FINANCIAL INSTITUTIONS RATING METHODOLOGY

Financial institutions play an important role in the economic development of a country. The objective of these institutions is to accumulate the scattered deposits and invest them in a productive manner for economic upliftment. The financial market is created to satisfy particular preferences of market participants. These markets transfer funds from those who have excess funds to those who need funds. That is, they facilitate the transfer of funds from surplus units to deficit units.

At present, there are 59 scheduled banks in Bangladesh among them 33 conventional Private Commercial Banks (PCBs) are now operating in the industry. Besides, 34 Financial Institutions are operating in Bangladesh. According to Bangladesh Bank data, domestic credit stood at 11360.843 Billion Taka in December 2018 which was 10082.407 Billion Taka in December 2017. The financial sector of Bangladesh has been experiencing a period of extreme volatility in the recent past due to lack of corporate governance and increase in bad debt culture. State Owned banks and a number of private banks have been suffering acutely due to huge non-performing loans (NPL). The non-performing loans (NPLs) rose to 939.11 Billion Taka as of December 31 2018 from 743.03 Billion Taka on the same day in 2017, according to the central bank's statistics. In December 2018, the percentage share of classified loan to total outstanding was 10.30 whereas it was 9.31 in December 2017.

ROLE OF FIs IN ECONOMIC GROWTH

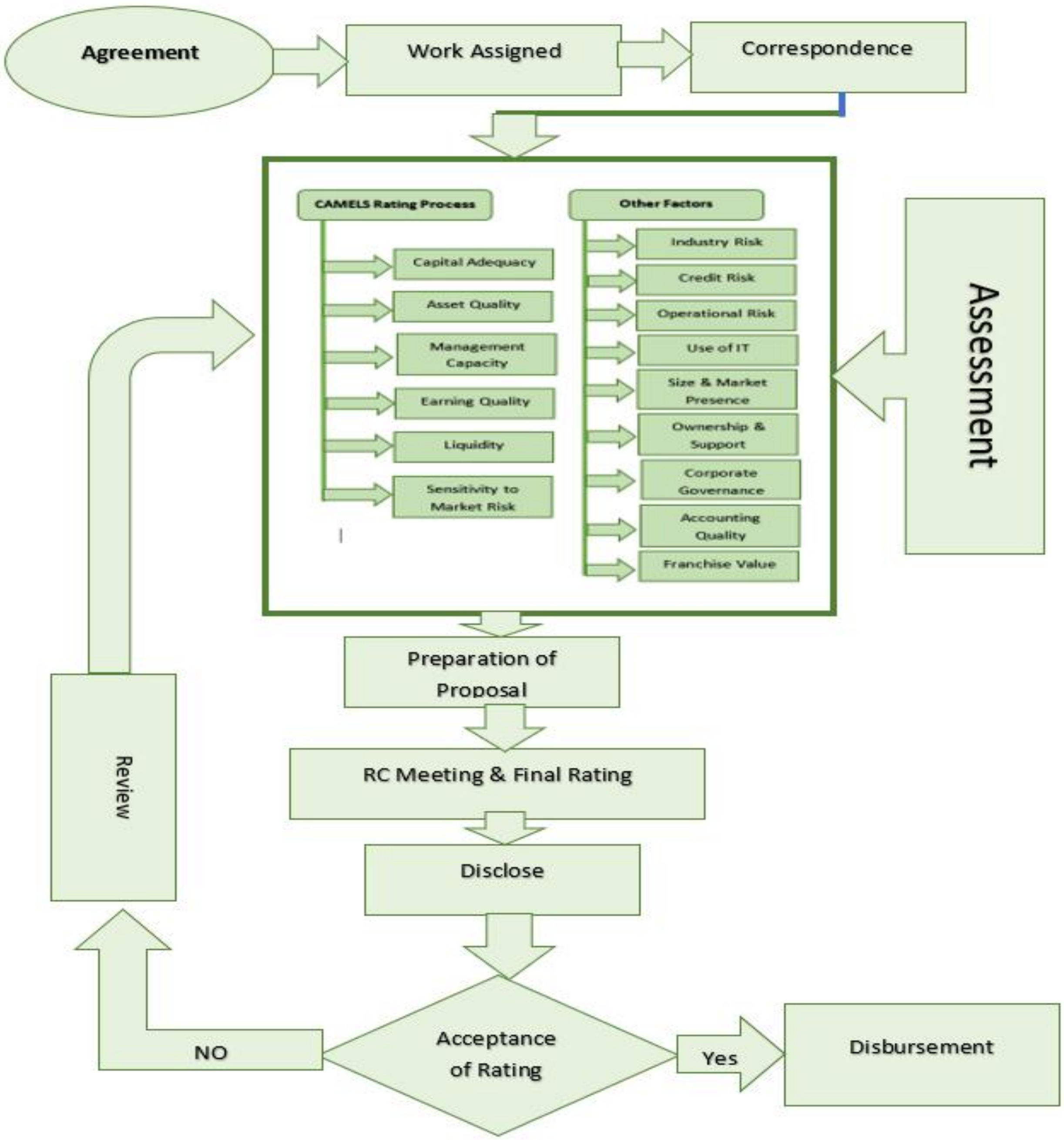
Bangladesh is one of the fastest growing South Asian countries with an average growth of 6.2% in the last ten years. Banking sector, the key component of finance, dominates the financial sector development of Bangladesh as capital market has not yet developed. Bangladesh has experienced tremendous growth in banking industries for last three decades or so. Domestic credits to the private sector by banks have increased from 16.07% of GDP in 1990 to 40.33% in 2018. Not surprisingly, it was only 5.77% in the beginning of eighties. After the economic reform, trade and financial liberalization in the nineties, the economy has started to grow even faster. In period October-December, 2018, total export finance was 712.340 Billion Taka whereas it was 641.705 Billion Taka in the corresponding period of 2017. Within the apparel sector, the RMG sector received the highest proportion of financing from banks, and the volumes and proportions have increased between 2014 and 2018. Import payments have been increasing over the years. Imports increased to 465.30 Billion Taka in January 2019 from 382.25 Billion Taka in December of 2018. Imports in January 2019 was all time high since 1976. Non-Bank Financial Institutions (NBFIs) are also playing a crucial role by providing additional financial services that cannot be always provided by the banks. The NBFIs, with more multifaceted products and services have taken their place in the competitive financial market to satisfy the changing demands of customers. NBFIs also play an important role in the capital market as well as in real estate sector of Bangladesh. Like the banks, most of the NBFIs have separate subsidiaries to operate merchant banking activities.

METHODOLOGY

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.

Process of FIs Rating:

The process of FI Rating is graphically represented below:



CAMELS Rating Process

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:

- The overall financial condition
- The conformity to the regulatory guidelines on capital adequacy ratio
- The size and the composition of the regulatory capital
- Stability of capital adequacy ratios
- The capacity to recognize and respond to an immediate need for additional capacity
- The risk in relation to off-balance sheet exposures
- Capital adequacy relative to its peers

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
- The diversification of the loan portfolio (whether any customer exceeds 10% of bank's capital)
- 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
- Top defaulters
- Impaired lending to gross finance
- Appraisal mechanism, portfolio management system, rescheduling philosophy

Management Capacity

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.

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.
- The overall profitability is reviewed in terms of Return on Equity, Return on Assets and Earning per Share
- Earing quality relative to peers

Liquidity:

Liquidity is an important parameter which reflects FIs 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

Sensitivity to Market Risk:

This component reflects the degree of economic changes in interest rate, equity position, foreign exchange, and the commodities which adversely affects the earnings and capital of every financial institution mostly banks.

NCRL considers following risks:

- Interest Rate Risk
- Equity Position Risk
- Commodity Risk

To assess the financial performance based on CAMELS rating process NCRL also considers following ratios:

CAMELS Parameters	Ratios
Capital Adequacy (C)	**Capital Adequacy Ratio** = Capital & Reserve/ Total risk weighted assets
	Loans to Total Assets Ratio = Total loans/ Total assets
	Leverage Ratio = Total debt/ Total equity
	Shareholder Equity Ratio =Total Equity / Total Assets
	Debt to Total Assets Ratio =Total Debt / Total Assets
	Govt Securities (G-Secs) to Total Investments= Govt. Securities / Total Investment
Asset Quality (A)	**Percentage of Classified Loans**= Non-performing loan/ Total loans
	Financial Assets to Total Assets =Financial Assets / Total Assets
	Investment to assets Ratio=Total Investment / Total Assets
	Fixed Assets to Assets Ratio = Fixed Assets / Total Assets
	Percentage of Loan Loss Provision =Loan Loss Provision / Total Loan
	Loan to Assets Ratio =Total Loan / Total Assets
Management Capability (M)	**Net Profit per Employee** = Net profit after tax/ Total number of employees
	Expenses per Employee = Total expenses/ Number of employees
	Loan to Deposit Ratio =Total Loan / Total Deposit
	Deposit Per Employee Ratio
Earnings (E)	**Net Interest Margin** = (Investment Income – Interest Expenses) / Average

	Earning Assets
	ROA =Net Profit (Loss) / Total Assets
	ROE=Net Profit (Loss) / Total Equity
	Earnings Per Share= Net profit after tax/ total number of common shares outstanding
	Operating Profit to Total Assets Ratio =Operating Profit / Total Assets
	Efficiency Ratio=Cost/Total Net Revenue
Liquidity (L)	**Loan to Deposit Ratio**= Total loans/ Total deposits
	Earning Assets to Deposit Ratio = Total earning asset/ Total deposit
	Liquid Assets to Total Assets Ratio =Liquid Assets / Total Assets
	Liquid Assets to Short-term Liabilities Ratio =Liquid Assets / Short-term Liabilities
	Liquidity Coverage Ratio= High Quality Liquid Asset Amount/ Total Net Cash Flow Amount
Sensitivity to Market Risk (S)	Interest Rate Risk
	Equity Position Risk
	Foreign Exchange Risk

Other Factors

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.

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.

Credit Risk

NCRL evaluates all the credit risks arising from on balance sheet activities as well as off balance sheet commitments. The structure of the Bank's Balance Sheet, including the relative proportions of different asset categories is examined. Generally, loans and advances constitute the most significant portion of assets of a commercial bank and therefore a comprehensive review of the credit portfolio is essential for the assessment of the credit risk. NCRL classifies the loans and advances by type of loans, size, maturity, economic sector and geographical location. We also look at concentrations of credit risk, including large exposures to individual customers/group and concentrations of credit in particular industrial sectors. We thoroughly analyze the non-performing loan portfolio and the required and actual provisioning for assessing the underlying risk. With reference to the other assets, we analyze the general quality of the securities, their maturity, any undue concentration and the valuation of these securities. An analysis of the Bank's inter-bank deposits and loan books will consider the size, maturity and concentration as well as the creditworthiness of the counterparties. We analyze the off-balance sheet commitments such as Bank Guarantee, Letter of Credit.

Operational Risk

Operational risk is defined as all other risks other than market, credit & liquidity risk. In the context of Basel II, however, the Basel committee has adopted a narrower definition of Operational risk: "the risk of loss resulting from inadequate or failed internal processes, people & systems or external events". Our analysis of operational risk focuses on a number of issues, including (a) a Bank's definition of such risk b) the quality of its organizational structure c) operational risk culture d) the development of its approach to the identification and assessment of key risks e) data collection efforts; and f) overall approach to operational risk quantification and management.

Use of Information 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.

Ownership and Support

The ownership of and potential support available to a bank is crucial to our overall rating assessment. NCRL analyzes the stability of the shareholding structure of the bank, as well as the ability and willingness of either its owners or the government to bail out the bank in case of need. The assessment of ownership pattern and shareholders support in a crisis is an important factor in rating a bank. In case of public sector banks, the willingness of the government to support the bank for bail out from crisis is important. The support from the owners is particularly relevant in case of larger sized banks, whose failures could have a contagious effect on the confidence in the overall financial system.

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.

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.

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.

Disclaimer:

For further details please contact:
National Credit Ratings Ltd
Zaman Tower (8th Floor).
37/2, Purana Paltan (Box Culvert Road),
Dhaka-1000
Tel: +88-02-47120156-58
E-mail: kishor@ncrbd.com
Website: www.ncrbd.com