CREDIT RATING

CREDIT RISK MANAGEMENT IN BANKS

Banks operate in a complex financial environment where they are exposed to multiple **risks**, with **credit risk** being the most significant. Effective credit risk management is crucial to ensure **financial stability, profitability, and regulatory compliance.**

Understanding Credit Risk in Banks

What is Credit Risk?

Credit Risk refers to the **inability or unwillingness of a borrower or counterparty to meet their financial obligations**. It arises from lending, trading, hedging, settlement, and other financial transactions.

Types of Credit Risk:

1 **Transaction Risk (Default Risk):** Borrower's inability to pay.

2 **Portfolio Risk:** The overall risk in a bank's loan portfolio.

- **Intrinsic Risk:** Risk specific to an industry or borrower.

- **Concentration Risk:** Exposure to a particular sector, borrower, or geography.

External & Internal Factors Affecting Credit Risk

External Factors: (Beyond the bank's control)

Economic Conditions: Recession, inflation, GDP slowdown.

Commodity & Equity Price Fluctuations.

Interest Rate & Foreign Exchange Volatility.

Government Policies & Regulations.

Trade Restrictions & Economic Sanctions.

Internal Factors: (Controlled by the bank)

Deficiencies in Loan Policies & Credit Appraisal.

Absence of Prudential Credit Limits.

Excessive Dependence on Collateral.

Poor Loan Review & Post-Sanction Monitoring.

The lack of robust risk management systems in Indian banks has led to repeated financial distress for some banks!

RBI Guidelines on Credit Risk Management

The **Reserve Bank of India (RBI)** has laid down four key components of credit risk management:

1 Measuring Credit Risk through Credit Rating & Scoring

Develop a **comprehensive risk scoring** model (industry, business, financial, and management risks).

Set a **minimum credit rating threshold**—below which banks **should not** lend.

Conduct **periodic reviews** (quarterly/half-yearly) and track **rating migrations**.

2 Quantifying Credit Risk

Estimate **Expected Credit Loss (ECL)** based on historical repayment behavior.

Calculate **Unexpected Loss (UL)** by analyzing variations in past trends.

3 Pricing the Risk Scientifically

Use **Risk-Adjusted Return on Capital (RAROC)** to price loans effectively.

 Allocate **economic capital** based on the extent of unexpected loss.

4 Monitoring & Controlling Credit Risk

 Early identification of weak loans for proactive action.
 Determine **adequate provisions** for potential credit losses.
 Set **loan exposure limits** based on risk ratings.
 Conduct **regular portfolio reviews** to assess loan book quality.
 Ensure **strict adherence to risk policies & top management reporting.**

  A well-structured risk rating/scoring system is essential to standardize credit decisions and improve risk management!

Importance of Credit Risk Rating in Banks

- A **risk rating system** is a **single-point indicator of diverse risk factors** that helps banks make consistent credit decisions.
- It **consolidates various risk factors** into a single, easy-to-understand rating or score, which helps banks make consistent and informed credit decisions

◆ Benefits of Credit Risk Rating System:

 Helps **assess lending risks** before sanctioning loans.
 Acts as a **key input for loan pricing & collateral requirements.**
 Facilitates **monitoring and early warning signals** for problem accounts.
 Ensures **regulatory compliance** with RBI guidelines.
 Improves **capital allocation** and overall loan book quality.
  A robust credit risk rating system provides banks with greater visibility into loan quality and helps prevent NPAs!

Final Takeaways

 Credit risk is the most critical risk faced by banks.
 Banks must follow RBI's risk management framework to minimize defaults.
 Early identification, risk quantification, and strict monitoring are essential.
 Risk-adjusted pricing ensures fair returns for the bank.
 Credit rating systems must be standardized & continuously updated.

CREDIT RATING: MEANING, OBJECTIVES & IMPORTANCE

What is Credit Rating?

A **credit rating** is a **grade assigned to an entity** (individual, company, or government) that indicates its **ability to repay borrowed money** on time. It helps lenders assess the **risk level** associated with a borrower before granting loans.

Key Factors Influencing Credit Rating:

- **Financial health of the borrower**
- **Past borrowing & repayment history**
- **Debt-to-income ratio**
- **Industry & economic conditions**
- **Management quality & governance**

Why is Credit Rating Important?

For Banks & Financial Institutions:

- **Helps decide** whether to approve or reject a loan application.
- **Determines loan pricing** (interest rate & terms).
- **Assists in risk management** by identifying high-risk

borrowers.

 Affects capital requirements (lower risk-weighted assets → lower capital requirements).

 Improves overall portfolio quality by classifying assets based on credit risk.

 For Borrowers:

 Higher rating = easier access to loans at better interest rates.

 Lower rating = higher interest rates or loan rejection.

 Affects reputation in the financial market.

Objectives of Credit Rating in Lending Decisions

1 Loan Approval/Rejection

- Helps decide **whether to accept, reject, or modify** a loan proposal.
- Ensures that lending decisions are **data-driven & risk-based**.

2 Loan Pricing

- Determines **interest rates based on borrower risk profile**.
- **Higher risk → Higher interest rates**

- **Lower risk → Lower interest rates**

3 Risk Management & Portfolio Analysis

- **Classifies loans based on risk ratings** to improve portfolio quality.
- Helps banks **set provisions for loan defaults**.
- Assists in **fine-tuning lending policies** based on risk exposure.

Global & Indian Credit Rating Agencies

International Agencies:

Standard & Poor's (S&P)

Moody's Investors Service

Fitch Ratings

Indian Agencies (Registered with SEBI):

CRISIL (Credit Rating Information Services of India Ltd.)

ICRA (Investment Information & Credit Rating Agency of India Ltd.)

 CARE (Credit Analysis & Research Ltd.)
 India Ratings & Research (Fitch Group)
 Brickwork Ratings

These agencies rate companies, government bonds, commercial papers, and other financial instruments based on their repayment capability.

How Credit Ratings Impact Banking Operations?

1 Regulatory Requirements

 Credit rating is **mandatory for large corporate loans** as per RBI guidelines.

 Banks must get external ratings for corporate exposures to optimize capital allocation.

2 Risk-Weighted Assets & Capital Requirements

 Higher-rated loans require less capital provisioning under Basel norms.

 Encourages banks to lend to **low-risk businesses**.

3 Decision-Making & Loan Structuring

 Banks structure loans based on credit ratings.

 Lower-rated borrowers may need additional collateral or guarantees.

Final Takeaways

 Credit rating is a crucial tool for banks in risk assessment & decision-making.

 Higher credit ratings lead to lower borrowing costs & better access to funds.

 Mandatory for large corporate borrowers as per RBI norms.

 Global & Indian rating agencies play a key role in financial markets.

 Directly affects a bank's capital requirements & financial stability.

INTERNAL & EXTERNAL CREDIT RATINGS: KEY CONCEPTS & PROCESS

What is Internal & External Credit Rating?

 Internal Rating:

 Done by banks using their own **credit rating models**.

 Helps in **risk assessment & pricing loans** effectively.

 If internal & external ratings differ significantly, banks require **justification & validation**.

 External Rating:

 Done by **SEBI-registered Credit Rating Agencies (CRAs)**.

 Used for regulatory compliance & capital adequacy calculations.

 If two ratings exist, banks usually take the **lower of the two** as per RBI guidelines.

Credit Rating Scale: Key Grades

Rating Scale	ICRA	CRISIL	CARE	India Ratings
Highest Safety (Lowest Default Risk)	AAA	AAA	AAA	AAA
High Safety (Low Default Risk)	AA	AA	AA	AA

Rating Scale	ICRA	CRISIL	CARE	India Ratings
Moderate Risk	A	A	A	A
Default Risk (Poor Financials)	D	D	D	D

 AAA → Best rating, lowest default probability.

 AA & A → Safe, but moderate risk.

 D → High-risk, likely default scenario.

 Key Factors for Scrutiny in Credit Rating

 1 Industry & Business Risk

 Market Position

 Competitive Environment

 Industry Growth Trends

 2 Financial Risk

 Revenue, Profitability & Cash Flows

 Debt-to-Equity Ratio

 Financial Flexibility

3 Managerial Risk

Promoters' Track Record

Corporate Governance Standards

Business Strategy & Long-Term Vision

How Do Credit Rating Agencies Assess Borrowers?

Qualitative Analysis:

- **Management quality & business model**
- **Industry dynamics & competitive advantage**
- **Market sentiment & reputation**

Quantitative Analysis:

- **Audited financial statements & ratio analysis**
- **Cash flow & working capital cycle**
- **Debt repayment history**

External Information Sources:

- **SEBI Disclosures (for listed companies)**
- **Analyst Reports & Industry Trends**
- **Media Reports & Market News**

Simple Credit Rating Model for Medium-Sized Firms

How it Works?

Financial Ratios (Liquidity, Profitability, Leverage) are calculated.

Compared with industry benchmarks & past financial trends.

Rating is assigned based on a score out of 100.

✅**Higher Score → Lower Risk & Better Rating (AAA, AA, A).**

❌**Lower Score → Higher Risk & Poor Rating (BBB, BB, D).**

METHODOLOGY OF SIMPLE CREDIT RATING SYSTEM

Overview of Credit Rating Process

A **credit rating model** is used to evaluate the financial **health & risk level** of a borrower. The rating is based on financial ratios, industry benchmarks, and qualitative factors like **management quality & business risk**.

□ Key Financial Ratios Used in Credit Rating

Financial Parameter	Ideal Range (High Score)	Medium Score	Low Score (High Risk)
Current Ratio (Liquidity)	**Above 1.50**	1.20 - 1.50	**Below 1.00**
TOL/TNW (Leverage)	**Below 3.00**	3.00 - 4.25	**Above 4.50**
EBIT/Interest (Debt Servicing)	**Above 3.00**	1.50 - 3.00	**Below 1.50**
PAT/Net Sales (Profitability)	**Above 15%**	7% - 15%	**Less than 6%**

□ **Higher the score → Lower default risk → Better loan terms**

□ **Lower the score → Higher default risk → Higher interest rate**

Internal & External Comparison for Rating

Internal Comparison (Company's Performance Over Time)

 If **financial ratios improve over 2-3 years**, company gets **positive points**.

 If **ratios decline**, company gets **zero or negative points**.

 Example:

- If **Current Ratio improves from 1.20 to 1.50**, **+2 marks**.
- If **PAT/Net Sales increases from 10% to 15%**, **+3 marks**.

 External Comparison (Industry Benchmarking)

 Compare company's performance with industry averages.

 Higher marks for outperforming industry standards.

 Zero or negative marks if ratios deteriorate.

 Additional Factors in Credit Rating

 1. Industry Profile (Weightage: ~25%)

 Competition & Market Risk

 Cyclicality of Industry (Is demand seasonal?)

 Regulatory & Environmental Risks

 User & Input Profiles (Who are the buyers & suppliers?)

2. Management Quality (Weightage: ~25%)

Competence & Track Record

Integrity & Professionalism

Corporate Governance Standards

Efficiency in Financial Management

More complex models for large companies include these qualitative factors.

Credit Rating Model & Interest Rate Decisions

Impact of Credit Rating on Loan Pricing & Approvals

Higher Credit Rating (AAA, AA) → ✅Lower Interest Rates

Medium Credit Rating (A, BBB) → Moderate Loan Terms

Lower Credit Rating (BB, D) → ❌Higher Interest or Loan Rejection

Example:

- **AAA** Rated Borrower → **8% Interest**
- **BB** Rated Borrower → **12% Interest**

Why? Lower-rated companies have **higher default risk**, so banks charge **higher interest** to compensate.

Cutoff Rating for Loan Approvals

Banks Set "Hurdle Ratings" Below Which:

No Enhancement of Existing Credit Limits

No New Loan Sanctions

Recovery Action Initiated for Risky Borrowers

Credit Rating Model Validation & Refinement

Periodic validation of rating models using **slippage analysis**.

If **too many defaults occur in "safe-rated" loans**, **rating parameters need adjustment**.

Example:

- If **10% of "BBB" borrowers** default in a year, bank revises its risk weight.

Credit Rating Models for Different Loan Sizes

Loan Type	**Applicable Credit Rating Model**
Loans ₹2L - ₹1 Cr	Annexure I (Basic Model)
Loans > ₹1 Cr (Except Traders)	Annexure II (Advanced Model)
Loans > ₹1 Cr (For Traders)	Annexure III (Specialized Model)

Banks use different models based on loan size & borrower type.

📌 Scope of Application of External Ratings in Credit Risk Assessment 🏢

♦️ 6.5.1 Consistency in Choosing the Rating

✔**Banks must consistently use selected Credit Rating Agencies (CRAs)** for specific types of claims.

✅**No "cherry-picking"** of ratings from different agencies for different exposures to the same borrower.

✅**If a bank decides to use specific CRAs for a claim type,** it must use only those agencies for all exposures of that type.

✅**Banks cannot apply ratings of one corporate entity** within a group to another entity of the same group.

📌 Example:

- If **Bank XYZ** chooses to use **CRISIL & ICRA** for rating corporate bonds, it **must use only** these agencies for all corporate bond assessments.
- **It cannot use CRISIL for one borrower and ICRA for another, unless those exposures are rated exclusively by those agencies.**

✅**Disclosure Requirement:**

- Banks **must disclose** the names of credit rating agencies used for risk weighting.
- Banks must also **reveal the risk weights** assigned by the RBI mapping process.

6.5.2 Entire Exposure Must Be Rated

✅**Ratings must cover the full extent of credit risk exposure**, including both **principal & interest**.

✅**A rating is valid only if:**

- It **includes all payments owed** to the bank.
- The rating agency has **reviewed the rating within the last 15 months**.

  ✅If a **rating is outdated**, the exposure is treated as **unrated** and assigned a **higher risk weight**.

6.5.3 Ratings Must Be Publicly Available

✅**External ratings must be accessible in public domain** and included in the credit rating agency's **transition matrix**.

✅ **Confidential or private ratings do not qualify** for risk weighting.

Why?

- Ensures **transparency** in credit risk assessment.
- Prevents **manipulation or selective disclosure** of ratings.

✅**Banks can use ratings of specific debt for unrated exposures only if:**

- The **unrated facility ranks pari passu (equal priority) or senior** to the rated facility.
- The **maturity of the unrated exposure is not later** than the rated exposure.

☑ **Regulatory Requirement:**

- As per **RBI's directive (June 4, 2021)**, External Credit Assessment Institutions (ECAIs) **must disclose the names of banks & their rated credit facilities**.
- If a rating agency **fails to disclose this information**, the rating **cannot be used** for capital computation by banks.