Rating Methodology

MERCHANT BANKS

CREDIT RATING INFORMATION & SERVICES LIMITED
Nakshi Homes (4th & 5th Floor), 6/1A, Segunbagicha, Dhaka 1000, Bangladesh
Tel: 717 3700 – 1, Fax: 956 5783 Email: crisl@bdonline.com Web: www.crislbd.com

RATING METHODOLOGY

MERCHANT BANKS

CREDIT RATING PHILOSOPHY

CRISL follows structured rating methodologies for each sectors of the national economy and accordingly it has developed distinct methodology for merchant banks. CRISL rating objective for merchant banks is to assess likelihood of the company not being able to make timely payment of its obligations. Ratings' being prospective in nature, CRISL integrates analysis of an entity's recent financial and operating performance with an assessment of the firm's strategic plan. CRISL rating methodology for Merchant Banks provides an analytical framework that focuses on the key operational, financial and qualitative factors. CRISL is critical in assessing the overall performance, competitive positioning and its ability to withstand challenging operating environment & services its debt obligations. CRISL rating methodology involves an in-depth analysis of several qualitative and quantitative factors. In CRISL view, the analysis of financial ratios alone (based on annual reports) would not be able to capture the entire business risks. While assigning the ratings CRISL duly considers continuously changing factors to capture the structural changes and dynamics in the industry. For the rating of a Merchant Bank, CRISL also considers the competitive position of the market participants; their revenues and business operations.

CRISL RATINGS

CRISL Merchant Bank Ratings are the OPINIONS of CRISL on the ABILITY and WILLINGNESS of a security firm to discharge its obligations money in timely manner vis a vis the earning prospect of a company towards its long term sustainability. These opinions are arrived at after a systematic analysis of both quantitative and qualitative factors in the areas of the firm's operation. 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 with standard minimum surveillance of six months on its expiry. Therefore, CRISL ratings are always to be read with time reference.

CRISL RATING PERSPECTIVE

Understanding the increasingly important role of ratings, 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.

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.

RATING FRAMEWORK

CRISL's evaluation of Merchant Banks compromises an analysis of the following:

INDUSTRY AND BUSINESS RISK

Merchant banks (MBs) are operating in a highly competitive and dynamic environment where activities can be greatly impacted by various macro and micro factors. The industry can also be significantly affected by event risk, particularly, resulting from regulatory or political developments. Such factors can lead to greater volatility in earnings and profitability compared to other sectors of the economy. Generally, MBs serve the basic function of issue management, underwriting, portfolio management, financing customer positions, providing advisory services etc. The importance of these functions, the size of the customer base, and the availability of substitute products or alternative suppliers will affect the approach to a rating. All Merchant banks have to be the members of Merchant Bank Association (MBA) and need to get permission from Securities and Exchange Commission (SEC) to operate the business. SEC provides rules for the MBs and they MBs will have to comply efficiently. In line with the market trend, capital market regulators make necessary changes in regulations and guidelines. The operations and profitability of the company are greatly affected by the change in regulation. Even any change in national policy by government such as imposition of tax, vat or other charges can affect the profitability of the company. Imposition of restrictive monetary and/or fiscal policy by the government at any time may affect the whole industry. These rules and regulations provide creditors protection through minimum capital, exposure limits and margin requirements. In addition to these, the company's efforts at prudent risk control in accordance with its business lines are also analyzed.

MANAGEMENT QUALITY AND STRATEGY

CRISL's framework involves reviewing the promoter's track record in terms of growth of the business, risk appetite, gearing policy, transparency in running the operations and their commitment and financial support to the business in distressful situation. Conservative business growth with no history of litigations or regulatory fines would be viewed favorably by CRISL over an aggressive business growth by compromising on the business ethics. In CRISL's view, companies backed by strong institutions as a strategic investor are expected to derive higher comfort as compared with any other company which is backed by individual promoters. Success of any organization also depends, to a great extent, on the continuity of its business strategies and depth & stability in its management team. CRISL reviews the corporate structure of the MBs. This area also reviews managerial involvement in risk control, its ability to innovate, focus of management on core competencies and the management's flexibility in responding to competition. Importance given to planning & implementation processes, and the decision-making hierarchy also provide insight into the level of controls in place in the company and the confidence in the management team itself. Per employee revenues and costs would help determine management efficiency and economical utilization of resources. In the end, management expertise is reflected in the financial performance of the company.

While developing an understanding of the management's business strategy, CRISL evaluates its competitive positioning and niche, and the viability of the company to operate in that niche as well as growth in business volumes. The above depends, to a great extent, on the company's ability to adapt to the changing needs of its clientele and offer innovative services & products which are consistent with the changing dynamics of the industry and market. Services could include convenience of online customer account status or other pertinent information, and ancillary products could include research reports and other publications, which add value to the clients. Market share and trends on business & client growth are effective tools to gauge the company's value.

The benefits to the company would be higher margins through enhanced volumes compared to other firms. Depending on the firm's business, CRISL examines the size of marketing force, customer profile, customer retention & growth, and average turnover in trading activity.

BUSINESS INFRASTRUCTURE

Being a dynamic industry where timely dissemination of information is very critical, the quality of service provided by a Merchant Bank would depend on its infrastructure. Merchant bank with poor back-office infrastructure are likely to compromise both on risk management as well as client servicing.

CRISL analyses the adequacy of infrastructure as required to comply with the requirements of regulators/Stock Exchanges, etc, adequacy of connectivity with the exchange houses, communication network and there redundancy levels with branches & sub-brokers, system's un-utilized capacity & its scalability, time taken to restore the connection failure, database maintained, policy on disaster house for maintaining clients transaction history and efficient real time margin monitoring system etc. CRISL also evaluates the banker's focus on continuous improvement and ability to scale up its IT systems in line with the business growth.

RISK MANAGEMENT & CONTROLS

Broad parameters of risk include price and interest rate risk, credit/counter party risk, market risk, portfolio management risk, operational risk etc. A company's vulnerability to these risk factors may be measured by the volatility in revenues and pre-tax income. Earnings of a merchant bank are exposed to the fluctuating market conditions. A MB's main sources of income include underwriting commission, issue management fee, portfolio management fee, trading in capital markets, gains on proprietary trading, consulting and advisory fee, underwriting income, portfolio management fee etc depending on the periphery of operation. The implementation of circuit breaker mechanism, to some extent, help limit losses from price fluctuations. In addition, these firms usually manage their risk, sourcing portion of revenues through more stable channels like fixed income investments. CRISL reviews the company's asset liability management procedures and any long term mismatches in its funding structures. Diversifying client base and developing a strong retail clientele is also vital to manage client turnover. Risks for smaller companies may be higher due to their inability to participate in the broader market or manage a large client base.

CRISL reviews the risk management guidelines, which have been developed by the company and the extent of any deviation from these guidelines. These would also include the level of exposure taken on any client and the client assessment procedures being followed. Margin requirements from clients can mitigate the counter party exposure of the company. The stock exchanges also guarantee commitments in COT in some of the key, liquid stocks which mitigate counter party risks while trading in these shares.

The MBs also need to manage and comply with the frequently changing regulatory requirements. In addition, these firms should have in place strong internal controls to mitigate operational risks. These would include errors in trading and investment, frauds and embezzlements etc. Since at any point, large number of transactions is being handled, losses from operational negligence could be substantial and may have long term consequences on the reputation of the company. Assessment also includes evaluation of any risk, which may be peculiar to the company.

Risk management should be a continuous process in the company. CRISL evaluates the level of risk and the risk measurement & management tools being used and the extent of transparency. These tools should be robust enough to adapt to the changing needs of the company and the market. The management information system (MIS) should enable the company to carry out scenario and stress tests, identify concentration areas and signal non-compliance. Technology is one of the forces that have driven change in the capital markets. CRISL reviews the pace of adoption of technology at merchant banks and the degree of competitive advantage it may create, the prospect for new entrants resulting from technological change, such as Internet brokers, and the need for technological capital spending as a barrier to entry.

EARNINGS

Both trend analysis and industry comparison is conducted to determine the relative financial performance of the company. Revenue and cost structures are broken down into the separate business /product lines and contribution from different categories of customers. The quality of the company's own investment portfolio, return from proprietary trading, and income from client dealing, stability of underwriting and issue management income, and any other stable sources of income are taken into consideration. Across time and industry comparison determines how well a merchant bank has been able to manage its risk relative to other players. Performance measures would include the pre-tax return on funds employed, volatility in revenues, efficiency and any over/under-performance relative to the broader market and the reason for such results. Performance is also evaluated relative to projections and reasons for deviations are explored further.

CRISL assesses the financial flexibility of the company. The ability of the company to rationalize costs in times of sluggish market conditions and spread fixed costs over a larger volume is critical. Costs per transaction would help indicate the flexibility in pricing available to the company. Larger companies would fair well in their ability to develop economies of scale.

SOLVENCY AND LIQUIDITY

Given the volatile nature of the capital market, a merchant bank needs to have an adequate level of capital to be placed with the exchange houses for margin requirement. For analyzing banker's adequacy of funds, CRISL evaluates the parameters like financial flexibility in the form of availability of various sources of funding, quality of capital, committed bank lines for alternative liquidity, average utilization of the capital placed with the exchange houses, collection period from the clients and capital needs of off-balance sheet transactions. The rating framework also evaluates MB's capital adequacy for the current business operations and its ability to raise further funds for business expansion. In CRISL's view, strong capital levels provides necessary cushion in terms of absorbing any delay in collections from clients and losses during bad capital market. However, CRISL evaluates the company on the basis of free net worth available for the business after adjusting it for risky or ill-liquid investments. Merchant banks are expected to have low external borrowings, at-least on the balance sheet, as they normally place Bank Guarantee with Exchange Houses for margin requirement. Therefore, for the analysis of company's actual gearing, CRISL also considers the bank guarantees as a part of external debt program.

CRISL

CRISL RATING SCALES AND DEFINITIONS

LONGTERM – MERCHANT BANKS

Rating	Definition
AAA Triple A (Highest Safety)	Merchant 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 Merchant Banks.
AA+, AA, AA- (Double A) (High Safety)	Merchant 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)	Merchant 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)	Merchant 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 Merchant 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)	Merchant 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 Merchant 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)	Merchant 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)	Merchant 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)	Merchant 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)	Merchant 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)	Merchant 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

SHORT TERM - MERCHANT 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 Entity failed to meet scheduled principal and/or interest payments.