits from various institutions etc. Additionally, as per the Basel III framework on liquidity standards, banks are required to maintain a liquidity coverage ratio of 100% i.e. high-quality liquid assets (HQLA) should be equivalent of 100% of the net cashflows over the next 30 calendar days (as defined in the RBI guidelines). The excess SLR holdings of a bank (over and above the statutory requirements) can also be a source of comfort during any sudden liquidity requirements.

For FIs, the assessment includes the availability of a fairly liquid investment portfolio which can be accessed quickly to meet any unforeseen funding requirements. The ability of FIs to mobilise resources from the market also enhances their liquidity profile and is factored in while assessing their liquidity profile.

Operating Environment

Acuité also evaluates the overall operating efficiency of the bank and its ability to gain from economies of scale by evaluating the operating processes. Acuité evaluates the bank's performance on four fronts:

- Scale of Operations and Branch Spread

Acuité believes that sustaining a healthy earning profile along with a robust asset book depends on the bank's ability to diversify sources of cash flow. One of the key indicators is the geographical spread of operations. Acuité also evaluates the benefits derived from economies of scale by ascertaining the decline in operating expenses as a proportion of the spread.

- Product Spread

Active product development and a wide product spread are vital to ensuring a healthy earning profile and maintaining a competitive edge. In a changing business environment, a bank's ability to differentiate its products is the key to maintaining healthy returns on working funds. To this end, Acuite evaluates the exposure concentration of products and the bank's product innovation skills. Thus, the history of active product innovation and market development activities undertaken add significant buoyancy to the operating risk profile by enhancing stability in the growth of future cash flows.

- Technological Prowess

The technological prowess of a bank lies in embracing the latest in technological developments with an aim to limit costs, increase market penetration and enhance customer satisfaction. Using the latest technologies coupled with an efficient Core Banking System and advanced services like RTGS and Mobile Banking enable banks to limit turnaround time, improve margins on transaction fees and exponentially enhance profitability per employee. Further, these guarantee a higher level of customer satisfaction and improve the customer retention rate too. Preparedness to handle the cyber security breaches and threats.

- Human Resource Management

The quality of a bank's service offering is determined by its human capital. With increasing competition in the sector, emphasis is to be laid on customer experience and having efficient processes in workflow management. Acuite believes that the bank's recruitment policy and its human resource development practices, along with the overall management of organisational culture, are important aspects in maintaining a healthy operating risk profile.

Market Risk Profile

The market risk profile of a bank is evaluated at two levels. Acuite first ascertains the bank's exposure to systematic risk factors and subsequently evaluates its ability to access the market, raise resources and manage market risks.

- Exposure to Systematic Risk Factors

Systematic risk factors are macroeconomic factors that affect the entire economic system at large. It is thus impossible for a commercial entity to avoid exposure to systematic risk. At the same time, systematic risk factors may have a differential impact on different borrower classes. However, exposure to these factors can be managed in such a way that the overall impact on the bank portfolio is minimal. Thus, measures the bank's exposure and ability to manage systematic risk in its portfolio by assessing the following parameters:

- a. Assets under Management and Concentration in the Loan Book

Banks with large loan books with limited concentration are in a better position to guard against their exposure to systematic risk. Also, banks with large AUMs and diversified portfolio are less likely to be adversely affected by systematic risk factors

as the overall probability of default in the portfolio will be much lower. However, Acuité also notes that banks with large AUMs having large exposure to a single party are more exposed to systematic risks, as the ability to manage the impact of systematic risk factors significantly diminishes. Exposure to a wide range of financial products and catering to different types of financing requirement, limits revenue concentration from a borrower profile.

b. Nature of Contingent Liabilities and Assets

Banks, through bank guarantees, co-acceptances, underwriting and merchant banking operations, derivatives exposures and other financial products, often take off-balance sheet exposures on their books which are often triggered by macroeconomic and systematic factors. Thus, Acuité conducts a detailed evaluation of the gamut of contingent assets and liabilities held by the bank to better assess the probability of these contingencies arising in the short to medium term.

c. Gap Assessment

Systematic risk factors of a bank are its exposure to interest rate risk. This is evaluated by assessing the Rate Sensitive Gap (RSG) of the bank considering the current interest rate cycle. RSG is defined as the difference between the Rate Sensitive Assets (RSA) and Rate Sensitive Liabilities (RSL).

- i. Floating Rate versus Fixed Rate Lending: Acuité believes that banks with maximum exposure to floating rate assets tend to have higher degree of exposure to interest rate risk. Generally, in times of inflation and high-interest-rate cycles, floating rate assets improve the profitability of a bank.
- ii. Re-pricing & Refinancing Risk: While a bank may be able to maintain a healthy liquidity profile in case of assets with shorter maturity as compared to liabilities, it will be exposed to a higher degree of interest rate risk. Such risk is more pronounced when interest rates are declining. When rolling over assets or sanctioning of new loans, the bank's issuing rate may decline, whereas the cost of borrowing shall continue to remain fixed because of the long maturity of bank debt. On the other hand, a shorter maturity of its debt as compared to its assets in an environment of rising interest rate exposes the bank to a high degree of refinancing risk - wherein the cost of borrowing may increase substantially and adversely affect its Net Interest Margin.

d. Systemic Importance and Government Support

The banking sector is a systemically important economic intermediary. Therefore, while the RBI regulates the Indian Banking system, it also extends necessary support from time to time in the form of Liquidity Adjustment Facility (LAF) and Marginal Standing Facility (MSF), operational support and regulatory assistance. The degree of support varies with the scale, nature, size and scope of operations. Further, the extent of government holding, and the regional and socio-economic importance are other factors that play a major role. Acuité believes that a healthy degree of

support from the government on these grounds further strengthens the credit risk profile of the bank.

e. Cost of Borrowing, Resource Mobilisation Ability

A bank's resource mobilisation ability is a function of its cost of borrowing, ability to raise resources from the market and availability of unutilised lines of credit. Expanding the Current Account & Savings Accounts' portfolio (CASA) is one of the ways to raise low-cost high-volume financial resources for banks and reduce the weighted average cost of funds. Acuite ascertains the trend related to the growth in the bank's CASA over a period and analyses the CASA Ratio of the bank.

B. Business Development, Business Channels

Acuite believes that growth in the scale of operations is driven primarily by two factors:

a. Market Presence and Distribution Network

The geographical distribution and the network of branches, marketing strategies and growth in CASA are key factors that determine the bank's ability to expand business operations in the short to medium term. However, the maintenance of a vast distribution network is typically associated with higher selling and distribution and fixed costs for the bank. Acuite therefore evaluates the expansion strategy of the bank in the light of its cost-effectiveness and economies of scale.

b. Customer Relations, Service Standards and Fair Practices

In a highly competitive business environment, adherence to service standards and healthy customer relations is imperative to maintain a competitive edge. Therefore, Acuite also evaluates the grievance redressal systems, adoption of technology-enabled processes and other operating processes to assess the overall quality and service standards of the bank.

Treatment of Banks' Additional Tier I (AT1) Bonds under Basel III

One of the key differentiators of Basel III regulations vis-à-vis the previous versions has been its high emphasis on 'quality of capital' held by banks / institutions besides the 'quantity of capital'. The presence of several instruments in the bank's capital base with differentiated loss absorption characteristics has made it imperative that the rating of these instruments factor in these differences.

One of the key instruments for augmenting the capital base of banks/ institutions is the AT1 Bonds (Additional Tier 1 Bonds). An AT 1 bond is essentially a hybrid instrument with higher loss absorption characteristics (i.e. higher risk to investor) vis-à-vis other Tier 2 instruments such as Subordinated Debt instruments. The term 'hybrid instrument' indicates that it has attributes of both equity and debt. From an investor standpoint, the characteristics of these bonds are similar to Tier 2 bond instruments as long as the issuing bank's financial and capital position is at healthy levels; however, in case of a sharp deterioration in their performance (such as reduction in capital adequacy below certain thresholds), the issuing bank has the option of

skipping the payments due under these bonds without affecting its going concern status.

The three broad characteristics of AT1 bonds which differentiate these instruments are:

- 1) Discretion in coupon payment
- 2) Thresholds for likely coupon payment
- 3) Principal Loss absorption

The presence of these additional risk factors makes these bonds attractive "yield kickers" for the investors seeking slightly higher yields (albeit by assuming higher risk). The key point to be noted is that breach of capital adequacy triggers below certain levels (pre-specified triggers) magnifies the risk of non-servicing/ write down in respect of AT1 bonds. The concept of PONV (Point of Non-Viability) is also relevant here. PONV will be decided by the regulator bank as the point at which the operations of the bank become unviable unless it effects a write down of the bonds / conversion to equity/ additional capital infusion.

Against the above background, Acuité assesses the risk associated with AT1 bonds differently from other regular bonds issued by the same issuer. Usually, these bonds are rated between 1-2 notches below the ratings assigned to the regular bond instruments issued by the bank to factor in the higher risks of both interest and principal losses. The extent of notch down will be limited for stronger banks with a robust capital position, and importantly, those who also have the demonstrated ability to raise equity capital from its shareholders. This may also cover the public sector banks that have been supported significantly by the Government of India through consistent capital infusion which has helped the latter to tide over longer high NPA cycles in the past. Clearly, the notch down needs to be of a greater extent for relatively weaker banks, particularly in the private sector whose capital position is uncertain due to asset quality risks. The notch down is linked to the capital buffers available vis-à-vis the regulatory thresholds in case of additional stress scenarios with regards to asset quality and also factors such as management's stance on maintaining the buffers over the regulatory levels through timely mobilisation of equity capital.

Acuité may also adopt a different notch down for AT1 bonds in banks where senior bonds are in the same rating levels, based on its assessment of the differential risk in terms of asset quality, profitability and therefore capital stability. The current / expected performance of the banks across the various parameters like profitability, asset quality, fund raising plans and more importantly, the impact of these on capital adequacy levels, i.e. CET 1 & Tier 1 levels, are guiding principles in this regard.

It may also be noted that the equity-like characteristics associated with AT1 instruments impart a moderately higher volatility to the ratings of AT1 bonds as against the ratings of regular Tier II Bonds. Whenever there is a significant deterioration in the financial performance of the bank which typically involves increased pressures on asset quality and profitability, a rating action on senior Tier II bonds may be followed by a stronger action on AT1 bonds. The risk of default on AT1

bonds increases in an accelerated manner for a bank whenever there is an unexpected stress on asset quality, along with an inability to raise capital in a timely manner.

Acuité, however, will incorporate its expectation of strong support from the Government of India in the AT1 bond rating criteria for public sector banks. Acuité has noted that there has been no incidence of default in AT1 bonds issued by these banks since the adoption of Basel III, despite the continuing high level of stress on banking sector asset quality. While the standalone performance parameters of some of these banks have been severely impacted due to a high level of loan provisions and write-offs, consistent capital infusion over the last few years has enabled them to mostly keep their capital adequacy above the minimum levels. It has also been observed that wherever banks were under prompt corrective action (PCA) with a potential risk of non-payment of coupons for AT1 bonds, the latter were prepaid through the available call option. While many market investors understand the inherent risks in such hybrid debt instruments, any default on them for public sector banks may build a perception of sovereign default. Therefore, Acuité will take into account a significant expectation of support even for AT1 bonds for government banks while applying the corresponding rating criteria.

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