



Rating Criteria for Commercial Banks

Introduction and Executive Summary

ACER Credit Rating Private Limited (ACER), a SEBI-registered credit rating agency, is committed to delivering independent and transparent opinions on issuer and credit ratings. ACER credit insights aim to empower investors, lenders, and businesses with opinions on ratings. With a clear vision to support India's economic growth story, ACER upholds the highest ethical and analytical standards, combining deep domain expertise, advanced analytics, and rigorous processes to ensure every rating is objective and insightful.

The Company reserves the right to amend this policy from time to time in accordance with the applicable regulations, circulars, and directives issued by the Securities and Exchange Board of India. This rating criteria will be reviewed annually.

Banking institutions exhibit unique operational characteristics that distinguish them from other corporate entities. Banks function as financial intermediaries, accepting deposits and extending credit, which creates inherent maturity and credit risk mismatches. Their business model relies heavily on leverage, making capital adequacy and risk management paramount to institutional stability. The regulatory environment has a significant influence on banking operations, with prudential norms, capital requirements, and supervisory oversight playing crucial roles in determining operational parameters. Banks face multiple risk categories, including credit risk, market risk, operational risk, liquidity risk, and interest rate risk, each requiring separate assessment.

Banks operate within interconnected financial systems where individual institution failures can trigger broader systemic risks. This interconnectedness requires evaluation of not only standalone credit quality but also systemic risk contributions and potential contagion effects. The criteria consider banks' role in payment systems, interbank markets, and broader financial infrastructure.

Rating Framework

ACER's credit rating framework for Commercial Banks is structured around four primary pillars to ensure a balanced approach that adequately considers both financial metrics and qualitative aspects of a bank's profile. This multi-dimensional approach provides comprehensive risk assessment while maintaining analytical consistency across different banking institutions.

Four-Pillar Structure

- **Pillar I: Ratio Analysis** encompasses a comprehensive quantitative assessment of financial health through systematic evaluation of key performance indicators across capital adequacy, asset quality, profitability, liquidity, and risk metrics.



- **Pillar II: Business Parameters** involves evaluation of market positioning, strategic execution, operational characteristics, and competitive dynamics that influence long-term sustainability and growth prospects.
- **Pillar III: Management Quality** focuses on assessment of leadership capabilities, strategic vision, corporate governance practices, and organizational effectiveness in managing banking operations and risks.
- **Pillar IV: Legal and ESG Parameters** analyses regulatory compliance, legal risk exposure, environmental stewardship, social responsibility, and governance effectiveness that impact institutional reputation and operational continuity.

Integration Criteria

The four pillars operate synergistically to provide a comprehensive risk assessment. Strengths in one pillar may compensate for weaknesses in others, while severe deficiencies in any single pillar may impact overall credit quality. The criteria recognize that banking risks are interconnected and require integrated evaluation rather than isolated assessment.

1. Pillar I: Ratio Analysis - Quantitative Financial Assessment

This pillar systematically evaluates key performance indicators across capital adequacy, asset quality, profitability, liquidity, and risk metrics to provide an empirical foundation for credit evaluation.

a. Capital Adequacy Assessment

- Capital Adequacy Ratio (CRAR) measures financial strength by assessing the sum of Tier I and Tier II capital as a proportion of risk-weighted assets. This ratio indicates the bank's capacity to absorb losses and undertake additional business activities.
- Tier I capital ratio reflects the bank's core capital, primarily comprising equity capital and disclosed reserves, relative to risk-weighted assets. Tier I capital is considered the highest quality capital for loss absorption, providing permanent funding that enhances operational stability and regulatory compliance.
- Common Equity Tier I (CET-I) measures the bank's highest quality capital, comprising common shares and retained earnings, relative to risk-weighted assets. This permanent funding, which cannot be withdrawn, indicates the loss-absorption capacity during stress.
- Leverage Ratio measures Tier I capital against total exposure, encompassing both on-balance sheet and off-balance sheet exposures adjusted for credit conversion factors. This provides a complementary capital assessment independent of risk weighting, indicating absolute capital adequacy relative to total exposure.



b. Asset Quality Analysis

- Gross Non-Performing Assets (NPA) ratio measures total non-performing assets as a proportion of gross advances, indicating overall delinquency levels in the loan portfolio.
- Net NPA ratio represents gross NPAs minus provisions as a percentage of net advances, providing a refined asset quality assessment after accounting for loss provisions.
- Provision Coverage Ratio (PCR) indicates the extent of provisions set aside for gross non-performing assets, representing the buffer against potential credit losses.
- NPA Recovery ratio assesses the bank's effectiveness in recovering funds from non-performing assets, indicating collection efficiency and workout capabilities.
- Write-off ratio measures the proportion of loans written off relative to total advances, indicating the bank's approach to balance sheet cleanup and loss recognition practices.
- Credit cost measures expenses related to credit losses, including provisions and write-offs, relative to average total assets. This indicates the ongoing cost of credit risk management and its impact on profitability.
- CASA ratio represents the proportion of Current Account and Savings Account deposits to total deposits, with higher ratios indicating access to cheaper funding sources and reduced interest rate sensitivity.
- Slippage ratio measures fresh additions to gross NPAs divided by standard assets at the beginning of the period, providing forward-looking indicators of asset quality deterioration trends.

c. Profitability Analysis

- Return on Assets (ROA) indicates net income generated relative to total assets, reflecting overall efficiency in asset utilization and profitability generation.
- Return on Equity (ROE) measures net income relative to shareholders' equity, indicating returns generated for equity investors and the effectiveness of equity capital utilization in profit generation.
- Net Interest Margin (NIM) measures the difference between interest income and interest expense relative to average total assets, reflecting the efficiency of core lending and borrowing operations.
- Cost-to-Income ratio indicates operating expenses as a proportion of total income, measuring operational efficiency through expense management relative to revenue generation.
- Operating efficiency examines the bank's ability to manage operational expenses relative to business scale and income generation, indicating management effectiveness in resource optimization.
- Provision and Contingency to Profit Before Depreciation, Interest, and Taxes (PBDIT) evaluates the impact of provisions and contingencies relative to PBDIT, assessing the bank's ability to cover potential losses from operating income.

d. Liquidity Assessment



- Liquidity Coverage Ratio (LCR) measures the ability to meet short-term liquidity needs through high-quality liquid assets sufficient for acute stress scenarios lasting thirty days.
- Net Stable Funding Ratio (NSFR) assesses resilience to funding disruptions over one-year horizons by requiring stable funding sources for activities and assets.
- Loan to Deposit Ratio (LDR) compares total outstanding loans to total deposits, indicating the extent of deposit dependence for lending activities and funding structure sustainability.

e. Portfolio Analysis

Value-at-Risk (VaR) provides a statistical measure of potential portfolio losses over defined periods and confidence intervals, delivering quantitative market risk assessment.

f. Operational Efficiency and Technology Adoption

- Digital Transaction Ratio: This represents the proportion of transactions conducted through digital channels, indicating technological adoption and operational efficiency improvements.
- Business per Employee: This measures total business generated per employee, reflecting human capital productivity and operational efficiency.
- Branch Productivity: This refers to the business generated per branch, reflecting distribution network effectiveness and scale efficiency.
- Third-Party Risk Management: This evaluates cybersecurity risks arising from vendor relationships and partners, crucial for comprehensive risk management.

g. Priority Sector Lending

This measures a bank's total lending to priority sectors as mandated by the regulator, which often includes agriculture, MSMEs, education, housing, and others. Adherence to these norms reflects regulatory compliance and social commitment.

h. Growth & Business Metrics

- Deposit Growth (YoY): This measures the year-on-year growth rate of a bank's deposits, where consistent growth indicates a strong and expanding liability franchise and public confidence.
- Advance Growth (YoY): This measures the year-on-year growth rate of a bank's loan book, noting that healthy and sustainable growth is important, but higher growth in risky segments is viewed as a credit negative.
- Income Growth (YoY): This measures the year-on-year growth rate of a bank's total income, where consistent income growth indicates business expansion and sustained profitability.

i. ALM & Interest Rate Risk



- **Duration Gap:** This measures a bank's exposure to interest rate risk by assessing the difference between the average duration of its assets and liabilities. A mismatch can lead to volatility in earnings due to fluctuations in interest rates.
- **Net Open Position (Forex):** This measures a bank's exposure to foreign exchange risk by quantifying the difference between its foreign currency assets and liabilities, indicating potential capital impairment from currency fluctuations.

2. Pillar II: Business Parameters

This pillar evaluates the bank's market position, strategic execution capabilities, operational characteristics, and competitive dynamics that influence long-term sustainability and growth prospects.

a. Market Position and Entity Size

- Market share and position trends involve assessment of competitive standing relative to public and private sector peers, examining market share evolution and positioning sustainability.
- Total Business size of the entity assesses the overall scale and operational reach of the entity, measured in substantial terms to gauge market presence.

b. Operational Infrastructure and Network

- Years of operations refer to the operational history of the bank, indicating stability, established processes, and resilience through economic cycles.
- Branch network assessment involves analysis of geographic reach and distribution network based on branch presence, supporting deposit mobilization and business expansion.
- Deposit growth consistency evaluates deposit growth trends, indicating public confidence and funding base stability.
- CASA ratio stability assesses the consistency of the current and savings account deposit mix, indicating access to low-cost funding and customer relationship depth.

c. Portfolio Management and Risk Distribution

- Portfolio concentration risk evaluates loan portfolio diversification across sectors, mitigating risks from specific industry downturns.
- Large exposure management assesses the concentration of the bank's exposure to its largest individual borrowers and groups of connected borrowers, indicating credit risk distribution effectiveness.
- Credit quality trends involve analysis of gross NPA trends over multiple years, indicating credit risk management effectiveness and portfolio quality maintenance.
- Provision coverage trends refer to the evolution of provision coverage ratios, demonstrating conservative provisioning approaches and loss preparation adequacy.



d. **Revenue Diversification and Sustainability**

- Revenue growth stability and diversification trend assess net interest income plus fee income growth consistency across diversified business segments.
- Net interest margin sustainability evaluates NIM trends reflecting core lending profitability, sustainability, and interest rate management effectiveness.
- Cost-Income ratio efficiency trend assesses cost management effectiveness and operational efficiency trends over multiple periods.
- Technology and digital leadership evaluate the bank's investment in technology and digital initiatives, specifically technology expenses as a proportion of operational expenses on information technology.

e. **Economic Resilience and Adaptability**

- Interest rate sensitivity evaluates exposure to interest rate risk and hedging effectiveness, crucial for earnings stability.
- Collection efficiency assesses loan collection processes and efficiency, indicating credit administration quality and asset quality maintenance capability.
- Geographic diversification and spread evaluates the geographic spread and operational diversification of the bank, which helps mitigate regional economic risks.

f. **Trend analysis and forecasting with peer-to-peer companies**

- ACER may analyze the company revenue growth trend for the past three years & provide an assessment on revenue streams. The assessment may include evaluating the consistency of revenue growth and diversification of revenue streams over the past three years, using peer comparison.
- Growth trend analysis in profit margins (gross operating & net): Through this ACER would evaluate the trends and stability of profit margins (gross, operating, and net) over the last three years, considering peer performance.
- Position of the company's profitability ratios against peers: This evaluates the bank's profitability ratios relative to the sector median and top quartile performers.
- Leverage ratios comparison with peers: This compares the bank's Debt/EBITDA ratio and Debt/Adjusted Tangible Net-worth against its peers, assessing its leverage profile relative to earnings.
- Liquidity ratios: This evaluates the bank's liquidity ratios in comparison to its peers within the sector.

3. **Pillar III: Management Quality**



This pillar examines leadership quality, strategic vision, corporate governance practices, and organizational capabilities that significantly influence long-term institutional success and stability.

a. Leadership Excellence and Experience

- CEO experience evaluates the chief executive's experience in the banking sector, indicating industry knowledge depth and leadership capability.
- Leadership stability assesses top management team consistency and tenure, reflecting strategic continuity and execution effectiveness.

b. Corporate Governance Framework

- Board composition and independence involve evaluation of board size appropriateness and independence levels, facilitating effective oversight and decision-making.
- Quality of promoters assesses promoter credentials, track record, and integrity, which are crucial for strategic direction and capital support provision.

c. Innovation and Adaptability

- Innovation capability evaluates the ability to innovate, embrace new products and services, and adapt to changing business environments.
- Financial planning and forecasting assess management's financial forecast accuracy compared to historical performance and industry trends.
- Strategic execution consistency involves evaluation of strategic plan implementation effectiveness and target achievement consistency.

d. Ownership Structure and Capital Support

- Ownership structure involves evaluation, including diversification levels and concentration analysis, influencing stability and support availability.
- Business scale considers the overall operational scale, often correlating with economies of scale and market influence.
- External recognition tracks external credit rating changes, providing an independent perspective on credit trajectory and market perception evolution.

4. Pillar IV: Legal and ESG Parameters



This pillar examines regulatory compliance, governance structure, environmental stewardship, social responsibility, and legal risk management that increasingly influence long-term sustainability and stakeholder confidence.

a. Regulatory Compliance and Legal Framework

- The Director of attendance and engagement assesses non-executive director participation in board meetings and tenure completion, indicating oversight effectiveness.
- Whistleblower framework evaluates whistleblower policies and tracking mechanisms, demonstrating corporate governance strength and fraud prevention capability.

b. Operational Risk

- Stress test performance evaluates performance in regulatory stress tests, indicating financial resilience and risk management effectiveness under adverse scenarios.
- Operational risk management assesses operational risk management effectiveness, including internal controls and fraud reporting mechanisms.
- Compliance culture evaluates adherence to Anti-Money Laundering (AML), Know Your Customer (KYC), and SEBI Rules, signifying compliance strength.

c. Legal Risk Exposure

- Litigation/NCLT/CGTMS claims cases exposure by the bank: This evaluates exposure to litigation, regulatory proceedings, and claims from NCLT/CGTMS by the bank relative to business scale, indicating legal risk management effectiveness.
- Litigation cases against the bank (other than above) of total business: This measures the proportion of other litigation cases filed against the bank relative to its total business, providing insights into potential legal liabilities.
- Regulatory violation analysis assesses the nature and extent of regulatory violations, indicating adherence to regulatory guidelines and institutional soundness.

d. Capital Management and Regulatory Relations

- Capital adequacy evolution assesses CRAR trends over multiple years, indicating capital management effectiveness and financial maintenance.
- Regulatory rating considers supervisory ratings assigned by regulatory authorities, providing an external assessment of institutional health and compliance.



- Regulatory agility assesses the ability to proactively comply with and adapt to regulatory environmental changes, signifying governance strength and risk management effectiveness.

e. **Social Responsibility and Community Engagement**

- CSR activities assess community and corporate social responsibility engagement relative to institutional size and operational scale.
- Social impact involves evaluation of broader social contributions and community development initiatives, reflecting institutional commitment to stakeholder value creation.

5. **Rating Integration and Quality Assurance**

- Comprehensive Risk Synthesis** The criteria integrate insights from all four pillars, resulting in a comprehensive understanding of credit risk across financial performance, business positioning, management capabilities, and regulatory compliance dimensions. This supports balanced assessment while recognizing interconnected risk factors.
- Forward-Looking Assessment** The rating process emphasizes forward-looking analysis, incorporating economic scenarios, regulatory developments, and strategic initiatives that could influence future credit quality. Stress testing and scenario analysis may provide additional insights into resilience and adaptability.
- Peer Analysis and Benchmarking** Comparative analysis positions individual institutions within an industry context while recognizing unique characteristics and strategic positioning. Peer benchmarking provides important relative performance context while maintaining focus on standalone credit assessment.
- Committee Oversight and Decision Framework** ACER's rating committee provides expert oversight, ensuring analytical quality, consistency, and objectivity through systematic decision-making processes and clear documentation standards.

6. **Conclusion**

ACER's rating criteria for the banking sector represent a dynamic and comprehensive approach to assess banks' creditworthiness. The framework integrates detailed quantitative analysis with thorough qualitative evaluation, combining systematic parameter assessment with expert judgment to provide reliable and forward-looking credit risk opinions.

This criterion supports assessment of multiple factors influencing banking sector credit quality, from fundamental financial metrics to strategic positioning, management effectiveness, and



regulatory compliance. Its multi-dimensional structure provides stakeholders with comprehensive insights into relative credit risk while maintaining analytical consistency and market relevance.

The framework recognizes that banking institutions operate within complex, interconnected systems where individual performance reflects both standalone capabilities and systemic interactions. ACER's criteria provide stakeholders with reliable tools for credit risk assessment and investment decision-making in the evolving financial services landscape.