Rating Methodology – Bank Loan / Facility Rating

INTRODUCTION

CRISL defines credit rating is a measure of assessing relative risk of default and the severity of default associated particular securities issue, issuer and/or other financial assets. It is a symbolic indication of current opinion of the relative capability of timely servicing of the debts and obligations as per the terms of contract. It is an independent, impartial best judged professional OPINION on the ABILITY and WILLINGNESS of a borrower to discharge its debt obligation when due, in case of a debt instrument and assessment of net worth, external liability and earning prospects in case of a Corporate Entity.

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 Expected Loss (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 bond holders/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.

BANK LOAN RATING

Bank Loan Rating (BLR) is the offshoot of Banks' Capital Adequacy Requirement under Basel-II framework applicable for scheduled banks. Basel Capital Accord-II in respect of Capital Measurement and Capital Standards aligns capital of a bank more closely with the underlying Risk a bank undertakes through providing funded and non funded facilities/ guarantees/ commitment to the client/ in favour of client/ counterparty.

CRISL BLR is the Opinion of CRISL on the relative degree of risk associated with timely repayment of principal and interest or fulfilling commitments on a specific bank facility/exposure/ commitments. CRISL assigns BLRs with the acronyms *"blr"* in the long term and short term facilities as it is done with the other short term and long term rating depending on the sectors. CRISL standard rating methodology applicable sector wise are applied while carrying out

BLRs. In addition, CRISL also places special emphasis on the banking behavior of the counterparty with the bank and the securities offered against the facilities. CRISL BLRs are designed for the use of banks/ FIs in determining risk weights against the exposures as per the requirement of Bangladesh Bank.

CAPITAL RELIEF THROUGH RATING

At present capital adequacy is determined as a percentage of the risk weighted assets. Again, different risk weights are applied depending on the nature of risk including 100% risk weight on private sector loans and advances irrespective of quality of the advances. Under standardized approach of Basel-II, risk weight will be determined on the basis of the rating of the clients instead of 100% risk weight for all corporate. Banks are operating with limited equity which is the costliest security. Therefore, banks can intelligently operate by rationally utilizing the capital through using the services of rating agencies in client loan/ facility rating and get capital relief. It is to be mentioned here that banks may get substantial capital relief (about five times) against the good borrowers. Therefore, credit rating agencies and ratings are going to benefit the banks/FIs and also its counter parties significantly.

TIME HORIZON

CRISL ratings are forward looking and sustainable throughout normal business cycle. CRISL issues normally two types of ratings – Long term and short term. Short term rating carries the validity of six months while the long term rating is valid for one year. The change in economic scenario, complexities and change in government policy may have an impact on the ratings assigned over a period of time. CRISL updates the rating periodically with the cooperation of the clients. In case the client is not willing to cooperate, CRISL withdraws the rating after due notice to the client. Therefore, CRISL ratings are to be read with the time frame.

RATING DEFINITION

CRISL follows standard definition of ratings in line with the global rating agencies. It follows a ten notch scale with AAA being the highest and D, the lowest rating reflecting default in discharging its liabilities in time. With the addition of plus (+) and minus (-) signs before the scale, the 10 notches scale reflects 26 positions. These plus and minus signs indicates the position of each rating in the scale. The rating scales along with the definition are enclosed at the end of this methodology.

CRITERION FOR ASSIGNING BLRS

In order to arrive at a meaningful rating CRISL considers a large number of qualitative and quantitative factors and applies the same in its analytical rigor. In order to avoid biasness in analysis, CRISL tries to convert the qualitative factors to quantitative which ultimately assist CRISL for back-testing of its methodologies. Quantitative factors include appraisal of the historic and projected financials, level of profitability, capacity utilization, capital expenditure need, and cash flow adequacy, debt servicing capacity, free cash flow, and time series analysis. In order to arrive at meaningful assessment the financial statements are recast in order to make the ratios and analytical factors meaningful in line with the time horizon. All the factors considered by CRISL in its analytical rigor may be clustered into five broad analytical risk blocks- Industry Risk, Business Risk, Governance Risk, Financial Risk, Credibility & Relationship and Security issues and Environmental Risk. The above rigor is applied in case of BLR depending on the sector where the Bank loans and facilities are used. The focus may vary depending on the sector of the economy where the client belongs.

A. INDUSTRY RISK

Industry Characteristics, Industry Financials, Global Perspective, Industry Prospects (Growing, Stable, Declining), Position in the business cycle, Product Profile (Nature of Product such as Commodity, Luxury, Normal, Product life cycle, Strategic importance) Elasticity of demand

- Industry Structure: Number of participants-Nature of Competition-Monopoly, Oligopoly, Competition-Supply Chain Management
- Entry and Exit Barriers: Start-up capital requirement- Brand Value- Infrastructure requirement Regulatory Environment- Labor intensive or capital intensive nature of production
- Level of cyclicality: Source of Cyclicality such as Demand, Price, Input Prices
- Technological Change
- Fixed capital expenditure requirement: Recurring, Investment plans of major players
- Overall Capacity versus aggregate demand

B. BUSINESS RISK

Market Position: Competitive Position- Brand Value, Market Share, Market Position, Diversification (nature and extent of Diversification) - Product Quality, Quality Control, Supply side risk, Marketing/ Marketing network

Operating Efficiency: Labor availability, efficiency, Labor relations- Location of production facility, Access to markets, Access to supply sources, manufacturing efficiency compared to the competitors;

Plant & machinery / infrastructure: Plant visit observations, Layout ,Labor Situation, Capital Expenditure Requirement, Technology, Economies of Scale, Capacity Utilization, Product Design & Development, Regulatory Framework;

Economic policy and trend, Government regulations and deregulations, relating to industry, or general trend analysis, litigations, import/ export policy, industrial policy, taxation policy.

C. GOVERNANCE RISK

Corporate Governance: Board of Directors, Board formation meetings, Boards Philosophy, Committee functions, Directors independence, Domination in Board. Delegation of power to the management and Committees

Management Track records: Previous history - Policy trends - important decisions corporate strategy: corporate plans - Execution status of the plans - Perspective plans.

Management Pattern: Style of management - delegation of authority and responsibility.

Professionalism: Family management vs. professional approach - Quality of professional staff

Management philosophy: Approach to the decision making - Management beliefs - Management goals

Organizational structure: Pattern of the organization - Delegation vs. control - Actual strength vs. posts provided in the structure. Job description

Personnel policies: Human resource plan - Staff compensation package - Promotion policies - incentive schemes - corporate environment.

Decision making process: Decision making approach - authority and responsibility - management philosophy etc.

Delegation of Authority: Delegation and re-delegation of authority - extent of authority - independence in authority execution.

D. FINANCIAL RISK

Capital Structure: Equity Growth Rate, Structure of Funding Instruments, Off Balance Sheet, unfunded obligations Debt equity ratios, future plans with respect to capital structure

Earnings: Stability of Earnings / Cash Flows, Revenue Growth, Margins, Return on Investment, Debt & Debt Servicing Coverage, Stress Testing, Profitability indicators-Profitability measurement systems, identification of trends - Analysis systems - Future trends etc.

Cash flow vs. Business growth: Cash flow Trends - Cash flow vs. commitment for Cash - Working capital need, Profitability Vs: cash - cash flow vs. financing business growth etc.

Liquidity: Debt characteristics- Maturity structure- Dependence on short term loans/ commercial paper, Exposure to interest rate fluctuations (Fixed/ floating mix)- Credit triggers- Rating triggers-Financial covenants, Material adverse change (MAC) clauses- Defined events of default- Other potential calls on cash- Post retirement benefits obligations- Environmental liabilities- Asset retirement obligations- Take or pay obligations, guarantees and support obligations, derivatives obligations- Other contingent liabilities.

Operating sources of liquidity such as Expected near-term free cash flow, Ability to liquidate working capital, Flexibility to curtail spending

Bank credit facilities- Total amount of facilities- Nature of bank commitments- Facility maturities- Bank group quality- Evidence of support/lack of support of bank group – banking relationships

Other alternative sources of liquidity- Cash and other liquid assets – high cash and liquid assets- Ability to tap debt and equity markets – no past record of having done so- Ability to sell non-strategic assets – no substantial peripheral assets- Flexibility to curtail common and preferred stock dividends- high Parental support- Overall Financial Flexibility

E. ACCOUNTING QUALITY

Accounting Practices: Accounting systems - Measurement systems - Revenue recognition - Inventory valuation systems - Depreciation methods - Quality of accounting - Auditors qualification and comments

Financial Management: Working capital Management - Business plans vs. budget- Financial flexibility - Fund management - Budgetary control systems - Receivable management systems - bad debt management.

Cost control mechanism: Costing systems - cost accumulation and allocation procedures Cost centers- Linkage between costing and financial accounting systems.

Accounting responsiveness to business growth: How accounting information is utilized - Users of accounting information – Information based reporting - Accounting reporting etc.

Sensitivity Analysis: Financial flexibility in the circumstances of decrease in Capacity utilization, sales volume, price and increase in major expenses like price of raw materials etc.

F. BANKING RELATIONSHIP AND SECURITIES

Exposure wise transaction behaviour, relationship between cash flow and transaction behaviour, past history, force loan history in case of non funded exposure, limit utilization and its relation with business cycle, compliance with the covenants and conditions of loan, cash withdrawal vs. cheque payments, inter-company cash transfer, securities and guarantees offered, company liabilities/ group liability towards other banks, deposits with the same bank if any.

G. ENVIRONMENTAL RISK

Regulatory Environment: Operating environment - National economic outlook, areas of special significance to the national economy, pending litigation - Tax status - Vat status- duty structure possibility of default risk under a variety of future scenarios

Regulatory Framework: Economic policy and its trend - govt. regulations and deregulation relating to specific industry or general trade environment - import / export policy-industrial policy.

In conducting the rating assignments on various corporate sectors of the economy CRISL professionals follow the analytical rigor as mentioned above. However, CRISL has formulated its own Rating Methodologies to cater the need to accomplish the ratings on various fields of the economy.

CRISL RATING SCALES AND DEFINITIONS

BANK LOAN/ FACILITY RATING SCALES AND DEFINITIONS- LONG-TERM

RATING	DEFINITION
Blr **AAA** (*blr* Triple A) (Highest Safety)	**Investment Grade** Bank Loan/ Facilities enjoyed by banking clients rated in this category are adjudged to have highest credit quality, offer highest safety and carries almost no risk. Risk factors are negligible and almost nearest to risk free Government bonds and securities. Changing economic circumstances are unlikely to have any serious impact on this category of loans/ facilities.
blr **AA+,** *blr* **AA,** *blr* **AA-** (*blr* Double A) (High Safety)	Bank Loan/ Facilities enjoyed by banking clients rated in this category are adjudged to have high credit quality, offer higher safety and have high credit quality. This level of rating indicates that the loan / facilities enjoyed by an entity has sound credit profile and without any significant problem. Risks are modest and may vary slightly from time to time because of economic conditions.
blr **A+,** *blr* **A,** *blr* **A-** (*blr* Single A) (Adequate Safety)	Bank Loan/ Facilities rated in this category are adjudged to carry adequate safety for timely repayment/ settlement. This level of rating indicates that the loan / facilities enjoyed by an entity has adequate and reliable credit profile. Risk factors are more variable and greater in periods of economic stress than those rated in the higher categories.
blr **BBB+,** *blr* **BBB,** *blr* **BBB-** (*blr* Triple B) (Moderate Safety)	Bank Loan/ Facilities rated in this category are adjudged to offer moderate degree of safety for timely repayment /fulfilling commitments. This level of rating indicates that the client enjoying loans/ facilities under-performing in some areas. However, these clients are considered to have the capability to overcome the above-mentioned limitations. Cash flows are irregular but the same is sufficient to service the laon/ fulfill commitments. Risk factors are more variable in periods of economic stress than those rated in the higher categories.
Blr **BB+,** *blr* **BB,** *blr* **BB-** (*blr* Double B) (Inadequate Safety)	**Speculative / Non investment Grade** Bank Loan/ Facilities rated in this category are adjudged to lack key protection factors, which results in an inadequate safety. This level of rating indicates loans/ facilities enjoyed by a client are below investment grade. However, clients may discharge the obligation irregularly within reasonable time although they are in financial/ cash problem. These loans / facilities need strong monitoring from bankers side. There is possibility of overcoming the business situation with the support from group concerns/ owners. Overall quality may move up or down frequently within this category.
Blr **B+,** *Blr* **B,** *Blr* **B-** (*Blr* Single B) (Somewhat Risky)	Bank Loan/ Facilities rated in this category are adjudged to have weak protection factors. Timely repayment of financial obligations may be impaired by problems. Whilst a Bank loan 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. Special monitoring is needed from the financial institutions to recover the installments.
blr **CCC+,** *blr* **CCC,** *blr* **CCC-** (*blr* Triple C) (Risky)	**Risky Grade** Bank Loan/ Facilities rated in this category are adjudged to be in vulnerable status and the clients enjoying these loans/ facilities might fail to meet its repayments frequently or it may currently meeting obligations through creating external support/liabilities. Continuance of this would depend upon favorable economic conditions or on some degree of external support. These loans / facilities need strong monitoring from bankers side for recovery.
Blr **CC+,** *blr* **CC,** *blr* **CC-** (*blr* Double C) (High Risky)	Bank Loan/ Facilities rated in this category are adjudged to carry high risk. Client enjoying the loan/ facility might not have required financial flexibility to continue meeting obligations; however, continuance of timely repayment is subject to external support. These loans / facilities need strong monitoring from bankers side for recovery.
Blr **C+,** *blr* **C,** *blr* **C-** (Extremely Speculative)	Bank Loan/ Facilities rated in this category are adjudged to be extremely risky in timely repayment/ fulfilling commitments. This level of rating indicates that the clients enjoying these loan/ facilities are with very serious problems and unless external support is provided, they would be unable to meet financial obligations.
Blr **D** (Default)	**Default Grade** Entities rated in this category are adjudged to be either already in default or expected to be in default.

Note: For long-term ratings, CRISL assigns + (Positive) sign to indicate that the issue is ranked at the upper-end of its generic rating category and - (Minus) sign to indicate that the issue is ranked at the bottom end of its generic rating category. Long-term ratings without any sign denote mid-levels of each group.

SHORT-TERM RATINGS

Blr **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.
Blr **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.
Blr **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.
Blr **ST-4**	**Moderate Grade** Moderate liquidity and other protection factors qualify issues as to invest grade. Risk factors are larger and subject to more variation.
Blr **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.
Blr **ST-6**	**Default** Institution failed to meet financial obligations

END