

Rating Criteria for Bank and Financial Institutions

WASO RATING FRAMEWORK

This paper serves as a general guide to WASO Ratings' analytical framework for Bank and financial institution ratings, which measure the fundamental credit strength of Bank and financial institutions. Each bank or financial institution in our rating portfolio is assessed by using the "**CAMEL plus 3R**" approach, which rigorously examines the institution's overall aspects. This broad-based "**CAMEL plus 3R**" approach is then adapted to appraise the relevant risks associated with a particular type of bank or financial institution.

An entity specific analysis is done through a qualitative and quantitative approach following a structured Model called the "**CAMEL plus 3R**" Model. Based on the rating criteria, the relative strength and weakness of each entity in comparison to its peer are evaluated. WASO also evaluated the market position of the bank & FIs rated and the franchise value it attained through its responsibility to stakeholders to cope with the emerging competitive scenario.

WASO Ratings' quantitative analysis will involve charting financial data and compiling a set of financial ratios for peer comparison, and to detect the trends and anomalies in the institution's market and financial positions. While quantitative analysis is an important consideration when determining a financial institution's strength, qualitative factors also play a critical role when assessing the creditworthiness of a financial institution.

The "**CAMEL plus 3R**" model comprises to the following:

- Capital Adequacy
- Asset Quality
- Management and System Evaluation
- Earnings Potential
- Liquidity/Asset Liability Management
- Plus
- Resource Raising Ability
- Regulatory Compliance
- Risk Management

No single factor is of overriding importance or considered in isolation from others. All six factors are viewed in conjunction while assigning a rating.

WASO RATING METHODOLOGY

CAPITAL ADEQUACY

Capital provides the necessary cushion to withstand credit risk and other risks related to banking operation. While assigning a rating, WASO consider its capital base and its sustainability from medium to long term. This assessment is significantly influenced by the perception of relative profitability, the entity's risk profile and asset quality. The analysis encompasses the following factors:

Size of Capital

The absolute size of capital imparts flexibility to a bank/ FIs to withstand shocks. Therefore an entity with a high absolute capital is viewed favourably. In addition, a few other factors are also evaluated, like, whether the Capital level is upper the regulatory requirement at minimum shock on average, internal capital generation trend is in line with business growth, to what extent existing capital base can support Pillar II capital requirement and others.

Quality of Capital Components(Tier I & Tier II)

The proportion of Tier I capital or core capital is the primary indicator of the quality of the banks or FI's capital. Although presence of Tier II capital does provide some cushion over the short to medium term, such capital needs to be periodically relinquished.

WASO also analyses other issues like such as presence of hidden reserves, (unutilized gains on investment portfolio) and the percentage of the investment portfolio that is marked to market. These issues help streamline accounting policy differentials across entities, and have a bearing on the capital quality. A key element in WASO capital adequacy analysis is a study of Tier I capital coverage for un-provided weak assets (defined as restructured assets + Gross Non-performing Assets + a portion of exposures at below investment rating category and below) (which is obtained from the asset quality analysis).

Sustainability of Capital Ratios

An entity can enhance its internal capital either through internal accruals or by raising fresh equity capital or by issuing hybrid capital. WASO therefore evaluate the rated entity's access to capital market to increase Tier I capital needs or to service the increased capital base. Internal Capital generation is considered as the prime factor in assessing the sustainability of its capital adequacy. An entity is able to maintain its assets growth through internal generation without impairing the capital adequacy is viewed favourably.

Capital Vs. Business Growth Plans

WASO also factors the growth plan of the banks & FIs in analyzing the capital adequacy. Its capital adequacy may be regarded as unsustainable (although presently it is high) if the entity pursues a high growth strategy. Additional focus is also provided how Capital Plan formulated to absorb unexpected loss (ICAAP).

ASSET QUALITY

Quality of the asset portfolio is considered as the most important factor of any bank or FI. Because, it reflects the strength of any bank or FI about its loan portfolio, expected cashflow and also the expected return. In studying the bank's credit portfolio, WASO also factors its credit appraisal mechanisms, portfolio monitoring procedures and problem asset resolution strategies. WASO analyses the asset quality on the following parameters:

Geographical Diversity and Sectoral Diversity

Geographical diversity of asset base and diversity across industries, along with single risk concentration limits are important inputs in determining the asset quality of bank/FI. Foreign banks with limited operations and branch network have lesser flexibility to diversify their advance portfolio than banks with national banks having larger networks and are thus susceptible to adverse economic conditions.

The industry exposure and single risk concentrations are monitored by central bank through exposure guideline. However, some banks and FIs show a high degree of exposures to certain industries, leaving themselves vulnerable to downturns in those industries. To ascertain the credit concentrations in the credit portfolio, WASO reviews the rated bank's largest exposures.

Profile of the Large Exposures

The credit quality of a bank's credit portfolio (funded as well as non-funded) is an important input in analysis of asset quality. WASO analyses the top 50 or 100 corporate exposures in the asset portfolio of a bank to make a judgment on portfolio quality. The ability to attract clients with a better quality is an important indicator of its own future credit quality. The single part exposure limit is also a good factor for any bank/FI to attract big clients that is considered favourably in rating exercise. Also a bank/FI's ability to attract or retain good clients by providing value added services would enhance asset quality in future.

Quality of Non Industrial/Specialized Lending

Banks in Bangladesh are obliged to lend a proportion of their funds to the priority sector that primarily encompasses agriculture and small scale industries. Specially state owned banks have good exposures in this area. To this extent FIs are in better place than bank due to their non-obligation to lending in such sectors. WASO analyses the credit quality of this non-industrial portfolio in judging the overall asset quality of a bank. The credit quality of the asset portfolio by the segment wise non –performing asset (NPA) level of the portfolio.

In recent times, Bank and FIs are focusing significantly on retail segment primarily for vehicle and house building loan. WASO looks at the retail credit growth, quality of credit portfolio and the underlying recovery mechanism to arrive at the asset quality implications of the retail segment.

NPA/Weak asset Levels

The asset quality of a bank depends not only on the credit quality of its clients but also on its ability to manage its assets portfolio. The weak asset (calculated based on rating distribution approach for corporate loans and on a lagged delinquency approach for retail loans) level helps benchmark the bank/FIs ability to manage its asset portfolio on a relative scale. Weak asset levels are an indicator of the inherent quality of the entity’s asset portfolio and thus, of its credit appraisal capabilities. Weak asset levels net of provisioning are considered as an indicator in judging the balance –sheet strength of the bank, the proportion of earning asset held by it and the potential credit loss. The proportion of earning assets and the potential credit loss would have a bearing on the bank’s future earnings capability.

Movement of Provisions and Write-offs

Some banks/FIs follow a practice of writing off a large portion of their bad loans in order to clean up their balance sheets. The present weak asset numbers are thus not a true indicator of the inherent credit quality of a bank’s asset portfolio. Therefore, weak asset levels alone cannot be a criterion to assess a bank’s future asset quality. Average provisioning, including write-offs, over a five-years timeframe is an indicator of the level of clearing up done by a bank over a period of time. This average provisioning level and its movement is an indicator of the portfolio’s credit risk and the expected write-offs and provisioning, which would further affect the bank’s earnings capability.

Growth in Advances

High growth rates in the financial sector bring the risks associated with the establishment of collection systems, tracking of asset quality and lack of seasoning of lending portfolio. WASO closely analyses the pattern and nature of such growth, studying entities with higher growth rates more carefully to look at the nature of the growth, the reasons for it and its implication for the asset quality. An entity that has grown by attracting good quality clients would be viewed more favourably than one that has grown just by increasing its geographical presence or diluting credit criteria.

MANAGEMENT EVALUATION

WASO believes that the quality of management is an important differentiating factor in the future performance of a bank/FI. The management is evaluated on the following parameters:

Goals and Strategies

A bank’s future goals strategies are evaluated to form a view on its management’s vision. The bank’s ability to adopt to the changing environment and manage credit and market risks, especially in a scenario of increasing deregulation of the financial markets, assumes critical importance. WASO also has extensive discussions with the bank’s managements on their policy with regard to diversification, asset growth, maintenance of capital, provisioning and liquidity levels.

Systems and Monitoring

WASO studies credit appraisal systems and the systems for managing and controlling credit and market risks at a portfolio level. Significant emphasis is laid on the analysis of risk

monitoring systems and the periodicity and quality of monitoring. Most banks face the challenges of enhancing the coverage and quality of their information systems and reporting. The degree of acceptance of new systems and procedures in the bank, data monitoring systems and the extent of computerization and interconnectivity between branches within a bank is given significant importance. The level of computerization is gauged on the basis of the extent of business covered by computerization, computerization in branches and of the money market and foreign exchange desks.

WASO attaches significance to the operating systems for data capturing and MIS reporting in a bank. A bank's balance sheet that has a large volume of transactions pending reconciliation reflects its lack of operating systems and is viewed negatively. WASO also analyses expenses made on technology during the recent period and the bank's strategy of using technology effectively as a delivery platform to reduce costs and improve service levels.

Risk Appetite

WASO also analyses the management's attitude towards risk and growth. An analysis of the strength of systems and processes put in place by the management to strengthen the structures within financial institution/banks are also undertaking to assess the management risk appetite. A high-risk propensity typically reflects in higher volatility in earnings in both the fund-based and the fee businesses. A management with a higher propensity to take on risks is viewed cautiously.

Competence and Integrity

Assessment of the competence and integrity levels of management is a key analytical driver of the management evaluation. This delves into the past track record of the management to identify positive and negative attributes of both these areas.

EARNINGS POTENTIAL

WASO analyses a bank/FI's earnings on the basis of the level, diversity and stability of earnings.

Level of Earnings

The level of earnings as measured by the net profitability margin (NPM) or Net Interest Margin (NIM) provides the bank/FI with a cushion for its debt servicing and also increases its ability to cover its asset risk. NPM is a function of interest spreads, expense levels, and fee based income earned by the bank. Purely from the viewpoint of size, the absolute profit levels registered by a bank are also germane to the earnings profile of a bank.

Earnings of banks/FIs can be significantly affected due to volatility in interest rates. Thus, the trend in profitability at gross profit levels over the past years is examined to form a view on the sustainability of earnings. The various elements leading to profitability, such as interest spreads, fee levels, expense levels and provisioning levels are also analysed to form a view on profitability trends and the sustainability of profits.

Diversity of Income Sources

Diversity of income sources is an important input in analyzing the stability of earnings. Diversity in fund-based income is achieved by focusing on different borrower segments such as industries, trade and retail. Bank also diversity their income streams through non-interest or fee income such as guarantees, cash management facility, service charges from retail customers and trading income. Fee income provides a cushion to profitability, especially in times of pressure on interest spreads.

WASO also views the composition of interest revenue streams while analyzing the earnings position of a bank/FI. Banks relying on short term, non-repetitive income sources such as bill financing and trading income are viewed less favourably than banks with long-term credit relationships with companies through cash credit or term loan exposures. WASO also analyses the composition of non-interest income while evaluating a bank/FI's earnings; this includes income from trading activities, which tend to be volatile. A closer analysis of the composition of revenue streams helps to form an opinion on the sustainability of earnings.

Operating Efficiency

WASO looks at the level and trend of operating expenses and degree of automation in the bank/FI. WASO looks at salary expenses and total non-interest expenses as a proportion of average assets to benchmark bank/FIs on efficiency parameters.

LIQUIDITY/ ASSET LIABILITY MANAGEMENT

WASO assesses the asset liability maturity profile of the rated entity to form an opinion on the liquidity and interest rate risks. The entity's policy on asset and liability management is discussed. The following issues are considered in evaluating liquidity;

Liquidity Risk

The liquidity risk is the factor of bank's resource strength and the liquidity support available to it in the form of access to call/repo borrowings and the extent of refinance available from BB. Banks are considered as the primary channel of retail savings into the economy. Most public sector banks with a widespread branch network act as conduits for mobilizing retail savings. WASO views most of the public sector banks favourably on this parameter due to the stable accretion to deposits and the attendant liquidity support available to them due to this large deposit base.

A FI's liquidity position is a function of its management's policy of maintaining treasury portfolios to meet asset and liability side liquidity demands. However, on account of their significance to the domestic sector, FIs enjoy a high degree of financial flexibility that reduces liquidity risks to fairly low levels.

The specific liquidity parameters analysed by WASO are:

Liquid Asset/Total Asset

To arrive at this ratio, WASO looks at the percentage of sovereign investments, liquid funds and other short term fixed income instruments in an entity's books to its total assets. This can also be derived from credit-deposit ratio.

Proportion of Small Deposits

WASO looks at the proportion of deposits below Tk. 1.0 million in the bank's total deposit base. These small sized retail deposits tend to be inherently more stable.

Interest Rate Risk

The rating factors in the volatility of the bank/FI's earnings to interest rate changes. WASO analyses the entity's asset liability maturity profile to judge the level of interest rate risk carried by it. In the banking system the interest rate maturity profiles of the assets and liabilities have an inherent mismatch. The floating rate advances portfolio (linked to prime lending rates) and the relatively long duration investment portfolio are funded through short to medium tenure liabilities, which exposes the bank to an element of interest rate risk.

FIs score over banks in this regard due to the wholesale nature of their operations and policies that link the nature of borrowing (fixed/Floating) with correspondingly matched lending.

RESOURCE RAISING ABILITY

WASO analyses the resource position of the bank & FIs in terms of its ability to low cost and stable resource base. In the domestic context the resource position of a Bank is very different from FIs. Banks are significantly deposit funded both retail and wholesale but FIs are basically dependent on wholesale funds. Though FIs have access to retail fund but is a limited scale. Given the basic distinction of funding composition in a bank and FI, WASO evaluates the funding composition differently.

The following issues are considered in analysis the resource position of a bank:

Size of Deposit Base

A large deposit base provides stability to a bank's resource position by diversifying the depositors base, and ensuring a continuous and stable source of funds.

Diversity of Deposit Base and Geographical Spread

The diversity of deposit base in terms of number of small deposits, geographical spread, and optimal rural/urban mix leads stability to the resource position of the bank. Thus a bank with a large number of branches spread all over the country and with an optimal rural/urban mix is viewed favourably.

Deposit Mix

A bank's deposit mix has an impact on its funding mix. A high portion of savings and current deposits leads to a low cost resource base. WASO also analyses the trend of deposit mix to form an opinion on future stability and cost. The proportion of wholesale or bulk deposits is assessed to form a view on stability and cost of borrowing.

Growth in Deposit Base

Accretion of deposits specially the low cost deposit is the main source of funding asset growth and managing liquidity risk in banks. WASO compares a bank's growth in deposits relative to industry trend to make relative judgment on cost of deposits.

Cost of Deposits

Keeping cost of deposit low is a function of the bank's deposit mix, its region of operation, and ability to attract deposits at lower rate. WASO analyses all inclusive of funding cost of a bank, this factors in the operating cost involved in mobilizing deposits, and the negative impact incurred due to the SLR and CRR norms for banks.

The relevant issues while analyzing the resource position of a FI are as under:

Diversity of Investor Base

Given that FIs are predominantly wholesale funded, the diversity of investor population can mitigate an FI's Risk profile to some extent. FIs that are dependent on few investors are viewed less favourably than those that have large investor base.

Funding Mix and Cost of Funds

Traditionally FIs enjoyed concessional funding from the central bank, and this facility has been progressively withdrawn. Now FIs have been increasingly moving towards market borrowings. Recently BB also approved to explore foreign cheap funding. The funding mix between domestic and foreign is also examined to determine an FI's overall risk profile. FIs that tend to have a foreign currency funding carry the risk of foreign currency borrower defaulting on payment obligations and thus exposing the FIs to increase foreign currency risk.

Retail Penetration and Tax Benefits

Some leading FIs regularly raise bonds and deposit from retail investors. These funds impart stability to funding mix and the trend in funding mix and the trend in raising retail sources are favourably factored in WASO risk evaluation. Any tax benefit related to bond or any other resource may be considered favourably for FIs.

REGULATORY COMPLIANCE

Compliance of regulatory issues considered as a big issue in the recent rating practices. Because, non-compliance of any regulatory issues may raise high business risk. In view, WASO evaluates to what extent BOD placed due importance on BB Comprehensive audit response; compliance of regulatory limit like capital market exposure limit, related party transaction; introduction of IT audit, risk audit, compliance of accounting principles, litigation status against write-off client and others.

RISK MANAGEMENT

Risk management is now playing a vital role in the banking operation specially with the advent of Basel II. Hence, WASO evaluates how a bank or FI is advancing towards BB guideline in compliance of Basel guideline. In addition, WASO also factors the full implementation issues of core risk guidelines issued by BB.

ADDITIONAL FOCUS:

WASO also provides some additional focus in the following areas in the rating exercise:

MARKET POSITION

WASO considers the size of the entity and its market positioning in the industry. A large size enables an entity to withstand against the systematic shock and determines the extent of systematic support the entity can expect. WASO also consider its diversity in products, portfolio, business lines and customer base.

FRANCHISE VALUE

In evaluating the franchise value, WASO factors the many issues like: any evidence of regulatory non-compliance or internal or external fraud that affect business reputation, any penalty imposed by BB, foreign affiliation addition to synergy, contribution to CSR activities, customer service at minimum cost, etc.

GOVERNMENT SUPPORT

WASO positively factors in government support for specialized entities in the financial sector, which have a policy role to play in the national economy. Further public sector banks benefit from the high likelihood of support arising from government ownership. In WASO's opinion the likelihood of support is underpinned by strong economic and moral imperatives to provide assistance, given the role that the banking system plays in the economy. Bank are primary agencies for channeling of savings in the economy and the government uses the banking system as a vehicle to fulfill its economic and social agenda through priority sector lending.

While the authorities have stepped in to rescue troubled private sector banks in the past, WASO believes that the support to public sector banks would unquestionably be of a higher order. The assets of public sector banks represent a big portion of the assets of the banking system. Moreover, government ownership and control of banks is a politically sensitive issue and the government will find it difficult to deny support to public sector banks in the event of difficulty.

RATING DECISION

Order of Seniority or Notching Approach	
Deposits	Financial Institutions Ratings
Guarantee	Financial Institutions Ratings
Senior Unsecured Debt	Financial Institutions Rating , or one notch down to FI Rating if the regulation explicitly state that senior debts are ranked below deposits
Subordinated Debt (Tier 2 capital)	Usually 1 or 2 notch down to FI Rating
Hybrid Securities/Preference Shares (Tier 1 Capital)	Usually 2 or 3 notch down to FI Rating