Rating Methodology

BANK

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RATING METHODOLOGY

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CREDIT RATING PHILOSOPHY

CRISL follows structured rating methodologies for each sectors of the national economy and accordingly it has developed distinct Methodology for rating Banks. The basic philosophy of CRISL Bank rating is arising from the fact that the banks and financial institutions are highly leveraged. A bank in Bangladesh with an average owners' equity of 5% are undertaking a liability of 95% with 100% guarantee to repay in timely manner. The fund collected through the above guarantees are invested with 100% risk to earn a net interest margin of 2% to 4% through undertaking high Credit Risk, Operational Risk and Market Risk. The above situation puts the banks and financial institutions in such a vulnerable position that any mistake in the process may put the bank in a distress situation. Keeping in view the above globally banks are managed through a very cautious Asset Liability Management system (ALM). CRISL has developed its bank/FIs rating methodology keeping in mind the above situation.

The Bangladesh financial sector is under going through a phase of transition, transformation and convergence. The regulators are more active than ever before to bring the sector up to an international standard. The competitive environment created with the presence of too many banks in a small economy has also been forcing the Banks to increase risk in both sides of the balance sheet. In the asset side, banks are shifting from traditional financing from sector corporations to private and retail sectors such as financing to small private sector group business, housing, automobile commercial vehicles and SMEs etc. On the liabilities side, the transformation is from passive retail strategy to a very active retail trust to attract and retain customers and increase in deposit base.

Keeping in view the above CRISL has developed its own methodology precisely called as CAMELS PLUS based on basic bank rating system of CAMELS. While the word "CAMELS" stands for Capital Adequacy, Asset Quality, Management, Earnings and Liquidity, Sensitivity-the CAMELS PLUS takes into account the size of the bank, its capacity of external fund mobilization, regulatory environment, strong emphasis on Corporate governance together with shareholding pattern, market position with franchise value, Application of Information Technology in addition to CAMEL. CRISL puts special emphasis on the banks capacity to handle Credit Risk, Operational Risk and Market Risk in a systematic manner. Under the above broad spectrum of methodology, CRISL looks into the following areas in Bank in credit rating.

CRISL RATINGS

CRISL Bank Ratings are the OPINIONS of CRISL on the ABILITY and WILLINGNESS of a Bank/FI to discharge its obligations including depositors' money in timely manner that is as per contract. These opinions are arrived at after a systemetic analysis of both quantitative and qualitative areas of the Banks.
CRISL offers two types of ratings- Long term and Short Term. Long term ratings are valid for maximum one year while short term rating carries a validity of maximum six months. Therefore, CRISL ratings are always to be read with time reference.

CRISL RATING PERSPECTIVE

Understanding the increasingly important role of ratings, especially in the light of Basel II guidelines, consistent and uniform default definition is critical and it has significant impact on the reliability and comparability of ratings across rating agencies. A rigorous and transparent definition of default makes the ratings assigned by a rating agency meaningful. Ratings can either indicate probability of default (PD) or Expected Loss (EL). The underlying principles guiding each of these approaches are not similar, and ratings that indicate probability of default are not directly comparable with ratings that indicate Expected Loss, especially at lower rating levels. Investors and market participants, thus, will compare only those ratings that are based on similar approaches, or make appropriate adjustments before comparison.

Considering the stage of development of rating environment in Bangladesh CRISL adopted rating definition of "Probability of Default". Therefore, all CRISL ratings indicate the probability of default and not the EL that may arise after the default.

portion of the investment portfolio that is marked to market, if any, having an impact on capital all are given due importance in rating.

DEFINITION OF DEFAULT

CRISL adopted the international definition of default as being adopted by global rating agencies. Under the above definition, Default is:

A) A missed installment (Principal and or Interest) which has not been discharged / paid as per schedule or within the grace period allowed by the regulators/ creditors.
B) Failure to honour the corporate guarantee obligations as per contract or within the allowed grace period;
C) The legal insolvency or bankruptcy of the issuer/ entity
D) A distress exchange in which the bondholders/ creditors are offered a substitute instrument with inferior terms and conditions
E) Restructuring of a financial obligation substantially disadvantageous to the creditors;

SCOPE AND LIMITATIONS OF CRISL RATINGS

CRISL ratings are in local currency and therefore, it does not take into consideration the sovereign risks and foreign currency risk of Bangladesh Government. CRISL, being a domestic rating agency of Bangladesh considers the government of Bangladesh as the highest pay master and all government guaranteed securities/ guarantees are considered as AAA.

CAPITAL ADEQUACY

Capital provides a cushion against losses arising from Credit Risk, Operational Risk and Market Risk. The operational risk, in recent days, in view of the change of the nature of business of banks /FIs covers a wide spectrum of Risks needing due attention. Under the Basel III perspective, each bank should have its own capital assessment process to have an extra cushion against the risk exposure. CRISL places due consideration to those factors in the rating process and also evaluate the banks' status in managing those risk exposure and determines the capital requirement, maintaining the capital level in any form, growth in internal capital generation to achieve the target, maintenance of the regulatory capital and the buffer against heavy shock. The bank leverage is also a good indicator to judge the capital level against its external liabilities. CRISL also reviews the dividend policy and other capital build up process through increase of tier II/ tier III capital base in line with the future requirement. Each bank should have in internal capital assessment process (ICAAP) in line with its business growth and business plan to judge the prospective capital adequacy, sustainability of Capital adequacy ratios. Presence of hidden reserve,

ASSET QUALITY

Asset quality reflects how the Banks/ FIs are managing its credit/investment portfolio at an expected level. In reviewing the asset quality, CRISL places due importance to the Banks/ FIs credit appraisal mechanism, Credit Risk Grading Management system, portfolio management system, problem asset resolution strategy, repayment rescheduling philosophy etc. In addition to the above CRISL emphasis covers the areas such as portfolio diversity and sectoral concentration, client profile of top 20 or more, large credits covering at least 70% of the total portfolio, quality of non-industrial lending, level of non performing loans, sectoral NPL status, reason behind rescheduling and its subsequent performance, movement of provisions and write offs, growth rate of advances, aggressiveness in lending, etc. CRISL also reviews the impaired asset management process in controlling the NPL. In the rating process the quality and nature of security/collateral at gross level are also reviewed to have an understanding about its controlling asset value in default.

MANAGEMENT

The quality of management in banking/FI sector gets highest priority since it plays the key role in Asset and Liability Management (ALM). Banks/FIs are basically considered as human resource based institutions where development of human capital gets due attention in serving to its large clientele. CRISL places strong emphasis on the quality of management, experience and educational background of the senior, mid level and junior management, management philosophy, goals and strategies, management appetite towards risk taking. Human resource development plans, retention policy, quality of training being offered, management operating efficiency calculated on the basis of earning by spending one taka staff cost etc are assessed. Due emphasis is placed on system based banking, staff motivation plans, staff turnover etc. Banks are no longer considered as the organization only dealing with deposits and granting loan on demand. Banks/ FIs being a provider of wide range of services has been undertaking tremendous amount of credit risk, operational risk and market risk which needs system based banking with due emphasis to information technology. CRISL reviews the IT system and its adequacy to meet the growing need of various products and services.

EARNING PROSPECTS

Earning is the gateway to increase shareholders value of any organization. While reviewing the earnings and its prospects, CRISL reviews the level of earning, its diversity, interest rate management, basic earning before provisioning and tax, sustainability of the earnings. Earnings are compared in terms of Return On Assets (ROA), Return On Equity (ROE), earnings as the percentage of net loan, interest rate management and Banks/ FIs policy in this regard, non-funded business prospects and its contribution towards earnings etc. In the process CRISL also reviews the interest rate policy, product mix management, risk vs return policy, risk appetite to increase earning etc of the bank and how it is reviewed regularly in the ALCO meeting. CRISL also reviews that variance in different earning indicators set in its business plan. In the cost efficiency side CRISL focus covers a wide range of measurements such as cost efficiency in terms of cost to income ratio, NIIM trend, yield per taka staff cost, personnel expenses as percentage of total assets. Intra firm and peer analysis are carried out to identify the position of the Bank/FIs in the peer as well as in the industry.

LIQUIDITY AND FUNDING

Liquidity and funding is the vulnerable area, which may be a cause of bank failure even having strong fundamentals in other sector. The banks are required to maintain high liquidity against demand and time liabilities. The central bank also requires the bank to maintain SLR and CRR at certain percentage, depending on monetary policy and compliance thereof. CRISL evaluates the asset-liability maturity structure, deposit renewal ratios, proportion of liquid assets to total assets and the extent to which core assets are funded by core liabilities side by side with the Loan to Deposit Ratio. CRISL also considers the core and non-core deposit mix and identifies various indicators to assess the mix of corporate and retail deposits, concentration of deposit mix to top 50/100 deposit size, etc. The liquidity indicators are sensitized to measure coverage against total borrowings, maximum possible stress analysis by measuring coverage against a portion of contingent liabilities that may mature within a time horizon. The impact of interest rate volatility on deposit and its trend is also examined in the evaluation process of liquidity strength of a Bank/ FIs.

SIZE OF THE BANK & MARKET POSITION

The funding base and branch network plays an important role in assessing the competitive position of the Bank. The number of branch network plays an important role in having low cost and diversified deposits. In Bangladesh economy both small and large banks are coexisting with different market niche which are given due importance in the CRISL rating process. CRISL also reviews that market share of the bank in the industry in terms of both credit portfolio and deposit base.

CAPACITY OF EXTERNAL FUND MOBILIZATION

CRISL evaluates the Banks in terms of its ability to raise fund through stable sources in cost effective manner. The banks normally rely on its deposit base while the FIs are dependent mostly on wholesale fund. CRISL analysis covers wide range of areas such as size of deposit base and its diversity, deposit mix, growth potential, cost of deposit etc. While evaluating the funding base of FIs, CRISL takes into account the regulatory restrictions on money market borrowing, funding lines availed and available vis a vis the credibility of such funding sources to allow the Banks to avail of fund in distress situation.

CORPORATE GOVERNANCE

Corporate governance in the financial sector is being viewed by the regulators of the country seriously in view of the absence of many common fundamentals of the governance norms in the sector. CRISL analytical rigor covers a wide range of factors such as ownership/ shareholding pattern, composition of board and its committees, delegation of power at required level of management, operational independence, interruption in the system by external interference, conflict of interest issues in the operational management, personnel policy and employee satisfaction, recruitment and training, application of information technology in the system, policy about IT Audit function etc. Besides BASEL –II placed due importance to the senior management along with Board members to handle the risk exposure which are also factored in the rating process.

APPLICATION OF INFORMATION TECHNOLOGY

Bank management today is almost impossible without appropriate application of Information Technology. CRISL reviews the IT infrastructure, its application in business operation especially in Risk management, database management, credit risk analysis, data transfer mechanism, data disaster management system etc in order to assess the strength of the system.

REGULATORY ENVIRONMENT AND COMPLIANCES

Bangladesh Bank has issued a number of instructive circulars and best practice guidelines for the Banks covering a wide range of operational areas such as maintenance of CRR/ SLR, restriction on directors on borrowing from bank, composition of Board, Executive Committee, Audit committee, maintenance of capital adequacy, role of the Board members and the Chairman, appointment and removable of the CEO, credit rating, foreign exchange management, risk management, lending risk analysis, internal control, delegation of power at operating level, large loan policy, loan classification policy, loan against shares, Debenture, disclosure system, money laundering and terrorism act implementation, Compliance of Basel III and BSEC regulations and so on so forth. CRISL review, inter alia, covers the compliance status vis a vis management system installed to comply the same on regular basis.

BASEL-III COMPLIANCES

International Convergence of Capital Measurement and Capital Standards, popularly known as BASEL-III has already been implemented by Bangladesh Bank . Under BASEL-III banks are required to comply with a new set of risk management system covering its credit risk, market risk, operational risk and disclosure management. All these warrant to bank to bring the existing system as close to BASEL III requirement as possible so that the bank do not face any major change in the system abruptly. CRISL examines the current status and management policy to bring the bank to a position within a time horizon. BASEL–II emphasized on the adequate disclosure of banks risk management system which is also considered by CRISL in the evaluation process.

RISK MANAGEMENT & SENSITITVITY TO MARKET RISK

Risk management function plays the key role in assessing the overall risk of the bank. The CRISL analysis covers various aspects of risk management in the areas of Credit Risk, Operational Risk and Market risk. Hence, CRISL reviews the structure and activities of the Risk Management Department and its review process. How the TOR specified by Bangladesh Bank is implementing by the RMU is also a key consideration factor. CRISL also reviews how the bank is compliant with five core risk management guideline of BB and its own ICAAP. The use of Stress Test policy as well as formulation of policy considering the result of stress test is also consideration factor in the CRISL review process.

In addition to the above CRISL considers credit policy and process manual of the bank, operational risk management and market risk management, banks earning position affected by interest rate volatility, effect of foreign exchange volatility to company's earnings and effect of commodity price changes etc.

ACCOUNTING QUALITY

Financial disclosure to reflect the business and its result plays very important role in rating. Financial disclosure as per requirement of IAS/ BAS/IFRS/BFRS vis a vis Bangladesh Bank guidelines are given due weight in CRISL evaluation. The policies of income recognition, capitalization, equity build up, provisioning policy, write off, asset revaluation, investment valuation, quality of audit are reviewed objectively

FRANCHISE VALUE

In reviewing the franchise value, CRISL considers strategic alliance, global linkage, technical collaboration, client base, national and international awards and recognitions, product diversity, CSR activities, capital market perception etc.

CRISL RATING SCALES AND DEFINITIONS

LONGTERM - BANK

Rating	Definition
AAA Triple A (Highest Safety)	Banks rated in this category are adjudged to be of best quality, offer highest safety and have highest credit quality. Risk factors are negligible and risk free, nearest to risk free Government bonds and securities. Changing economic circumstances are unlikely to have any serious impact on this category of banks.
AA+, AA, AA- (Double A) (High Safety)	Banks rated in this category are adjudged to be of high quality, offer higher safety and have high credit quality. This level of rating indicates a corporate entity with a sound credit profile and without significant problems. Risks are modest and may vary slightly from time to time because of economic conditions.
A+, A, A- Single A (Adequate Safety)	Banks rated in this category are adjudged to offer adequate safety for timely repayment of financial obligations. This level of rating indicates a corporate entity with an adequate credit profile. Risk factors are more variable and greater in periods of economic stress than those rated in the higher categories.
BBB+, BBB, BBB- Triple B (Moderate Safety)	Banks rated in this category are adjudged to offer moderate degree of safety for timely repayment of financial obligations. This level of rating indicates that a bank is under-performing in some areas. These entities are however, considered to have the capability to overcome the above-mentioned limitations with special care and cautious operation. Risk factors are more variable in periods of economic stress than those rated in the higher categories.
BB+, BB, BB- Double B (Inadequate Safety)	Banks rated in this category are adjudged to lack of key protection factors, which results in an inadequate safety. This level of rating indicates a bank as below investment grade but deemed likely to meet obligations when due. Overall quality may move up or down frequently within this category.
B+, B, B- Single B (Risky)	Banks rated in this category are adjudged to be with high risk. Timely repayment of financial obligations is impaired by serious problems which the entity is faced with. Whilst an entity rated in this category might be currently meeting obligations in time, continuance of this would depend upon favorable economic conditions or on some degree of external support.
CCC+,CCC, CCC- Triple C (Vulnerable)	Banks rated in this category are adjudged to be with vulnerable protection factors. This rating indicates that the degree of certainty regarding timely payment of financial obligations is doubtful unless circumstances are favourable.
CC+,CC, CC- Double C (High Vulnerable)	Banks rated in this category are adjudged to be with high vulnerable position. This rating indicates that the degree of certainty regarding timely payment of financial obligations is quite lower unless overall circumstances are favourable or there is possibility of high degree external support.
C (Near to Default)	Banks rated in this category are adjudged to be with near to default in timely repayment of financial obligations. This type rating may be used to cover a situation where a insolvency petition has been filed or similar action has been taken, but payments on the obligation are being continued with high degree of external support.
D (Default)	Banks rated in this category are adjudged to be either currently in default or expected to be in default. This level of rating indicates that the entities are unlikely to meet maturing financial obligations and calls for immediate external support of a high order.

SHORT TERM - BANKS

ST-1	**Highest Grade** Highest certainty of timely payment. Short-term liquidity including internal fund generation is very strong and access to alternative sources of funds is outstanding, Safety is almost like risk free Government short-term obligations.
ST-2	**High Grade** High certainty of timely payment. Liquidity factors are strong and supported by good fundamental protection factors. Risk factors are very small.
ST-3	**Good Grade** Good certainty of timely payment. Liquidity factors and company fundamentals are sound. Although ongoing funding needs may enlarge total financing requirements, access to capital markets is good. Risk factors are small.
ST-4	**Satisfactory Grade** Satisfactory liquidity and other protection factors qualify issues as to investment grade. Risk factors are larger and subject to more variation.
ST-5	**Non-Investment Grade** Speculative investment characteristics. Liquidity is not sufficient to insure against disruption in debt service. Operating factors and market access may be subject to a high degree of variation.
ST-6	**Default** Issuer failed to meet scheduled principal and/or interest payments.