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PARAMETERS OF RATING OF INDIAN COMMERCIAL BANKS – A CRITICAL ANALYSIS

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ABSTRACT

Ranking is a universally accepted benchmark of performance, given by an independent third party after objective analysis of commercial banks. There are many national and international rating agencies that give rankings to commercial banks. However the parameters used for ranking differ from one rating agency to the other. In this paper a comparative analysis has been carried out among the parameters used by various rating agencies. The comparative analysis has revealed that the parameters are based on the broad categories of CAMEL framework. However, there are differences in the use of parameters within these broad categories. The most commonly used parameters have been highlighted.

KEYWORDS

Banking, India, Commercial Banks, Rating Agencies.

INTRODUCTION

Rating provides a universally accepted benchmark of performance by independent and objective analysis. Ratings are usually considered to be unbiased, as are given by independent rating agencies. The idea behind publishing ratings is to provide an opportunity to benchmark once performance with its competitors and peers (Toprankingsindia 2007). The rating agencies evaluate various companies on the basis of parameters. However the parameters differ from one rating agency to another. Such as, Standard & Poor rate the banks on the basis of economic risk, industry risk, corporate structure, management structure, accounting & financial reporting, credit risk & its management, liquidity, capital, earnings, profitability, asset composition and asset quality of the banks. On the other hand, Moody rates the banks on the basis of capital, asset quality, earnings, liquidity, market leadership, risk management, ownership structure and so on. The parameters can be statistical parameters like capital adequacy, liquidity, profitability etc. or non-statistical parameters like management capability, ownership structure, and concentration of risk.

A review of literature has been carried out to understand the rating parameters of commercial banks.

LITERATURE REVIEW

It is found that there are many research agencies which give ratings to the commercial banks. The rating parameters of some of the rating agencies have been discussed in this section.

Fitch rating (2004) has emphasized that to rate a bank one needs to understand the business of the bank, the risks inherent to the business, the objectives of its management, the environment it operates in and the most likely future development of its business. Fitch has based its analysis on a number of quantitative and qualitative factors. The major criteria for rating are Risk management, Funding and liquidity, Capitalization, Earnings and performance, Market environment, Diversification of business and franchise, Management & strategy and Corporate governance.

Unlike the Fitch rating, Moody (2007) focuses more on statistical factors for ranking. The statistical parameters are Capital, Asset quality, Earnings and Liquidity. In respect of Earnings, Moody has considered pre-provision pre-tax income to be the most relevant factor. It has used 'pre-provision income minus preferred dividends minus consumer net charges offs to risk weighted assets plus securitized assets', 'return on risk weighted assets plus securitized assets', 'non interest expenses to net interest income plus non-interest income' and 'net interest margin' ratios for analysis of earnings of commercial banks. For the assessment of asset quality, it has used 'non-performing assets to tangible common equity plus loan loss reserves', 'non performing assets to pre provision profits and provisions to pre provision profits' ratios. The capital adequacy parameter has been evaluated by 'tangible common equity to risk weighted assets plus securitized assets' ratio and for liquidity position it has taken 'net cash capital position at bank level', 'core deposits to loans', 'net short term position at bank holding company level' and 'double leverage ratio'. Moody considers that size of the bank is an important parameter of ranking. The size has been assessed by total assets size. Similar to the Fitch ratings, Moody has stated that the non statistical factors play a key role in determining ratings. The non statistical parameters examined are market leadership in lines of business, risk appetite, monitoring and control, management's reaction to shareholder pressure for earnings per share growth and ownership structure.

Standard & Poor (2007) have emphasized that both quantitative and qualitative parameters are important for rating of banks. Under quantitative parameters Profitability, Asset quality, Liquidity and Capital are the major parameters. The Profitability has been estimated by revenues, net interest income, non interest income, non interest expenses, net operating income before loan loss provisions, net operating income after loan loss provision, loan loss provisions, pretax profits and net income with relation to average assets, risk adjusted assets and revenue. The liquidity has been estimated by the 'total deposit to total liabilities', 'loans to customer (core) deposits', 'loans to assets' and 'net inter-bank deposits to total liabilities' ratios. The capital adequacy is estimated by 'adjusted common equity to assets', 'adjusted common equity to risk assets', 'adjusted common equity to loans', 'double leverage (parent company equity investments in subsidiaries divided by total consolidated shareholders' equity)', 'equity plus loans loss reserves to loans', 'tier I equity to regulatory risk assets', 'adjusted total equity to assets', 'adjusted total equity to regulatory risk assets' and 'dividend payout ratio'. In respect of asset quality the parameters are 'loan loss provision to average loans', 'net charge-offs to average loans', 'loan loss reserve to gross loans', 'loans loss reserve to risk assets', 'net npa to net loans' and 'loans loss reserve to NPA'. The non statistical parameters taken by standard & poor are ownership structure of banks, bank's market shares in key businesses, diversification of business, capability of management team and its strategy, the accounting principles used, and differences from United State's Generally Accepted Accounting Principles.

Besides the ranking parameters of international rating agencies, some Indian rating agencies have also been studied. The Business India (2004) has ranked the commercial banks on the basis of Capital adequacy, Resources Deployed, Asset quality, Management, Earnings quality and Liquidity. Business Standard Research Bureau (BSRB) (2004) for has ranked the banks on the basis of five broad indicators- Profitability, Safety, Productivity, Efficiency and Growth. For ranking of banks, the Business Today- KPMG (BT-KPMG) (2007) has divided the parameters into three broad categories- Growth, Size and Strength. Each category has a set of parameters making total twenty-six parameters. Business World (BW) (2006) has divided the ranking parameters of banks into six broad groups namely, Profitability, Efficiency, Safety, Size, Valuation and Growth. Financial Express – Ernst &Young (FE&EY) (2007) have taken five major categories of parameters namely Strength and Soundness, Growth, Profitability, Efficiency/Productivity and Credit quality. Six sub-criterions have been taken within each of the major criteria. Top Rankings India (2006) has ranked the banks on thirty-four parameters. These thirty-four parameters have been put under five functional categories: Operational parameters, Profitability parameters, Credit efficiency parameters, Per-rupee parameters and Productivity parameters. Indian Banks Association (2006) publishes group-wise information on major performance indicators of scheduled commercial banks. The key performance indicators for public sector banks and private sector banks are as Total Assets, Deposits, Investments, Advances, Non-Performing Assets (Gross and Net), Interest Income, Other Income, Total Income, Interest Expenditure, Operating Expenditure, Total Expenditure, Operating Profit, Provisions and Contingencies, Net Profit, Credit-Deposit Ratio, Investment-Deposit Ratio, Spread to Total Assets, Operating expenses to total expenses, Return on Assets, Capital Adequacy Ratio, Net NPA to Net Advances, Business and Profit per employee .

The Reserve Bank of India has used six key parameters for rating of Indian banks. These are called CAMELS rating parameters, where C stands for Capital Adequacy, A stands for Asset Quality, M stands for Management, E stands for Earnings performance, L stands for Liquidity and S stands for Systems. The key parameters under the CAMEL rating parameters are capital to total assets, capital minus estimated losses to total assets, delinquent loans to total loan, net charge offs to average loan, non earning assets to total assets, operating expenses minus provisions for loan losses and interest expenses to average assets, net income before statutory reserve transfers to average assets and net income after transfers to average assets.

From the review of literature it emerges that there are large different parameters used by different rating agencies. The objective of this paper is to carry out a comparative analysis of parameters employed by different rating agencies and to critically analyze the parameters.

COMPARATIVE ANALYSIS OF PARAMETERS

A comparative analysis of parameters has been carried out as shown in Table 3.1 to Table 3.7. The frequencies of parameters have also been calculated in the tables.

It could be observed from the comparative analysis that for capital adequacy the Capital Adequacy Ratio i.e. Capital to risk weighted assets ratio is the most commonly used ratio. The Reserve Bank of India has used its alternative 'capital minus estimated losses to total assets' ratio which shows a more appropriate picture of capital adequacy after deduction of estimated losses. The S&P has used 'adjusted total equity to assets ratio' along with the capital adequacy ratio. S&P's 'equity plus loan loss reserves to loan' ratio is also a slight modification of the capital adequacy ratio since in numerator it takes capital and in the denominator it has the loan which is the major asset for commercial banks. The debt equity ratio taken by Business India and S&P shows the leverage position of the bank. However since banks are in the business of borrowing and lending, the debt equity ratio of banks might not reveal much about the capital adequacy. 'Double leverage' ratio has been used by Moody and S&P. The 'Tier I equity to regulatory risk assets' ratio has been used by only S&P. The 'dividend payout ratio' has also been used by the S&P for capital adequacy.

Regarding the asset quality it has been observed that 'net NPA to net advances' is the most frequently used parameter. However Business India has not used this parameter and in place it has used parameters that are related to investments. Moody has used three different parameters 'net NPA to total assets', 'NPA to pre provision profits' and 'provisions to pre provision profits'. These three parameters present effect of NPAs on the assets and the profits of the bank. Hence these parameters are the leading indicators of asset quality while 'net NPA to net advances' is a lagging indicator because it presents the past picture and nothing about the future. The three parameters used by the Reserve Bank of India namely, 'delinquent loans to total loans', 'non earning assets to total assets' and 'net charge offs to average assets' are also leading indicators of asset quality. The parameters used by BSRB, BT-KPMG, BW and FE&EY are all lagging indicators because they present only the past position of NPAs. Business India has taken only the investments related parameters.

For the analysis of the management quality 'operating profit per employee' is the most frequently used parameter. However Fitch ratings, Moody and S&P have used some non statistical parameters for analysis of management quality and management strategy. Business India, BSRB, BT-KPMG, BW and FE&EY have used total income per branch and per employee and business per employee and per branch parameters.

For analysis of earnings 'return on assets', 'return on equity' and 'net profit margin' are with the highest frequency. The other frequently used parameters are 'net profit margin', 'net interest income to average assets', 'net interest margin', 'spread to assets', 'non interest expense to total income' and 'cost to average assets ratio'. BSRB has used 'staff expenses to operating expenses ratio' which shows the expenditure on employees. Huge number of employees has been a major problem of public sector banks. BSRB and BT-KPMG have used 'non interest income to gross income' which indicates the fee based income earned by the bank. Fee based income is a more stable and less risky kind of income for banks. The Fitch Rating examines earnings and performance of banks on the basis of the historical trend of a bank's earnings performance, the stability and quality of earnings and its capacity to generate profits, earnings for each of the bank's business lines, Net interest income, Non-interest income, Non-interest expenses and Provisioning levels. S&P have taken 'net profit before loan loss provisions' and 'net profit after loan loss provisions' which show the profitability after provisioning for NPAs. It shows the amount of earnings blocked into the provisions. The net income has been further analyzed as interest income and non interest income.

It has been found that the 'credit-deposit ratio' is the most frequently used parameter of liquidity. This ratio indicates the amount of money landed as compared to the deposits with the bank. A very high ratio would indicate a difficult liquidity position. The other two common parameters are 'liquid assets to total assets' and 'borrowings to deposits' ratio. Liquid assets to total assets ratio shows the actual liquidity position of the bank and borrowings to deposits ratio shows the amount of deposits financed by the borrowings. BSRB has taken demand and savings deposits to total deposits ratio because demand and saving deposits are most important from liquidity point of view. Higher the amount of these two kinds of deposits, higher is the requirement of liquidity. S&P have taken 'total deposits to total liabilities' ratio for liquidity which shows the portion of deposits out of total liabilities. Higher this ratio, higher would be the requirement of the liquid assets. S&P has also taken 'net inter bank deposits to total liabilities' ratio which shows the amount of inter bank deposits out of total liabilities. A high amount of inter bank deposits would indicate a lesser liquidity risk. The Business India has used the asset liability mismatch technique for assessment of liquidity risk.

Business India, BSRB, BT-KPMG, BW, FE-E&Y, Moody and Indian banks Association have used certain absolute parameters for measurement of size of the operations. The most frequently used parameter is Total assets. BSRB, BT-KPMG and FE-E&Y have used some growth parameters like advances growth, investments growth, deposits growth and net profit growth.

FINDINGS

Comparative analysis of parameters in the above section reveals that there are following points which need attention in selection of parameters:

- The emergence of retail as the business of the future has necessitated almost a complete review of the way Indian banks have traditionally been evaluated. Specific segments such as retail assets, fee-based services and delivery channels require to be managed with an active strategy for 'customer acquisition' and 'customer retention'. These strategies require measurement in a manner that extends beyond CAMEL and stand-alone non-financial measures.
- Banks are basically leveraged institutions and leverage increases the volatility of asset depreciation. So earnings are the primary line of defense against losses. There is a need to focus on well diversified income stream. Earnings from non-fund based services like credit guarantees, L/Cs, cash management, logistics management, tax collection etc. are more permanent and involve less amount of credit and market risk. On the other hand, for earning interest income and treasury income bank has to bear credit risk and market risk respectively.
- Besides, increasing the revenue another way to increase profit margins is, to reduce the cost of operations. A major chunk of operating cost in Public Sector Banks is the staff cost, also called establishment cost. Its significance in performance of a bank has also been recognized by RBI in its Report on Restructuring of Weak Banks, Oct 1999. But the breakup analysis of operating cost is not considered in most of ratings.
- In the above ratings non-performing assets have largely been taken in comparison with total assets or net advances. It reveals a post-mortem picture. It is required to measure the chances of future increase in NPAs. So instead of NPA ratios, the loan segmentation by industry sector and by large relationship or by individual loan exposures would be better predictors of future asset quality problems. The rating should also try to anticipate the increase in future credit expenses (i.e. provisions and expenses related to recovery) with declining loan quality or vice-versa.
- Another important factor in the analysis of asset quality is credit risk concentration. Credit risk concentration is measured by relating a volatile loan category to capital. It should be tried to ascertain what would happen to core earnings (and possibly to capital) if a bank needed to write-off several of its largest loans.

- As noted in most of the ratings, absolute size is not a direct driver of the rank. However, it is found that size is often correlated with other, more qualitative factors that are important to our ratings. For example, size can be correlated with business diversification, broader geographical reach, reduced concentration risk, economies of scale etc. hence, though not heavily weighted, it should be incorporated in ratings.
- For a commercial bank maintenance of liquidity is as important as its profitability. Liquidity risk can be measured from maturity mismatch of assets and liabilities. It is managed by Asset Liability Management Committee (ALCO) through ALM techniques. This has not been considered in most of the ratings.
- To implement Basel II norms, banks need to have a strong framework for credit risk and operational risk management. Hence, banks initiatives towards risk management should be given due consideration in its rating.
- As we proceed with liberalization in the insurance and pension sectors our banks will face more competition from non-bank financial intermediation. In such an environment product innovation is going to become the strategy for survival and growth for mid and small size banks. Product innovation could be an important parameter.
- Use of information technology is no longer a choice for the banks, it has become a necessity. But early and effective deployment of technology as a strategic resource will be a competitive advantage resulting into high speed, efficiency, cost reduction, risk management and customer service. So implementation of high-tech banking software must definitely add a weight to the rank of the bank.
- Moreover, there are various other qualitative criteria which need to be quantified to take part in ranking of banks. For example, customer satisfaction, risk appetite, market sensitivity, ownership structure, corporate governance, location advantage/ disadvantage, auditor's comments, performance of subsidiaries and linking of performance with strategic objectives etc. Without incorporating these parameters ranking will not serve its purpose completely.

CONCLUSION

From the above analysis it could be concluded that broadly the parameters are based on the CAMEL framework. However, there are differences in the use of parameters within these broad categories. For capital adequacy 'capital to risk weighted assets ratio' is the most appropriate parameter. For asset quality 'net NPA to net advances', 'net NPA to total assets', 'NPA to pre provision profits' and 'provisions to pre provision profits are the useful parameters. The Management quality has been commonly measured by the 'operating income per employee' however the management quality could be best assessed by non statistical parameters like organizational structure, dependence of management team on one or more persons, coherence of the team, corporate governance and independence of management from major shareholders. 'Earnings' is a major parameter for banks and it can be assessed by Net profit margin, Return on assets and Return on equity. Individual analysis of interest income, non interest income and investments is also helpful. Further the evaluation of earnings would be incomplete without evaluation of costs of the bank Hence cost to income ratio is important. Liquidity can be evaluated by credit deposit ratio, Liquid assets to total assets ratio, Borrowings to deposits ratio, Loans to assets ratio and Asset liability mismatch. Asset liability mismatch is a very good indicator of interest rate risk also. Moreover besides the above CAMEL parameters, size of the bank operations and growth of the bank are important parameter for evaluation.

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TABLES

Table 3.1
CAPITAL ADEQUACY PARAMETERS

S.No.	Parameters	Business India	Business Standard Research Bureau	Business Today-KPMG	Business World	Financial Express-Ernst &Young	Top India's Ranking	Fitch Rating	Moody	Standard & Poor	Indian Banks Association	Reserve Bank of India	*Frequency*
1	Capital adequacy ratio	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	10
2	Capital -estimated losses to total assets											✓	1
3	Adjusted total equity/assets									✓			1
4	Debt equity ratio	✓								✓			2
5	Double leverage								✓	✓			2
6	Equity+loan loss reserves/ loans									✓			1
7	Tier I equity/regulatory risk assets									✓			1
8	Dividend payout ratio									✓			1

Table 3.2
ASSET QUALITY PARAMETERS

S.No.	Parameters	Business India	Business Standard Research Bureau	Business Today-KPMG	Business World	Financial Express-Ernst &Young	Top India's Ranking	Fitch Rating	Moody	Standard & Poor	Indian Banks Association	Reserve Bank of India	*Frequency*
1	G-secs to investments	✓											1
2	G-secs to assets	✓											1
3	Investments to assets	✓											1
4	Increase in Gross NPA					✓							1
5	Increase in gross NPA to increase in gross advances					✓							1
6	Gross NPA to gross advances			✓		✓							2
7	Delinquent loans to total loans											✓	1
8	Non earning assets to total assets											✓	1
9	Increase in net NPA to increase in net advances					✓							1
10	Net NPA to total assets		✓			✓			✓				3
11	Net NPA to Net worth					✓							1
12	Net NPA to net advances		✓	✓	✓		✓			✓	✓		6
13	NPA to preprovision profits								✓				1
14	Provisions to pre provisions profits								✓				1
15	Loan Loss Provisions to average loans									✓			1
16	Loan loss reserves to gross loans									✓			1
17	Loan loss reserves to risk assets									✓			1
18	Loan loss reserves to NPA			✓						✓			2
19	Loan Loss Provisions to average assets									✓			1
20	Loan Loss Provisions to revenue									✓			1
21	Net charge offs to average loans											✓	1

Table 3.3

MANAGEMENT PARAMETERS

S.No.	Parameters	Business India	Business Standard Research Bureau	Business Today-KPMG	Business World	Financial Express-Ernst &Young	Top India's Ranking	Fitch Rating	Moody	Standard & Poor	Indian Banks Association	Reserve Bank of India	*Frequency*
1	Total income per branch		✓										1
2	Total income per employee		✓										1
3	Operating profit per employee	✓	✓	✓	✓	✓	✓				✓		7
4	Business per employee					✓	✓				✓		3
5	Business per branch						✓						1

Table 3.4
EARNINGS PARAMETERS

S.No.	Parameters	Business India	Business Standard Research Bureau	Business Today-KPMG	Business World	Financial Express-Ernst &Young	Top India's Ranking	Fitch Rating	Moody	Standard & Poor	Indian Banks Association	Reserve Bank of India	*Frequency*
1	Return on assets		✓	✓	✓	✓			✓	✓	✓		7
2	Return on equity	✓	✓	✓		✓	✓						5
3	Net profit to spread		✓										1
4	Net profit margin (net profit to total income)		✓		✓					✓			3
5	Net profit to deposits		✓										1
6	Net profit to total average assets	✓					✓						2
7	Net operating income before LLP to avg assets						✓			✓			2
8	Pretax profits to average assets									✓			1
9	Net operating income before LLP to revenue									✓			1
10	Net operating income after LLP to revenue									✓			1
11	Pretax profit to revenue									✓			1
12	Net income to revenue									✓			1
13	(Pre-provision income-preferred dividends-consumer net charges offs) to risk weighted assets + securitized assets								✓				1
14	Net income after transfers to average assets											✓	1
15	Net income before statutory reserve transfers to average assets											✓	1
16	Non interest income to gross income		✓	✓									2
17	Non interest income to revenue									✓			1
18	Non interest income to average assets						✓			✓			2
19	Commission and fee to total assets					✓							1
20	Other income to net interest income	✓											1
21	Net interest income to avg earning assets									✓			1
22	Net interest income to average assets			✓			✓			✓			3
23	Net interest income to revenue									✓			1
24	Net interest margin				✓		✓		✓				3
25	Yield on investments		✓										1
26	Yield on advances		✓			✓							2
27	Spread to assets	✓	✓								✓		3
28	Spread over establishment expenses		✓										1
29	Non interest expenses to total income						✓		✓	✓			3
30	Staff expenses to operating expenses		✓										1
31	Cost to average assets ratio		✓	✓		✓							3
32	Cost to income ratio			✓		✓							2
33	Operating expenses-Provisions for loan losses-Interest expenses to average assets											✓	1
34	Operating expenses to total assets					✓					✓		2
35	Spread to total assets					✓							1

Table 3.5

LIQUIDITY PARAMETERS

S.No.	Parameters	Business India	Business Standard Research	Business Today-KPMG	Business World	Financial Express-Ernst	Top India's Ranking	Fitch Rating	Moody	Standard & Poor	Indian Banks Association	Reserve Bank of India	Frequency
1	Liquid assets to total assets	✓	✓										2
2	Credit deposit ratio	✓	✓			✓	✓		✓	✓	✓		7
3	Demand & savings deposits to total deposits		✓										1
4	Borrowings to deposits		✓			✓							2
5	Total deposits to total liabilitites									✓			1
6	Loans to assets									✓			1
7	Asset liability mismatch	✓											1
8	Net interbank deposits to total liabilitites									✓			1

Table 3.6

SIZE PARAMETERS

S.No.	Parameters	Business India	Business Standard Research Bureau	Business Today-KPMG	Business World	Financial Express-Ernst &Young	Top India's Ranking	Fitch Rating	Moody	Standard & Poor	Indian Banks Association	Reserve Bank of India	Frequency
1	Total assets	✓		✓	✓	✓			✓		✓		6
2	Liquid assets	✓											1
3	Investments	✓				✓					✓		3
4	Advances	✓											1
5	Fixed assets and Other assets	✓									✓		2
6	Net interest income				✓								1
7	Net profit				✓								1

Table 3.7

GROWTH PARAMETERS

S.No.	Parameters	Business India	Business Standard Research Bureau	Business Today-KPMG	Business World	Financial Express-Ernst &Young	Top India's Ranking	Fitch Rating	Moody	Standard & Poor	Indian Banks Association	Reserve Bank of India	Frequency
1	Increase in total assets					✓							1
2	Advance growth		✓	✓		✓							3
3	Investments growth		✓			✓							2
4	Deposits growth		✓	✓		✓							3
5	Commission fee growth		✓	✓									2
6	Net profit growth		✓	✓		✓							3
7	Increase in market share of deposits			✓									1
8	Increase in market share of current account and savings account ratio			✓									1
9	Price/earnings ratio				✓								1
10	Price to book value				✓								1
11	Book value per rupee of equity capital						✓						1
12	Earnings per rupee of equity capital						✓						1
13	EPS growth	✓											1

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Looking forward an appropriate consideration.

With sincere regards

Thanking you profoundly

Academically yours

Sd/-

Co-ordinator