FINANCIAL INSTITUTIONS

OVERVIEW

Financial Institution Ratings are applied to assess the creditworthiness of financial institutions (entities whose principal activities are to take deposits or borrow, or both with the objective of lending or investing in financial assets, but excluding general and life insurers). The FI rating process works through sovereign and macro-economic issues; the financial sector outlook and regulatory trends; the FI's business profile (including strategy); and eventually to the CAMELS rating components. The CAMELS framework that is also employed by national bank regulators is largely supported by both theoretical and empirical literature and comprises capital adequacy, asset quality, management quality, earnings, liquidity and sensitivity to market risk.

ECRL believes, as a starting point in a FI rating, it is important to gain an appreciation of how a FI relates to the financial sector and the macro environment in which it operates. The economy in which a FI operates has a significant bearing on its financial performance, and it is essential to take into account any economic risk that may affect its creditworthiness. Of relevance is GDP growth, inflation, growth in consumer lending, savings and investment, trends in unemployment, exchange rates, bond yield and national and/or regional property price indices. A continuing benign inflation and interest rate environment does not imply a lesser need on the part of financial institutions to maintain sufficient buffers to meet unexpected developments. Furthermore, many financial institutions play a major role in maintaining confidence in the monetary system through their close relationship with regulatory authorities and governments, and their compliance with regulations.

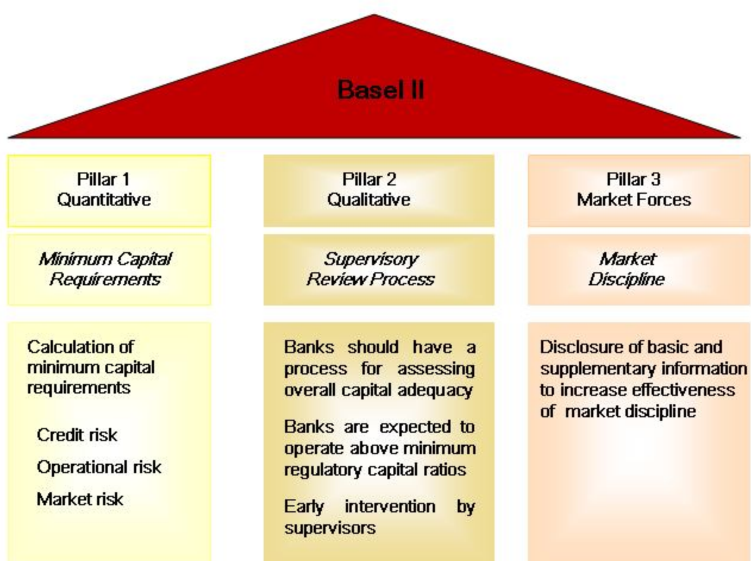
ECRL's coverage of a FI's business profile addresses its franchise value, size, market position, strategy, diversification efforts (be it in relation to business lines or geographically), ownership and legal status. Franchise value or reputation capital is undisputedly a key to success in a customer economy, and future earnings and future value. ECRL believes that it is important to establish whether the FI has a defensible franchise in any of its primary business lines. Size is relevant to our rating analysis – it could imply competitive advantages in terms of scale economies, ability to cross sell particularly in the case of universal banks. We also consider the FI's strategic priorities in the context of the financial sector as a whole and in relation to its competitors strengths and challenges as well as opportunities and potential threats. Diversification is now assessed not only in relation to business lines (including expansion to other key areas of financial services such as insurance operations) but also in terms of geography with the rising number of cross border acquisitions by domestic FIs. ECRL considers the extent to which such cross border acquisitions have altered the FI's risk profile. Ownership at times confers benefits to a FI. In the domestic context, expressions of explicit support (typically through letters of comfort) have been rare. ECRL is more willing to equate substantial government shareholdings with a higher degree of implicit support where there is evidence that significant amounts of capital have been invested in the past and where the latter appears broadly supportive of the FI's management and its strategy.

CAPITAL ADEQUACY

Adequacy of capital is a very important rating consideration as it is considered to be one of the pillars on which the soundness and stability of the banking system rests. Capital is viewed as a buffer or cushion for absorbing losses inherent in the normal conduct of an FI's business and to protect depositors and counterparties from the institutions' on- and off-balance sheet risks. The primary tool of capital regulation has been a framework for calculating the capital adequacy of banks. This set of minimum "risk-based" capital requirements for banks, known as the 1988 Basel classifies a bank's assets into risk buckets carrying weights of zero, 10, 20, 50 and 100 percent. Focused primarily on credit risk, assets are classified into one of the risk buckets based on the parameters of counterparty (sovereign, banks, public sector enterprises or others), collateral and maturity. Off-balance sheet exposures such as performance guarantees and letters of credit are accounted for in the calculation of risk weighted assets by applying variable credit conversion factors.

In the early 1990s, the Basel Committee updated the 1988 accord to include bank capital requirements for market risk. The limited risk sensitivity of the Basel I Accord in the measurement of credit risk was a key driver for the paradigm shift in supervisory approach towards one of assessing the quality of governance, controls and risk management processes as seen in the new capital framework, Basel II. The three pillars of Basel II – minimum standards which are a refinement of the standardized rules in Basel I, supervisory review of banks' internal assessment process and capital adequacy, and the use of disclosure to strengthen market discipline as a complement to supervisory efforts– are designed to address the growing complexity of banks' activities and the associated risks.

Exhibit 1: The Three Pillars of Basel II



Where banks are concerned, Basel II provides three options to compute capital requirement for credit risk, each with differing risk sensitivity. The standardized approach is an extension of the 1988 Accord's standardized risk-bucket approach to include the use of external credit ratings, additional risk buckets and allowances for risk reduction via credit risk mitigation techniques. The foundation and advanced internal ratings-based (IRB) approaches are premised upon the use of bank internal rating systems. One of the most significant changes in the new Accord is

the proposal to incorporate an operational risk charge to address direct or indirect loss resulting from inadequate or failed internal processes, people and systems or from external events.
Again, Basel II allows three options to measure the capital requirement for operational risk, in increasing order of sophistication and risk sensitivity. The simplest of the three options is the basic indicator approach which allocates operational risk capital based on a fixed percentage of its gross income. The standardized approach proposes charges on the basis of business lines (e.g. corporate finance, retail banking, commercial banking, etc.)

Bangladesh Bank has issued the Basel II Road Map which requires the implementation of Basel II with parallel calculation of capital adequacy beginning in January 2009. The banks will adopt the standardized approach for credit risks, which makes use of external credit ratings from External Credit Assessment Institutions (ECAIs) for attaching risk weights, the standardized rule-based approach for market risk and basic indicator approach for operational risks. Under the standardized approach, the biggest impact would be felt with respect to borrowers rated B and below of banks as the risk weight for such borrowers increases to 150% from 100% under Basel I.

ECRL evaluates capital adequacy in the following context:

- The FI's overall financial condition;
- The risk profile of the FI's business operations;
- The capacity of the FI to recognize and respond to an immediate need for additional capacity;
- The trend and level of problem assets, as well as the adequacy of reserves for loan losses;
- Its balance sheet structure;
- The risk in relation to off-balance sheet exposures;
- The quality and level of earnings, as well as its dividend policy;
- Growth prospects, plans and the risk related to new activities and/or new banking products initiated by the FI;
- Access to capital markets and other sources of capital; and
- Internal targets with respect to capital adequacy ratios.

ECRL also considers the FI's capital adequacy relative to its peers and the banking sector average.

ASSET QUALITY

The primary focus of the asset quality analysis is on credit risk attached to the FI's loan and investment portfolio, and off-balance sheet operations. Loan quality has historically been the area of vulnerability for many FIs and the biggest cause of bank failures. FIs suffer losses on loans, advances and other credit facilities as a result of their becoming wholly or partially uncollectable. An evaluation of the adequacy of a FI's loan loss reserves is essential to an evaluation of not only its asset quality but also its earnings, capital adequacy and solvency. ECRL reviews the FI's loan loss provisioning policy and considers its specific and general provisions on an absolute and relative basis over time, in assessing trends in the quality of the loan portfolio.

For FIs with substantial retail and/or corporate lending operations, loans typically constitute a majority of such entities' assets, and interest earned on loans is an important revenue source. As
a consequence, even relatively small problems in the loan portfolio can quickly reduce earnings, deplete capital, and cause insolvency. The effectiveness of a FI in controlling its losses on loans, advances and other credit facilities depends upon a number of factors. Important among these are the FIs risk management framework, credit evaluation and approval system. Lax lending policies, lending aggressiveness, and loan concentrations have been traditionally associated with greater credit risk and bank failures. Concentration risk is also an important factor when reviewing the loan portfolio.

ECRL takes the following into consideration when evaluating the FI's asset quality:

- the perceived risk level of the FI's lending activity with reference to its lending criteria, credit scoring and review processes as well as approval process;
- the servicing of the loan portfolio, collection standards, write-off and foreclosure processes;
- the procedures and practices to identify, monitor arrears/defaults and collect problem assets;
- the trend and level of problem assets, as well as the adequacy of reserves for loan losses;
- the diversification of the loan portfolio;
- the FI's exposure to risk from default in payments by issuers of financial instruments held by the FI within its investment portfolio, and
- asset risk concentrations and the soundness of limits established by the FI.

ECRL pays close attention to a FI's NPL classification policy as decisions on classification usually affect the amount of reserves that are set aside against possible future loan losses. A loan might be categorized as "special mention" (not warranting classification as a NPL as yet) by one bank and "substandard" by another depending on internally established thresholds. Traditional asset quality measures have several limitations. First, they fail to measure performance on the basis of vintage. Banks that have experienced rapid loan growth tend to appear better in terms of asset quality than they might otherwise look. Another limitation is that commercial loan quality is generally cyclical. The real quality of a bank's underwriting standards may only become apparent when the economy slows. Given their performance characteristics, non-performing loans represent the bank's most likely source of charge-off loans. Given that NPLs are a leading indicator of loan losses, the reasons for increases in the Gross and Net NPL ratios are of particular interest to ECRL. A rising trend in NPLs will have an impact on the adequacy of loan loss reserves and loan loss provisions.

Loan loss reserves also form an important consideration in assessing bank asset quality. If a provision for impairment has been recognised in relation to a loan, write-offs for bad debts are made against the provision. If no provision for impairment has previously been recognised, write-offs for bad debts have to be recognised as expenses in the profit and loss account. If a bank's reserving methodology is inaccurate, loans on its books are carried at inflated values and earnings and capital are overstated. Because of the importance of loss reserves, regulatory guidelines on the treatment of nonperforming loans (NPLs) and loan loss provisioning exist. Where a declining trend in loan loss reserve coverages is observed, ECRL will seek further explanation from management and the nature of the plans (if any) to reverse them. At one-to-one or 100 percent, LLR equals NPLs, implying that the reserve can absorb all potential losses. However, not all NPLs will be charged off nor will all loans charged off ultimately represent a total loss to the FI. The extent to which a loan or facility is impaired may be moderated by the security available to the lender, in which case the facility is said to be well secured". As a result, a ratio value less than one-to-one may be sufficient to absorb a FI's loan losses.

MANAGEMENT

Areas of focus here are the quality and character of individuals that guide and supervise the bank, encompassing their knowledge, experience, and technical expertise; leadership, organizational, and administrative skills; planning skills and adaptability; and honesty and integrity. Apart from management, the effectiveness and independence of the Board, and the governance process are also significant. Management together with the Board holds primary responsibility for the oversight of risks undertaken by the institution.

ECRL would want to be assured that the governance framework and processes relating to risk management are tightly integrated with business strategy and execution. Evaluating management necessitates consideration of many factors and requires us to draw on a number of different sources. The FI's financial statements are one source. Declines in financial performance and unfavorable comparison with peer FIs may be indicators of management inadequacies. However, financial performance should not be taken as the sole measure of management performance. Bad management practices can be masked by such things as a strong economy or a strong competitive position. Once conditions reverse or competition strengthens, poor practices are revealed. Hence, the need to look beneath the numbers to the organizational and operational matters that produced the FI's operating results.

EARNINGS

Earnings quality refers to the composition, level, trend, and stability of the FI's profits. When earnings quality is good, the FI has sufficient profits to support operations, provide for asset growth, and build capital. On the other hand, when earnings quality is poor, loan growth will be constrained and the FI may have to provide for losses, and raise further capital. Moreover, depositors may be at greater risk, and shareholder returns may be inadequate. An FI's revenue comes from interest and non-interest sources. In most FIs, interest income from loans and investments makes up much of the bank's revenue. However, non-interest income from, for e.g, fees, service charges and commissions also represent an important and growing source of revenue. Likewise, FIS expenses can be thought of as being made up of interest and non-interest components. Besides these revenue and expense components, a FI's net income is affected by other items.

These include the provision for loan losses, which is used to maintain the FI's LLR, securities gains and losses, extraordinary items, and taxes. The level and quality of a FI's earnings depend upon a host of factors that are external and internal to the FI. External factors relate primarily to the environment in which the FI operates. Included among external factors affecting a FI's earnings performance are laws, regulations, economic conditions, technological change, and competition. From an internal perspective, a FI's earnings quality depends heavily upon a number of factors. Important among these are the FI's business strategy, asset/liability mix, asset quality, and operating efficiency. ECRL focuses on the net interest margin (net interest income as a percentage of average interest earning assets) because small changes in a FI's lending margin can translate into large bottom line changes. If margins are low or falling, ECRL seeks further clarification from the FI to uncover the drivers of the observed behaviour, i.e. whether competition is forcing the FI to pay more for deposits and charge less for loans? Exceptionally high values would be questioned as well. Are high margins the result of a favorable interest rate environment, or are they the result of the FI moving out of low-yielding, low-return securities into higher-risk, higher yielding and less liquid loans or investment securities?

The ROA type measures provide an indication as to how well the FI uses its assets to generate returns. ECRL's spreadsheet was designed to dissect earnings into its component parts thereby providing insights into areas needing attention. Finally, we also look at the FI's cost income ratio or overhead ratio. An increasing trend in this ratio prompts ECRL to look at individual expense items to identify that which have shown large increases over time.

LIQUIDITY AND FUNDING

ECRL believes that the existence of any material concentrations in the sources of a financial institution's deposit and borrowing liabilities is a useful indication of the potential risks inherent in the FI's funding arrangements and liquidity management. Significant depositors with, and lenders to, the FI could affect its ability to carry on business, either in general or at the same level, if those fund providers chose not to continue providing funds to the entity. The controlled matching and mismatching of the maturities of assets and liabilities is fundamental to the effective management of a FI. An unmatched position has the potential to enhance the profitability of the entity's operations, but can also increase the risk of losses. ECRL reviews the maturity profile of a FI's classes of assets and liabilities to assess its liquidity and solvency position. This maturity analysis complements the liquidity ranking of assets and liabilities in the balance sheet. At the same, many FIs have significant commitments and contingent liabilities that are off-balance sheet.

Commitments and contingent liabilities can represent an important part of the activities of a FI and may have significant effect on liquidity and solvency risks amongst other risks. Liquidity analysis also entails an evaluation of the FI's liquidity management policies.

SENSITIVITY TO MARKET RISK (RISK MANAGEMENT)

Banking has become more complex on many levels; the sophisticated trading/hedging strategies that investment banks carry out serve as an example. While ECRL recognizes that FIs are engaged in the business of taking risks in order to earn profits, risk levels have to be appropriately managed and controlled.

ECRL assesses how well this risk is managed over time as opposed to a point in time. ECRL assesses the market risk appetite of a FI by reference to the types of assets in its securities portfolio, the size as well as increase or decrease in its fixed income and equities portfolios, the trends in derivatives positions, value-at risk (VaR) of the trading portfolio/stress tests done on the FI's exposures. In respect of investment banks, ECRL would look at interest rate VaR and fair value risk of the trading portfolio within the context of the stated confidence levels and holding period assumptions. ECRL also considers risk mitigation mechanisms such as limits, sector-wise, individual, and stop loss that have been established by the FI to mitigate such market risk exposures as well as the frequency at which the limits are reviewed and exceptions reported.

Where transactions in the FI's trading portfolio entail counterparty risk exposure, ECRL would be interested in the measures taken to address counterparty risk exposure.