

FINANCIAL INSTITUTION RATING METHODOLOGY

1.0 OVERVIEW AND SCOPE

NCR's rating opinion reflects the credit worthiness of an issuer to meet financial obligations in timely manner over the life of the instrument. NCR has developed a comprehensive methodology for rating Banks keeping in view of the conceptual framework of BASEL III for Banks and NBFIs.

While rating of FIs is taken into account, NCRL categorizes the rating factors into two broad areas i.e. qualitative and quantitative. In the rating process, NCRL follows CAMELS (Capital Adequacy, Asset Quality, Management, Earnings, Liquidity and Sensitivity to Market Risk) rating approach to assess the performance and financial soundness of the activities of the banks and NBFIs. In addition, the rating process of NCRL considers size & market share of the bank/FI, operational risk, credit risk, industry risk, use of technology, ownership and support, corporate governance, management quality, accounting quality and franchise value. This analysis also helps in evaluating a given bank's competitive position within the industry. In order to carryout adequate analysis of a particular bank, it is helpful, to establish a "peer group", of comparable banks.

2.0 CAMEL RATING PROCESS

2.1 CAPITAL ADEQUACY

Capital Adequacy is an indication of the inner strength of a bank which makes it to stand in a good position during the times of crisis. Capital Adequacy may have an effect on the overall performance of a bank, such as expansion of network, opening of new branches, fresh lending in high risk but profitable areas, manpower recruitment and diversification of business. NCRL focuses on following factors to evaluate capital adequacy of a Bank/NBFI:

- Credit risk
- Market risk
- Operational risk
- The conformity to the regulatory guidelines on capital adequacy ratio
- The size and the composition of the regulatory capital
- The capacity to recognize and respond to an immediate need for additional capacity
- Capital adequacy relative to its peers

2.1.1 CAPITAL CALCULATION:

The regulatory capital under Basel-III is composed of (I) Tier-1 (Going-concern Capital) and (II) Tier-2 (Gone-concern Capital). From regulatory capital perspective, going-concern capital is the capital which can absorb losses without triggering bankruptcy of the Bank and gone-concern capital is the capital which will absorb losses only in a situation of liquidation of the Bank.

Tier-1 capital is composed of (a) Common Equity Tier 1 and (b) Additional Tier 1, Whereas, Common Equity Tier 1 (CET1) capital consists of paid-up capital, statutory reserve, general reserve, retained earnings, minority interest in subsidiaries etc.

Tier-2 capital is composed of general provision, subordinated debt, revaluation reserves etc.

2.2 ASSET QUALITY

Assets quality refers to the overall risk attached to the various assets held by a FI. Banks most commonly determine the quality of assets by determining how many of their assets are susceptible to financial risk and how much they need to keep as provisions against losses. Loans and advances are considered as the major components in asset composition of commercial banks. The higher concentration of loans and advances indicates the vulnerability of assets to credit risk. To determine the asset quality of a Bank/NBFI, NCRL looks into:

- Structure of balance sheet items
- Sector wise loan composition and diversification
- Maintained provision against required provision and write off
- Percentage of assets classified into standard, special mention account, substandard, doubtful or loss and the track record of recoveries
- Restructured assets in total exposure of banks
- Reschedule loan (Total reschedule loan during the year, number of accounts)
- Top defaulters
- Single borrower exposure limit. (As per the BB Master Circular No. 5, the aggregate outstanding principal amount of funded exposures of a bank to any individual or counter-party or group must not exceed 15 per cent of its capital at any point of time)

2.3 MANAGEMENT QUALITY

Capacity of Management aims to ensure the ability to use resources. Sound management is most essential and an inevitable requirement for the strength and solid growth of every financial institution. It is quite difficult to draw any conclusion regarding management efficiency based on quantitative indicators, as characteristics of a good management are rather qualitative in nature. Nevertheless, operating expenditure to total operating income, operating expenses to total costs, employee productivity and interest rate spread are used to portray management soundness. To assess the soundness of management of a Bank/NBF, NCRL examines:

- The composition of the board, frequency of change of CEO and the organizational structure
- The dependence of management team on one or more persons, coherence of the team, and the independence of the management from major shareholders
- Modern banking practices and systems, use of technology, capabilities of senior management, personnel policies and extent of delegation of powers.
- Loan recovery progress

2.4 EARNINGS QUALITY

High earnings ability should reflect the firm's current operating performance and a good indicator of future operating performance. The ability of earnings is an extremely significant parameter which expresses the quality of profitability and capability of a FI to sustain earning consistently. It primarily reflects the profitability of FI and enlightens consistency of future earnings. NCRL focuses on following factors while evaluating earning performance of a Bank/NBFI

- The historical trend of a Bank's earnings performance
- The stability and quality of its earnings and the capacity to generate profits
- The composition of income by segregating it into those generates from fee based and fund-based activities
- Reviews the net interest income, non-interest income, interest rate policy, product mix management, risk vs. return policy, risk appetite to increase earning etc.
- Earning quality relative to peers

2.5 LIQUIDITY

Liquidity is an important parameter which reflects FI's ability to handle its financial obligations. A FI has to maintain adequate amount of funds in a liquid form to cover its short-term liabilities. Excessive liquid funds may prevent from making higher profits. On the other hand, liquidity risk can damage good reputation of a FI. So, every FI's prior concern is to secure adequate amount of liquid funds. To determine the liquidity position of a Bank/NBFI, NCRL looks into:

- The structure and diversification of funding base
- Deposit Mix
- Concentration of deposit or borrowing
- Significant trends in funding sources
- The asset-liability maturity structure, deposit renewal ratios, proportion of liquid asset to total asset and the extent to which core asset are fund by core liabilities
- The core and non-core deposit mix and indicators to assess the mix of corporate and retail deposits
- Both the internal sources of liquidity (marketable securities, maturing loans, etc.) and external sources (such as access to capital markets, stand-by lines from other banks and rediscount facilities at the central bank)
- CRR and SLR

3.0 OTHER FACTORS**3.1 SIZE AND MARKET PRESENCE**

The size of a bank in terms of its asset, liabilities and branch network may have a bearing on the bank's competitive position. NCR analyses-

- The diversification of activities undertaken by a bank, in terms of geographical location and industrial sectors.
- The diversity of services and products it provides to customers, and its ability to create new products.

3.2 INDUSTRY RISK

Under Industry risk analysis NCRL gives an overview of current situation of Bank/NBFI and examines the FIs through several crucial aspects:

- Influence of industry scenario over the FIs.
- Strengths and challenges of FIs.
- Trends of technological changes.
- Government patronization.
- Political environment.

3.3 USE OF TECHNOLOGY

Now a days it is almost impossible to manage a bank without appropriate application of Information technology. It enables sophisticated product development, better market infrastructure, implementation of reliable & secured techniques for control of risks and helps to reach geographically distant and diversified markets. NCRL focuses on IT infrastructure, its use in risk management, disaster management etc.

3.4 CORPORATE GOVERNANCE

A bank's corporate governance practices can have a material impact on its credit quality. In assessing corporate governance, NCRL analyses governance data and information systematically and also performs more contextual, qualitative reviews of an individual entity's governance practices. The

important aspects, which are looked at by NCRL while evaluating the quality of corporate governance include, the independence and effectiveness of the board of directors, oversight of related party transactions that may lead to conflicts of interest, board oversight of the audit function, executive and director remuneration, complex shareholding/ownership structures.

3.5 ACCOUNTING QUALITY

Rating depends profoundly on audited data. Policies for income recognition, provisioning and valuation of investments are examined. Suitable adjustments to reported figures are made for consistency of evaluation and meaningful interpretation.

3.6 GOVERNMENT SUPPORT

Government support for specialized entities in the financial sector played important role in the economy. Besides, public-sector banks benefit from the prospect of support ascending from government ownership. In NCRL's opinion, the likelihood of government support is underpinned by strong policy and moral imperatives, given the role that the public sector banking system plays in the economy. NCRL believes the patronization to the public sector banks would unquestionably be of a higher order as demonstrated by capital infusion over the year.

3.7 FRANCHISE VALUE

NCRL take into accounts the strength and depth of a bank's franchise as well as its ability to safeguard existing business and gain new business. The joint venture/strategic alliance with foreign/local partners, management contract/technical collaboration with foreign/local partners and a bank's alliance/arrangement with international financial institutions or any certifications from such institutions are also taken into account.

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