



**ARGUS CREDIT RATING SERVICES
LIMITED**

**RATING METHODOLOGY:
FINANCIAL INSTITUTION**

RATING PROCESS FLOW

1. Primary Document Collection

2. Agreement Signing

3. Preliminary Assessment

4. Management Meeting

5. Assessment by IRC

6. Final Rating by RC

7. Publish Report

ACRSL'S RATING METHODOLOGY – FINANCIAL INSTITUTION

ACRSL's ratings are an opinion on the relative ability and willingness of an issuer to make timely payments on the specific debt obligations of the Bank/NBFI. ACRSL has developed a comprehensive methodology for credit rating of banks. Some of the factors considered in ACRSL's rating analysis are described below:



QUANTITATIVE FACTORS

Quantitative analysis involves primarily an insight into the financial statements of a company such as:

- Balance Sheet
- Income Statement
- Cash Flow Statement

Balance Sheet shows a certain state of the assets and the sources of assets on a specific date. Income Statement shows the company's success in a certain period that is expressed through Profit or Loss. The Cash Flow Statement represent the past economic situation of the company.

(i) CAPITAL ADEQUACY

Capital Adequacy is a measure of the degree to which the bank's capital is available to absorb possible losses. It also indicates the ability of the bank to undertake additional business. ACRSL examines the conformity of the bank to the regulatory guidelines on capital adequacy ratio. Higher proportion of Tier I (core capital) in the overall capital is viewed favorably. Further, ACRSL works out the 'stressed capital adequacy' on the basis of expected erosion of capital arising as a result of factors such as:

(ii) ASSET QUALITY

Asset Quality review begins with the examination of the bank's credit risk management framework. The overall asset quality is assessed by evaluating the sector by sector loan and guarantee exposures. The bank's experience of loan losses and write off/provisions are studied carefully. The percentage of assets classified into standard, substandard, doubtful or loss and the track record of recoveries of the bank is examined closely. The portfolio diversification and exposure to troubled industries/areas is evaluated to arrive at the level of weak assets. Restructured assets in banks total exposure are also taken into account to arrive at the potential NPAs of the bank.

- Additional provisioning for NPAs
- Possible losses from restructured assets
- Possible losses from other weak assets

(iii) EARNINGS QUALITY

ACRSL analyzes the composition of income of the bank by segregating it into those generated from fee based and fund based activities. Core earnings are also identified by excluding non-recurring income from total income. Each business area that contributes to the core earnings is assessed for risks as well as for its earnings prospects and growth rate.

Profitable operations are essential for banks to operate as an ongoing concern. Yield on business assets as also on investments are viewed in conjunction with cost of funds to arrive at the spreads earned by the bank. Operating efficiency is also examined in terms of expense ratios. Quality of bank's earnings is also influenced by the level of interest rate and foreign exchange rate risks that the bank is exposed to. Finally, the overall profitability is reviewed in terms of return on assets and return on shareholders' funds.

(iv) LIQUIDITY & CAPACITY OF EXTERNAL FUND MOBILIZATION

Lack of liquidity can lead to a bank's failure, while, strong liquidity can help even an otherwise weak institution to remain adequately funded during difficult times. ACRSL evaluates the internal and external sources of funds to meet the bank's requirements. The liquidity risk is evaluated by examining the assets liabilities maturity (ALM) profile, deposit renewal rates, proportion of liquid assets to total assets and the degree to which core assets (those that are relatively illiquid) are funded by core liabilities. The short term external funding sources in the form of refinance facilities from BB and the inter-bank borrowing limits available along with CRR and SLR investments are important sources of reserve liquidity.

(v) SIZE OF THE BANK AND MARKET PRESENCE

The fund base and branch network of the bank may have a bearing on the bank's competitive position. While both large and small banks have successfully co-existed in Bangladesh, in the rapid changing competitive banking environment, the niche strategy of smaller banks against the scale advantages of larger banks would be carefully examined to understand the business model of each bank.

Evaluation of quantitative factors is done, not only of the absolute numbers and ratios, but their volatility and trends as well. The attempt is to determine core, recurring measures of performance. ACRSL also compares the bank's performance on each of the above discussed parameters with its peers. Detailed inter-bank analysis is done to determine the relative strengths and weaknesses of the bank in its present operating environment and any impact on it, in future.

QUALITATIVE FACTORS

By analyzing qualitative factors, we get a cleaner image of the company from the aspect of its historical development, the core business of the company, the state of the market in which it exists.

The advantage of this analysis is that it provides an opportunity with the qualitative factors to discover the potential risks of the company in the future.

(i) MANAGEMENT

The composition of the board, frequency of change of CEO and the organizational structure of the bank are considered. The bank's strategic objectives and initiatives in the context of resources available, its ability to identify opportunities and track record in managing stress situations are taken as indicators of managerial competence. The adequacy of the information systems used by the management is evaluated in terms of quality and timeliness of the information made available to bank managers. The extent of frauds committed in the bank is taken as an indication of the imperfections of the control systems. ACRSL focuses on the modern banking practices and systems, degree of computerization, capabilities of senior management, personnel policies and extent of delegation of powers. The track record of labor relations is also examined.

(ii) REGULATORY ENVIRONMENT & COMPLIANCE

ACRSL examines the track record of the bank in complying with SLR/CRR, maintenance of capital adequacy, composition of Board, role of the Board of Directors, delegation of power, Audit Committee, Executive Committee, risk management, loan classification policy, and implementation of Basel-III among others as specified in the BB guidelines.

(iii) RISK MANAGEMENT

The management stance on risk and the risk management framework is examined. Credit risk management is evaluated by examining the appraisal, monitoring and recovery systems and the prudential lending norms of the bank. The bank's balance sheet is examined from the perspective of interest rate sensitivity and foreign exchange rate risk. Interest rate risk arises due to differing maturity of assets and liabilities and mismatch between the floating and fixed rate assets and liabilities. ACRSL also assesses the extent to which the bank has assets denominated in one currency with liabilities denominated in another currency. The derivatives and other risk management products used in the past and implication of these deals are also analyzed.

(iv) OWNERSHIP & CORPORATE GOVERNANCE

An assessment of ownership pattern and shareholder support in a crisis is significant. In case of public sector banks, the willingness of the government to support the bank is an important consideration.

(v) ACCOUNTING QUALITY

Rating relies heavily 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.

MEASUREMENT OF KEY RATING FACTORS

ACRSL ratings are dynamic and, thus, incorporate future financial and operating performance. The rating process makes use of both historical and projected financial results. Historical results of operations help us understand the pattern of a company's performance and how it compared to its peer group. By analyzing historical data, we analyze strength of balance sheet and earnings volatility in line with its business cycle; and on the other hand, evaluate expected or projected results are realistic or not. The rating process makes use of both historical and projected financial results. Table given below shows risk parameters and detailed weight distribution under each broad and sub-rating factors.

Risk Parameters	Max Score
a) Quantitative Factors	60
i) Capital Adequacy	15
1. Bank's plan to raise equity to support its growth is acceptable	4
2. Bank has maintained the Minimum CRAR	5
3. Leverage Ratio of the Bank	4
4. Is the dividend policy of the Bank satisfactory keeping in line with capital adequacy requirement	2
ii) Asset Quality	15
5. Does Credit Risk Management includes exhaustive pre-approval and post -approval process including documentation & covenant compliance	2
6. Is Portfolio Management System in place and periodic portfolio review being done	2
7. Is level of non-performing loans acceptable	3
8. Review of largest exposure to a single client/group and portion of it being non-performing are regularly reviewed	1
9. Sector from where the gross NPL are coming from are periodically reviewed	1
10. Are classified loans being followed regularly with clear action plan for recovery?	2
11. Have Credit Risk Grading of clients are in place & effective.	1
12. Portfolio Diversity are being ensured by the management	1
13. Nature of security/collateral are clearly analyzed and the frequency of valuation seems justified	1
14. Quality of non-industrial lending are analyzed properly and exposures are satisfactory	1
iii) Earnings Quality	15
15. Bank is maintaining satisfactory growth in level of earnings	2
16. Diversity of earnings is regularly pursued	1
17. Growth in Return on Assets (ROA)	2
18. Growth in Return on Equity (ROE)	2

Risk Parameters	Max Score
19. Interest Rate Management, Interest rate policy (extent of change in lending & deposit rates and how is impacting margins and profitability) are presented and reviewed on a regular basis in ALCO meeting	2
20. Non funded business prospects and its contribution towards earnings are regularly reviewed for income growth	1
21. Average cost of fund is well under bank's established parameter and are being monitored	1
22. Average lending rates are well under bank's established parameter and are being monitored	1
23. Average net spread is well under bank's established parameter and are being monitored	1
24. Net Interest Income Margin trend is satisfactory	1
25. Yield per taka staff cost is well under bank's control	1
iv) Liquidity & capacity of external fund mobilization	10
26. Bank is complying to SLR, CRR and Loan Deposit Ratio	2
27. Asset liability maturity structure are in place and is reviewed in ALCO meeting.	2
28. Bank liquidity ratio is satisfactory	2
29. Core asset funded by core liabilities are been identified and proper matching is ensured	1
30. Bank regularly review the impact on interest rate volatility on deposit and its trend	1
31. Bank has the ability to raise fund through stable sources in cost effective manner	1
32. Bank has in the past or going forward has the credibility of funding sources in distress situation	1
v) Size of the bank and market presence	5
33. Number of branch network and employees	2
34. Level of automation	2
35. Products and services offered are regularly reviewed	1
b) Qualitative Factors	40
i) Management	10
36. Bank is viewed as a human resource based institutions	1
37. Quality of Management is satisfactory	1
38. Experience and educational background of the senior, mid-level and junior management is acceptable	1
39. Management Philosophy is crystallized through a well laid down Vision and Mission	1
40. Bank's human resource development plans are properly documented and being properly implemented	1
41. Quality of training being offered by the bank is acceptable	1

Risk Parameters	Max Score
42. Management operating efficiency are being calculated on the basis of earning and are properly recognized	1
43. More emphasis are placed on system & process based banking	1
44. Staff turnover rate is acceptable	1
45. Management places emphasis on Information Technology and continuous enrichment of staff knowledge in this area	1
ii) Regulatory environment & compliance	10
46. Policy on loan classification and provisioning are in line with Bangladesh Bank guidelines/circulars	2
47. Policy on large loans are properly monitored and followed per Bangladesh Bank requirements	1
48. Loan against Shares, Debentures etc. are properly approved and monitored as per Bangladesh Bank guidelines	0.5
49. Disclosure requirement for banks are handled properly	1
50. Delegation of power at operating level are well defined and properly allocated	1
51. Instructions for compliance of provisions of Money Laundering Prevention Act, 20.0.2. are properly handled at required level	2
52. Company has been operating satisfactorily in complying to the regulations of BSEC and related bodies	1
53. Internal Control & Compliance mechanism as per Bangladesh Bank guidelines are fully implemented and is operative in all respect	1
54. Bank's effort in moving towards achieving the way for Basel II compliance is satisfactory	0.5
iii) Risk Management	5
55. Is Credit Policy & Process Manual (as per Bangladesh Bank guidelines) in place and fully implemented	2
56. Implementation of risk management in the areas of Operational Risk Management	2
57. Implementation of risk management in the areas of Market Risk Management	1
iv) Sensitivity to Market Risk	5
58. Changes in interest rates substantially affect company's earnings	2
59. Changes in foreign exchange rate materially affect company's earnings	2
60. Changes in commodity prices may affect bank's business	1
v) Ownership & Corporate Governance	5
61. Ownership and constitution of Board	2
62. Conflict of interest issues in the operational management are fully analyzed and dealt with efficiency	1

Risk Parameters	Max Score
63. Personal policy and employee satisfaction issue gets priority by the Board	1
64. Application of information technology in the system along with IT Audit function receives top priority by the Board	1
vi) Accounting Quality	3
65. Policies for income recognition is documented and properly accounted for in the financial statement of the Bank	1
66. Provisioning and valuation of investment are properly examined and accordingly entries are taken up	1
67. Bank's Books of Accounts are being audited by quality Audit Firm	1
vii) Franchise Value	2
68. Joint Venture Partner/Strategic alliance	1
69. Management Contract/Technical collaboration	0.5
70. Alliance/arrangement with World Bank/ADB/IFC/SEDF or any awards/certification or any other recognition granted to the Bank	0.5
Grand Total	100

All relevant quantitative and qualitative factors are considered together, as relative weakness in one area of the bank's performance may be more than adequately compensated for by strengths elsewhere. However, the weights assigned to the factors are different for short term ratings and long term ratings. The intention of long term ratings is to look over a business cycle and not adjust ratings frequently for what appear to be short term performance aberrations. The quality of the management and the competitiveness of the bank are of greater importance in long term rating decisions.

The rating process is ultimately a search for the fundamentals and the probabilities for change in the fundamentals. The assessment of management quality, the bank's operating environment and its role in the nation's financial system are used to interpret current data and to forecast how well the bank is positioned in the future. The final rating decision is made by the Rating Committee after a thorough analysis of the bank's position over the term of the instrument with regard to business fundamentals.

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