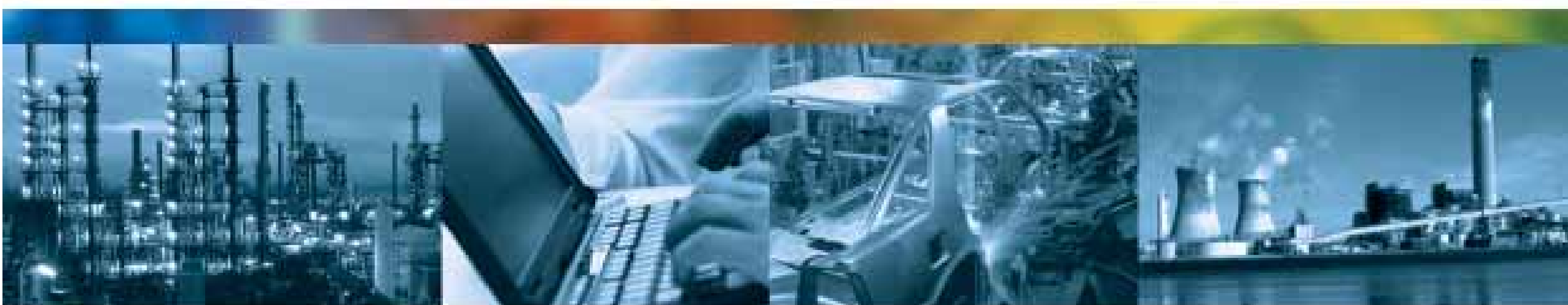
New Capital Adequacy Framework under Basel II Guidelines



ICRA's Line of Credit Rating Products

ICRA Limited

An Associate of Moody's Investors Service

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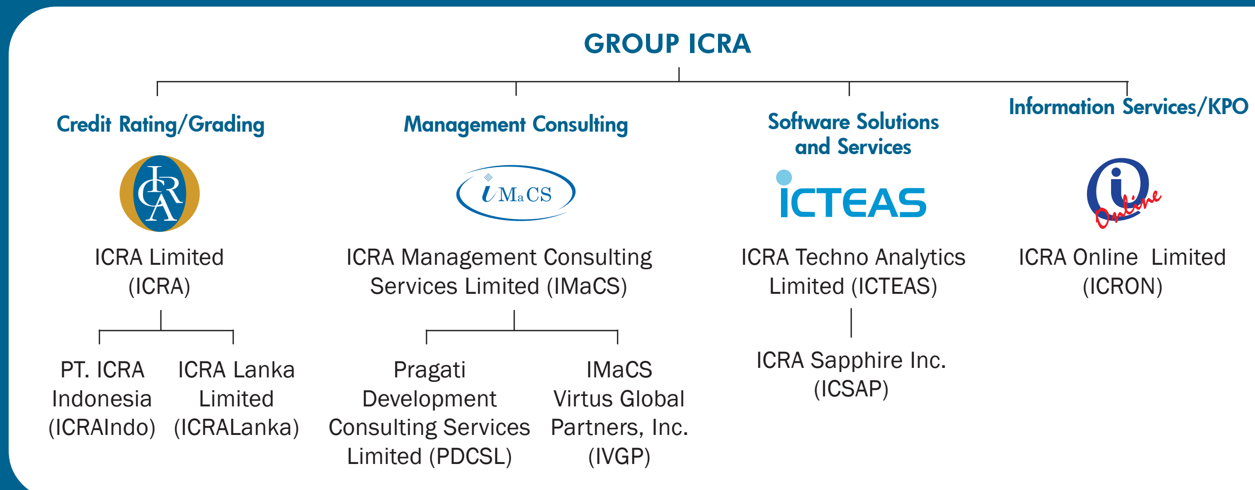
About ICRA

ICRA Limited (formerly Investment Information and Credit Rating Agency of India Limited) was set up in 1991 by leading financial/investment institutions, commercial banks and financial services companies as an independent and professional Investment Information and Credit Rating Agency.

Today, ICRA, a full-service credit rating agency with its shares listed on the Bombay Stock Exchange and the National Stock Exchange, has five wholly-owned subsidiaries: ICRA Management Consulting Services Limited (IMaCS); ICRA Techno Analytics Limited (ICTEAS); ICRA Online Limited (ICRON); PT. ICRA Indonesia (ICRAIndo), and ICRA Lanka Limited (ICRALanka). Together, ICRA and its subsidiaries, along with their subsidiaries, form the ICRA Group of Companies, that is, Group ICRA.



Expertise and Coverage

Over the years, ICRA has built up in-depth expertise in diverse sectors of the Indian economy besides the economy itself. The key areas of specialisation include, among others, the following:

- Economic research
- Corporate sector: including automobiles, pharmaceuticals, cement and building materials, textiles, hotels, metals and mining, media and retail
- Public finance sector: including State Governments, and municipal and urban local bodies
- Financial sector: including banks, insurance companies, and financial services companies
- Infrastructure and utilities: including power, oil and gas, and transportation
- Structured finance sector

Each of the sectors that ICRA specialises in is headed by a Sector Head, who is supported by a team of dedicated analysts. ICRA's sectoral focus provides for a specialised approach, higher rating consistency, and faster turnaround.

... specialised approach, higher rating consistency, and faster turnaround...

ICRA's Rating Products

Relevant for the New Capital Adequacy Framework under Basel II Guidelines

Background

The guidelines issued by the Reserve Bank of India (RBI) in April 2007 for the implementation of a New Capital Adequacy Framework allow commercial banks to allocate capital in relation to the credit risk embedded in their exposures. Credit risk in this case would be measured by the rating assigned to such exposures by external credit rating agencies like ICRA. As capital is the most expensive source of funding, any decrease or increase in such capital allocation could translate into substantial savings/ additional costs for banks.

Given the competitive market scenario, banks may be expected to share the savings achieved through lower capital allocation with investment-grade issuers; at the same time, given the pressures on profitability, banks may also be expected to pass on the additional costs for unrated exposure to their borrowers.

Benefits

Overall, the benefits for the rated entity may include the following:

- Pricing benefits, flowing from the capital relief for the bank
- Faster loan approval
- Ability to provide a higher level of comfort to prospective/existing lenders/investors
- Ability to negotiate terms on the basis of the credit quality as reflected by the rating
- Ability to access a broader investor base

Products – We believe the following ICRA products would address your requirements, given the demands of the Basel II regulations:

- Issue-specific long-term ratings: These ratings use ICRA's long-term scale to rate specific long-term loans and non-fund-based facilities.
- Rating of cash credit facilities: These ratings use ICRA's long-term scale and can be applied to risk-weight exposures of banks.
- Rating of other working capital facilities (fund-based and non-fund-based): These ratings use ICRA's short-term scale for short-term debt programmes.

Q1. Banks have been pricing their loans on the basis of risk for some time now. Under the new RBI guidelines what is the additional benefit an issuer would have from getting rating done?

With Indian banks moving towards risk-based pricing (by factoring in probable credit losses), issuers with better credit profiles have been benefited to an extent, as reflected by their cost of funds. However, so far, regulations did not allow banks to allocate lower capital for issuers with better credit profiles, and banks had to apply a uniform 100% risk weight to all exposures, irrespective of the underlying credit risk. This practice is undergoing a change under the Basel II approach, which allows banks to allocate capital in relation to the credit risk embedded in an exposure. Such embedded credit risks are proposed to be measured through ratings assigned by external credit rating agencies such as ICRA. Thus, under the revised framework, banks can lower their capital allocation to as much as one-fifth of the earlier requirement for rated exposures, depending on the level of the external credit rating.

As capital is the most expensive source of funding, any reduction in capital allocation would translate into substantial savings for banks. For instance, for exposures to investment grade issuers, a bank could save[1] on cost significantly, depending on the cost of capital for the bank and the underlying credit rating. Thus, the Basel II approach has direct implications for banks on their cost of extending credit. Given the competitive market scenario, banks may be expected to share the savings achieved through lower capital allocation with investment-grade issuers; at the same time, given the pressures on profitability, banks may also be expected to pass on the additional costs for unrated exposure to their borrowers.

Q2. How would the capital requirement be different for Unrated and Rated Exposures under the corporate category?

- Unrated Exposures: 100%
- Rated Corporate Exposures: Corporate exposures (both fund and non-fund-based) are to be risk weighted in accordance with the ratings assigned by rating agencies.

Table 1: Basel I vs. Basel II-Risk Weights and Capital Release

Basel I			Basel II			
				CAPITAL REQUIRED		CAPITAL RELEASE
Rating	Risk Weights	Capital Required	Risk Weights for Rated Exposures	Rated Exposures	Unrated Exposure	Rated Exposure
AAA	100%	9%	20%	1.80%	9%	7.20%
AA	100%	9%	30%	2.70%	9%	6.30%
A	100%	9%	50%	4.50%	9%	4.50%
BBB	100%	9%	100%	9.00%	9%	0.00%

[1] *If their borrowers get themselves rated*

Q3. Would non-fund limits also benefit from ratings?
Yes, the RBI guidelines on New Capital adequacy Framework are applicable to both fund-based as well as non-fund based exposures of the bank.

Q4. Is rating one-time exercise? Will it be subjected to any surveillance?
Once a rating is accepted, it would be reviewed periodically.

Q5. How frequently do banks typically report capital adequacy incorporating the risk weights assigned on the basis of whether an account is rated or not, and if rated, the level of rating assigned?
The reporting is done on a quarterly basis.

Q6. If ratings within a rating category are differentiated by means of the suffixes + (plus) and - (minus), does it mean that the risk weights would also be different for such ratings even though they belong to the same category?
The risk weights would be the same for all ratings within the same rating category. Thus, [ICRA]A+, [ICRA]A and [ICRA]A-, all of which belong to the rating category [ICRA]A, would attract the same risk weight. According to the April 2007 guidelines issued by the RBI, the risk weight for this category is 50%.

Q7. Would I get any benefit if my loans have a fixed rate of interest?
If you get rating done, the bank may have to allocate less capital against your loan depending on the credit rating. That is, some capital could get released for the bank. However, you would have to discuss directly with the bank the mode and extent of the benefit that the bank may pass on to you.

Q8. What is the relationship between the cost of capital and the savings achieved through capital release?
The correlation is direct. Higher the cost of capital, larger the savings.

Q9. What is the relationship between credit rating and the savings achieved through capital release?
Higher the credit rating, higher the capital release, and hence, larger the savings.

Q10. If the rating is sought by a bank would that be eligible for assigning of a lower risk weight?
No, the borrower has to solicit the rating.

Q11. Would the risk weights also depend on the tenure of borrowings/exposures?
Yes, for borrowings/exposures of tenure less than one year, short-term ratings would be applicable and the risk weights would be linked to short-term ratings. There could be substantial capital release on short-term exposures as well (refer Table 2).

Table 2: Short-term Risk Weights

Rating	A1+	A1	A2	A3	A4/D	Unrated
Risk Weights	20%	30%	50%	100%	150%	100%

Q12. I have an A1 CP rating outstanding from ICRA, and the rest of the borrowings are unrated. What would be the risk weights?
An A1 rated Commercial Paper (CP) would attract a 30% risk weight; the unrated short-term advances may attract 50% risk weight if the bank decides to apply the CP rating to the unrated claims (except for Cash Credit Limits).

Q13. What is the rating scale for Cash Credit (CC) limits?
CC limits are typically rolled over and hence the RBI would apply long-term ratings to such exposures.

Q14. I do not have ratings on any short-term debt. What would be the applicable risk weights?
The risk weight would be 100%.

Q15. Would unutilised CC limits/sanctioned term loans attract risk weights and hence require capital allocation?
Yes. The unutilised limits would first be converted into the equivalent credit exposure by applying a credit conversion factor, which is 20% for a limit maturing in less than one year and 50% for one with original maturity more than one year. Then, the relevant risk weight (for the rating category concerned) would be applied and the capital allocated accordingly.

Q16. If, say, the CC limit is Rs. 100 crore, utilisation Rs. 50 crore, and the rating category [ICRA]A, what would be the capital release?

Table 3: Capital Allocation for CC Limits

A	Utilised CC (Rs. crore)	50
B	Sanctioned but Not Utilised (Rs. crore)	50
C= B x 0.2	Equivalent Credit Exposure of Sanctioned but Not Utilised Limit (Rs. crore)	10
D = A+C	Total Credit Equivalent (Rs. crore)	60
E = D x 0.5[2]	Risk Weighted Assets as per New Framework (Rs. crore)	30
F	Risk Weighted Assets as per Old Framework (Rs. crore)	50
G = (F-E) / F	Reduction in Risk Weighted Assets or Capital Release	40%

Q17. What would be the risk weights and hence capital allocation for non-fund-based facilities?
The risk weights would be similar as in the case of fund-based limits and term loans. However, before applying the risk weights, these facilities would be converted into the equivalent credit exposure by applying a credit conversion factor, which is 20% for a limit maturing in less than one year and 50% for one with original maturity of more than one year. Then, the relevant risk weight (for the rating category concerned) would be applied and the capital allocated accordingly.

Q18. We are implementing a project that involves large borrowings and has three stages. How would my bankers allocate capital for the undrawn portion?
If a project is to be implemented in stages, banks are supposed to allocate capital both for the drawn portion and the undrawn one. However, if the borrower needs the bank's explicit approval for draw-down in the subsequent stages after completion of certain formalities, the bank need not allocate capital for loans that may be sanctioned for the later stages. In such a case therefore, the bank would have to allocate capital only for the loans (drawn and undrawn) pertaining to the stage under implementation. Here is an example to illustrate the point:

A term loan of Rs. 700 crore is sanctioned for a large project. The loan can be drawn down in stages over a three-year period. The terms of sanction allow draw-down in three stages: Rs. 150 crore in Stage I, Rs. 200 crore in Stage II, and Rs. 350 crore in Stage III. The terms also stipulate that the borrower would need the bank's explicit approval for draw-down under Stages II and III, after completion of certain formalities.

[2] ***50% risk weight for rating category [ICRA]A***

If the borrower has drawn Rs. 50 crore under Stage I, the undrawn portion would be computed with reference to Stage I alone, i.e., Rs. 150 crore minus Rs. 50 crore = Rs. 100 crore. Further, the appropriate credit conversion factor (CCF) would be applied to compute the credit equivalent of the undrawn portion.

If Stage I is scheduled to be completed within one year, the CCF will be 20%; if the period is more than one year, the applicable CCF will be 50%. The following table brings out the computations:

Table 4: Capital Allocation for Undrawn Portion of Project Loans

		Case 1 (if draw-down of balance portion is within one year)	**Case 2** (if draw-down of balance portion is beyond one year)
A	Drawn Portion	Rs. 50 crore	Rs. 50 crore
B	Undrawn Portion	Rs. 100 crore	Rs. 100 crore
C= B x CCF	Total Credit Equivalents of Undrawn Portion	Rs. 20 crore	Rs. 50 crore
D = A + C	Total Credit Equivalent (Drawn and Undrawn Portion)	Rs. 70 crore	Rs. 100 crore
E = D x 0.5	Risk Weighted Assets[3]	Rs. 35 crore	Rs. 50 crore

Q19. Which exposures qualify as retail exposures and what would be the risk weights for them?

Exposures less than Rs. 5 crore (per entity) would qualify as retail exposures, and a risk weight of 75% would be applied to them provided the following criteria are met:

- The annual turnover of the individual(s)/small business does not exceed Rs. 50 crore;
- The loan is not in the nature of a home loan, consumer loan or staff loan, is not used to transact in securities (bonds & equity) or commercial real estate and is not used to provide venture capital; and
- The bank's retail portfolio has sufficient diversification, with maximum size of individual exposure restricted to 0.2% of total retail loan portfolio or Rs. 5 crore, whichever is lower.

Q20. Which category of exposures would attract risk weights independent of the rating category?

- Residential mortgage: 50-125% risk weight subject to a loan-to-value (LTV) ratio and ticket size.
- Commercial property: 100% risk weight
- Exposure (other than subordinated debt) to any Schedule Commercial Bank (SCBs): 20% risk weight, irrespective of the rating of the instrument/bank concerned, provided the borrowing bank has a capital adequacy of 9%
- Exposure to subordinated debt of banks: 100% risk weight
- Exposure to the capital market: 125% risk weight
- Exposure to the non-deposit taking systematically important non-banking finance companies (NBFCs)[4]: risk weight: 100%.
- State government guaranteed exposures: 20% risk weight

[3] Assuming Category '[ICRA]A' rating which attracts 50% risk weight
[4] Which are not asset finance companies and infrastructure finance companies

Q21. If a bank were to invest in securitised paper, what would be the risk weight?

The risk weights for investments in securitised paper backed by commercial property would be as follows:

Table 5: Risk Weights for Securitised Papers Backed by Commercial Property

Credit Rating	AAA(SO)	AA(SO)	A(SO)	BBB(SO)
Risk Weight	100%	100%	100%	150%

The risk weights on investments in securitised paper backed by all other assets/loans would be as follows:

Table 6: Risk Weights for Securitised Papers Backed by Other Categories

Credit Rating	AAA(SO)	AA(SO)	A(SO)	BBB(SO)
Risk Weight	20%	30%	50%	100%

Q22. In the case of securitisation transactions originated by banks, how would the first loss piece and the second loss piece be treated as far as capital allocation is concerned?

The April 2007 RBI circular on the New Capital Adequacy Framework makes no distinction between the first and second loss pieces, if the originator provides credit enhancement (which is generally the case in India). The risk weight for the credit enhancement will be in accordance with the rating assigned.

Table 7: Risk Weights for Credit Enhancement Provided by the Originator

Credit Rating	AAA(SO)	AA(SO)	A(SO)	BBB(SO)	BB(SO) and Below or Unrated
Securitised Papers Backed by Commercial Property	100%	100%	100%	150%	Deduction from Capital
Securitised Papers Backed by Other Categories	20%	30%	50%	100%	Deduction from Capital

Q23. My debt is secured by corporate guarantee from a group company/parent company. Will the rating take comfort from the same?

In such cases, ICRA evaluates, among other factors, the terms of the guarantee, the financial position of the guarantor, and the nature of the relationship between the guarantor and the borrower company. It is the outcome of this evaluation that determines the extent of comfort or otherwise that the rating would draw from the guarantee.

The Rating Process

ICRA's rating process is initiated on receipt of a formal request (or mandate) from the prospective issuer. A rating team, which usually consists of two analysts with the expertise and skills required to evaluate the business of the issuer, is involved with the rating assignment. An issuer is provided a list of information requirements and the broad framework for discussions. These requirements are derived from ICRA's understanding of the issuer's business, and broadly cover all aspects that have a bearing on the rating. ICRA also draws on secondary sources of information, including its own research.

The rating involves assessment of a number of qualitative factors with a view to estimating the future debt servicing capacity of the issuer. This requires extensive interaction with issuer's management, specifically on subjects relating to plans, outlook, competitive position, and funding policies.

Plant/site visits are made to gain a better understanding of the issuer's production process, make an assessment of the state of equipment and main facilities, evaluate the quality of technical personnel, and form an opinion on the key variables that influence the level, quality and cost of production. These visits also help in assessing the progress of projects under implementation.

After completing the analysis, a Rating Report is prepared, which is presented to ICRA's Rating Committee. A presentation on the issuer's business and management is also made by the Rating Team. The Rating Committee is the final authority for assigning ratings.

The assigned rating, along with the key issues, is communicated the issuer's top management for acceptance.

If the issuer does not find the rating acceptable, it has a right to appeal for a review. Such reviews are usually taken up only if the issuer provides fresh material inputs. During a review, the issuer's response is presented to the Rating Committee. If the inputs and/or fresh clarifications so warrant, the Rating Committee would revise the initial rating decision. Non-accepted ratings are not disclosed and complete confidentiality is maintained on them.

ICRA-assigned ratings once accepted are subject to regular periodic reviews. The assigned rating may be retained or revised (that is, upgraded or downgraded) following the review.

The Rating Methodology

ICRA considers all relevant factors that have a bearing on the future cash generation and debt servicing ability of the issuer. These factors include: industry characteristics, regulations, competitive position of the issuer, operational efficiency, management quality, commitment to new projects and other associate companies, and funding policies of the issuer. A detailed analysis of past financial statements is made to assess performance under "real world" business dynamics. Estimates of future earnings over the next 3-5 years under various sensitivity scenarios are drawn up and evaluated against the claims and obligations that require servicing. Primarily, it is the relative comfort on the level and quality of the issuer's cash flows to service obligations that determines its rating.

The Rating Scale

Long-Term Rating Scale *All Bonds, NCDs, and other debt instruments (excluding Public Deposits) with original maturity exceeding one year.*

Rating	Description
[ICRA]AAA	Instruments with this rating are considered to have the highest degree of safety regarding timely servicing of financial obligations. Such instruments carry lowest credit risk.
[ICRA]AA	Instruments with this rating are considered to have high degree of safety regarding timely servicing of financial obligations. Such instruments carry very low credit risk.
[ICRA]A	Instruments with this rating are considered to have adequate degree of safety regarding timely servicing of financial obligations. Such instruments carry low credit risk.
[ICRA]BBB	Instruments with this rating are considered to have moderate degree of safety regarding timely servicing of financial obligations. Such instruments carry moderate credit risk
[ICRA]BB	Instruments with this rating are considered to have moderate risk of default regarding timely servicing of financial obligations.
[ICRA]B	Instruments with this rating are considered to have high risk of default regarding timely servicing of financial obligations.
[ICRA]C	Instruments with this rating are considered to have very high risk of default regarding timely servicing of financial obligations.
[ICRA]D	Instruments with this rating are in default or are expected to be in default soon.

Short-Term Rating Scale *All instruments with original maturity upto one year.*

Rating	Description
[ICRA]A1	Instruments with this rating are considered to have very strong degree of safety regarding timely payment of financial obligations. Such instruments carry lowest credit risk.
[ICRA]A2	Instruments with this rating are considered to have strong degree of safety regarding timely payment of financial obligations. Such instruments carry low credit risk.
[ICRA]A3	Instruments with this rating are considered to have moderate degree of safety regarding timely payment of financial obligations. Such instruments carry higher credit risk as compared to instruments rated in the two higher categories.
[ICRA]A4	Instruments with this rating are considered to have minimal degree of safety regarding timely payment of financial obligations. Such instruments carry very high credit risk and are susceptible to default.
[ICRA]D	Instruments with this rating are in default or expected to be in default on maturity.

Note:

For the short-term ratings modifiers {"+" (plus)} can be used with the rating symbols for the categories [ICRA]A1 to [ICRA]A4. The modifier reflects the comparative standing within the category.

For the long term rating modifiers {"+" (plus)/ "-"(minus)} can be used with the rating symbols for the categories [ICRA]AA to [ICRA]C. The modifiers reflect the comparative standing within the category.

(SO) The letters SO in parenthesis suffixed to a rating symbol stand for Structured Obligation. An SO rating is specific to the rated issue, its terms, and its structure. SO ratings do not represent ICRA's opinion on the general credit quality of the issuers concerned.

pp The letters 'pp' suffixed to a rating symbol stand for 'principal protected'. According to the terms of the rated instrument, the amount invested, that is the principal, is protected against erosion while the returns on the investment could vary, being linked to movements in one or more variables, such as equity indices, commodity prices, and/or foreign exchange rates. The rating assigned expresses ICRA's current opinion on the credit risk associated with the issuer concerned. The rating does not address the risks associated with variability in returns resulting from adverse movements in the variable(s) concerned.

pn The letters 'pn' suffixed to a rating symbol stand for 'principal not protected'. According to the terms of the rated instrument, the amount invested, that is the principal, is not protected against erosion, while the returns on the instrument could also vary. Payments on the rated instrument are linked to movements in one or more

Disclaimer

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