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Credit Rating Nepal Ltd

BANK LOAN RATING METHODOLOGY

FRAMEWORK

A bank loan rating (BLR) indicates the degree of risk regarding timely servicing of the bank facility being rated; the facility includes principal and interest, if any, on the principal in case of fund based facilities. For the non-fund based facilities like Letter of Credit, Bank Guarantee, etc., the rating indicates the degree of risk regarding timely meeting the funding obligations arising out of devolvement of Letter of Credit and/or invocation of Bank Guarantee. The analysis attempts to determine the fundamentals of the business and the industry and the probabilities of change in these fundamentals, which could affect the creditworthiness of the borrower. Once the rating is accepted, it is subject to annual surveillance.

BLR is used by banks to determine risk weights for their loan exposures, in line with the Nepal Rastriya Bank (NRB's) Guidelines for implementation of the BASEL III under Capital Adequacy Framework 2015.

RATING METHODOLOGIES

This methodology provides an overview of Infomerics Nepal's approach to bank loan rating. The methodology mainly focuses on assessing future cash generation capability of the borrower and their adequacy to meet debt obligations as per the repayment terms. For this purpose, the borrower's audited financials for past five years are studied and analysis of its projections for the next three financial years is carried out under various sensitivity scenarios.

Manufacturing Companies

The entity's past audited financials for five years are studied and analysis of its projections for the next three financial years is carried out under various sensitivity scenarios. Following are the various dynamics taken under considerations to determine entity's cash generation capability.



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Operational Factors	Market Factors	Financial Factors
<ul style="list-style-type: none"> • Installed capacity and capacity utilization • Infrastructure and other necessary setup • Manufacturing technology used and obsolescence thereof. • Operational plans and strategies • Marketing network and customer acquisition strategy • Workforce management • Analysis of cost components and extent of operating leverage • R&D expenditure • Compliance with statutory requirements 	<ul style="list-style-type: none"> • Demand -supply pattern of product manufactured, • Trend in realization, • Availability of substitutes, • Level of competition, • Economic cycle, • Cyclicalities, • Regulating domestic and international laws, • Government support to the sector 	<ul style="list-style-type: none"> • Accounting policies and practices • Debt servicing capacity • Trend in profitability, solvency and liquidity position through ratio analysis • Cash flows and working capital analysis • Projected financials and Scenario analysis • Other financial factors associated with specific projects.

Management capability	Project risk analysis
<ul style="list-style-type: none"> • Organization structure, • Succession planning, personnel policies, • Management competence, • Track record of the current management, • Corporate strategy & roadmap to achieve corporate 	<ul style="list-style-type: none"> • Size of the projects vs size of entity, • Type of project (expansion or related/unrelated diversification) • Project funding risk and status of financial closure



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objectives	
<ul style="list-style-type: none">• Internal control and audit systems• Presence and Performance of group companies and their support	<ul style="list-style-type: none">• Project implementation risk,• Post implementation risk

Financial bank (FI) and NBFC's

Infomerics Nepal's assessment for the purpose of credit rating of Non-Banking Finance Companies (NBFCs) or other FIs has been broken into various elements as follows:

Economic and Industry Factor

Various macroeconomic environment that includes growth prospects for the economy, monetary & credit growth, liquidity & credit demand in the system, structure, composition and trends of the banking system, strength and efficiency of the legal system with stress on bankruptcy laws. Infomerics Nepal also takes into account various regulatory framework both in domestic and international environment. Any major effects of changes in global regulatory trends are also factored while arriving at the rating.

Business Fundamentals

Infomerics Nepal analyses the business fundamentals of a bank with respect to Capital adequacy, Resource raising ability, Asset quality, Management quality, Earnings quality, Liquidity profile and Control Systems under the CRAMELS model.

➤ Capital Adequacy

To measure the degree of which the capital is available to absorb possible losses. Also to evaluate ability of the borrower to undertake additional business. For this Infomerics Nepal examines the conformity of the bank to the regulatory guidelines on;

- capital adequacy ratio
- proportion of Tier I capital



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Further it works out the stressed capital adequacy on the basis of expected erosion of capital arising as a result of factors such as:

- additional provisioning of NPAs
- possible losses from restructured assets
- possible losses from other weak assets

➤ **Resources Profile**

Resource base is analyzed to assess the cost & composition. Deposits constitute core funding source of the bank. Higher proportion of low cost deposits in total deposits and retail-wholesale deposit mix is viewed as positive. Deposit growth rates and their rollover rates are also analyzed. Average as well as incremental cost of funds is examined in the context of prevailing interest rate regime. Ability of the bank to raise additional resources at competitive rates is examined critically.

➤ **Asset Quality**

Asset quality holds the potential to impact future earnings (higher NPAs could dilute the yields and necessitate higher credit provisions) and capital (lower earnings could slow down the internal capital generation or in extreme situations “loss” could weaken the capital). The evaluation of asset quality begins with the examination of the bank’s credit risk management system. The quality of credit administration as reflected in design and implementation of appraisal and loan pricing methodologies and adherence to periodic review are examined. The overall asset quality is examined by evaluating the sector by sector loan and off-Balance Sheet exposures. The Bank's experience of loan losses and write off/provisions are studied carefully. The percentage of assets classified into standard, sub-standard, doubtful or loss and the track record of recoveries of the banks are examined closely.

➤ **Management Strategy**



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Shareholding pattern, composition of the board, organisational structure, personnel policies and extent of delegation of powers, organisational objectives, relationship with subsidiaries and support from group/government are closely monitored.

➤ **Earnings Profile**

Infomerics Nepal segregates the composition of income of the bank into those generated from fee based and fund based activities for its analysis. Also, non-recurring income are excluded from the total income for arriving at core earnings. Risks as well as earnings prospects and growth rate for each business area that contributes to the core earnings is assessed. Further, yield on business assets and investments are viewed in conjunction with cost of funds to arrive at the spreads earned by the bank. To examine operating efficiency, expense ratios are also analyzed. Infomerics Nepal understands that the quality of bank's earnings is also influenced by exposure of the bank to the level of interest rate and foreign exchange rate risks. Overall profitability is viewed in terms of return on assets and return on shareholders' funds.

➤ **Liquidity**

Liquidity plays an important role in the stability of the bank. It is important for a bank to maintain a favorable liquidity profile for the smooth functioning of its funding activity (fresh asset creation) and to honor its debt commitments in a timely manner. It is also important that a bank manage their interest rate risk, as the same could impact its future profitability. In assessing a bank's liquidity profile, the evaluation is done on the company's policy on liquidity, the maturity profile of its assets and liabilities, the asset-liability maturity gaps, and the backups available to plug such gaps. The evaluation also focuses on the diversity of the bank's funding sources and their quality (i.e. availability of these sources in a stress situation). The short term external funding sources in the form of unutilized limits available from other banks, etc. along with directed and other investments if any are important sources of reserve liquidity. The short term external funding sources in the form of refinance facilities from NRB and the inter-bank borrowing limits available along with CRR and SLR investments are important sources of reserve liquidity.



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BANK LOAN RATING SCALE WITH DEFINITIONS

Infomerics Nepal's Long Term Debt Instruments Rating Scale

Long term rating scale-All debt instruments with original maturity exceeding one year.

Symbols	Rating Definitions
IRN AAA	Instruments with this rating are considered to have the highest degree of safety regarding timely servicing of financial obligations and carry lowest credit risk.
IRN AA	Instruments with this rating are considered to have the high degree of safety regarding timely servicing of financial obligations and carry very low credit risk.
IRN A	Instruments with this rating are considered to have the adequate degree of safety regarding timely servicing of financial obligations and carry low credit risk.
IRN BBB	Instruments with this rating are considered to have the moderate degree of safety regarding timely servicing of financial obligations and carry moderate credit risk.
IRN BB	Instruments with this rating are considered to have the moderate risk of default regarding timely servicing of financial obligations.
IRN B	Instruments with this rating are considered to have the high risk of default regarding timely servicing of financial obligations.
IRN C	Instruments with this rating are considered to have the very high risk of default regarding timely servicing of financial obligations.
IRN D	Instruments with this rating are in default or are expected to be in default soon.

Note: Modifiers {"+" (plus) / "- "(minus)} can be used with the rating symbols for the categories IRN AA to IRN C, which will reflect the comparative standing within the category.

Infomerics Nepal's Short Term Debt Instruments Rating Scale

Short term rating scale: All Instruments with original maturity of up to one year.

Symbols	Rating Definitions
IRN A1	Instrument with this rating are considered to have a very strong degree of safety regarding timely payment of financial obligations and carry lowest credit risk.
IRN A2	Instrument with this rating are considered to have a strong degree of safety



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	regarding timely payment of financial obligations and carry low credit risk.
IRN A3	Instrument with this rating are considered to have a moderate of safety regarding timely payment of financial obligations and carry higher credit risk as compared to instruments rated in the two higher categories.
IRN A4	Instrument with this rating are considered to have minimal degree of safety regarding timely payment of financial obligations and carry very high credit risk and are susceptible to default.
IRN D	Instruments with this rating are in default or expected to be in default on maturity.

Note: Modifier {"+" (plus)} can be used with the rating symbols for the categories IRN A1 to IRN A4, which reflects the comparative standing within the category.

Disclaimer: Ratings assigned by Infomerics Nepal are an opinion on the credit risk of the issue / issuer and not a recommendation to buy, hold or sell securities. Infomerics Nepal reserves the right to change, suspend or withdraw the credit ratings at any point in time. Ratings assigned by Infomerics Nepal are opinions on financial statements based on information provided by the management and information obtained from sources believed by it to be accurate and reliable. The credit quality ratings are not recommendations to sanction, renew, disburse or recall the concerned bank facilities or to buy, sell or hold any security. We, however, do not guarantee the accuracy, adequacy or completeness of any information, which we accepted and presumed to be free from misstatement, whether due to error or fraud. We are not responsible for any errors or omissions or for the results obtained from the use of such information. Most entities whose bank facilities/instruments are rated by us have paid a credit rating fee, based on the amount and type of bank facilities/instruments. In case of partnership/proprietary concerns/Association of Persons (AOPs), the rating assigned by Infomerics Nepal is based on the capital deployed by the partners/proprietor/ AOPs and the financial strength of the firm at present. The rating may undergo change in case of withdrawal of capital or the unsecured loans brought in by the partners/proprietor/ AOPs in addition to the financial performance and other relevant factors.