Infomerics
Credit Rating Nepal Ltd

BANKS CREDIT RATING METHODOLOGY

Infomerics Nepal follows the CRAMELS framework to assign its ratings on bank and financial institutions. CRAMELS stands for Capital Adequacy, Resource raising ability, Asset quality, Management quality, Earnings, Liquidity profile and Systems. This framework is further classified into quantitative and qualitative factors, which are described in detail below:

Quantitative factors

a) ***Capital adequacy***

Capital provides the second level of protection to debt holders (earning being the first) and, therefore, its quality and adequacy (in relation to the embedded credit, market and operational risk) is an important consideration for ratings. Capital Adequacy is a measure of the bank's ability to meet its obligations relative to its exposure to risk and also relates to the degree to which the bank's capital is available to absorb possible losses. It also indicates the ability of the bank to undertake additional business. The evaluation by Infomerics Nepal factors the conformity of the bank to the regulatory guidelines on capital adequacy ratio. Higher proportion of Tier I (core capital) in the overall capital is viewed favorably. During the rating process, the expected erosion of capital and its impact on the capital adequacy is examined factoring additional provisioning for NPAs, possible losses from restructured assets and possible losses from other weak assets.

b) Resources Profile

Resource base of the bank is analyzed to assess the cost & composition. Deposits constitute core funding source of a bank. Higher proportion of low cost deposits (Current Account and Savings Account) in total deposits is viewed as positive. Deposit growth rates with the composition of term, saving and current are also analyzed. Deposits from corporate and institutional depositors are more volatile than retail and household deposits.

Cost of funds is determined by the composition of deposits, interest rate on deposits (influenced by market liquidity) and tenure of deposits. Other factor includes funding source from money market instrument (short-term treasury bills, national savings certificates (NSC), and overdraft financing) and cost incurred due to regulatory requirement reserve (CRR/SLR). Ability of the bank to raise additional resources at competitive rates while maintaining sufficient reserve is examined critically.

c) Asset Quality

Asset quality is the most important determinant of the overall financial condition of the bank. For a bank, the primary factor affecting the asset quality is the quality of the loan disbursed and the credit administration process. Asset quality carries the greatest amount of risk to the bank's capital. The asset quality determines the bank's existing and potential credit risk associated with the bank's loan and investment portfolio. Composition of assets of bank including proportion of performing and non-performing assets (further broken down into substandard, doubtful and loss assets) is analyzed carefully. Portfolio diversification in terms of exposure to weak sectors and granularity of exposures is seen. The Bank's experience in terms of recovery of NPAs is also critically analyzed.

d) Earnings Profile

The long-term viability of a bank depends greatly on its ability to generate sufficient earnings to protect and enhance its capital and reward its shareholders and depositors. The purpose of the evaluation is to assess the level of future earnings and quality of earnings of the Bank by analyzing its interest spreads, fee income, operating expenses and credit costs.

To sum up, the following areas are considered

- Composition of income from fee based and fund based activities.
- Core earnings are also identified by excluding non-recurring income from the total income. Each business area that contributes to the core earnings is assessed for risks as well as for its earnings prospects and growth rate.

- Yield on business assets are viewed in conjunction with cost of funds to arrive at the spreads earned by the bank.
- Operating efficiency, expense ratios are analyzed.
- Impairment charge for loans and other losses as per guidelines prescribed by NRB.
- Infomerics Nepal understands that the quality of bank's earnings is also influenced by the level of interest rate and foreign exchange rate risks that the bank is exposed to.
- Overall profitability is viewed in terms of return on assets and return on shareholders' funds.
- Distributable profits before the deduction of elements subject to restriction on distribution as prescribed by NRB are analyzed.

e) Liquidity Management

A bank needs to ensure that cash needs (to maintain the required level of reserves with NRB (CRR) and to meet expected and contingent cash needs) are met at reasonable cost. The internal sources (paid up capital, reserve fund, profit) and external sources (deposits, borrowing from central bank, debentures) of funds to meet the bank's requirements are examined. The degree of the bank's reliance on volatile funds in relation to total assets is examined. The liquidity risk is evaluated by examining the assets liabilities maturity (ALM) profile, interest rate sensitivity, deposit renewal rates, proportion of liquid assets to total assets and the degree to which core assets (those which are relatively illiquid) are funded by core liabilities.

f) Peer group analysis

Infomerics Nepal carries out peer group comparison on each of the above discussed parameters with the bank's performance. Detailed inter-bank analysis is done to determine the relative strengths and weaknesses of the bank in its present operating environment and any impact on it, in future. All relevant quantitative and qualitative factors are considered together, as relative weakness in one area of the bank's performance may be more than adequately compensated for by strengths elsewhere. The quality of the management and the competitiveness of the bank are of greater importance in long term rating decisions.

Qualitative Factors

a) Management quality

Here, culture, attitude, employee involvement and composition of board are taken into consideration. It also focuses on satisfaction of all stakeholders, have a sustained customer focus and apply continuous improvement with facts and database. It deals with experience and track record of senior management, modern banking practices and systems, degree of computerization, personnel policies and extent of delegation of powers. Following are considered to gauge the managerial competence:

- Reduced cost of operations
- Mobilization of resources
- Ability to identify opportunities
- Track record in managing stress situations
- Track record of labor relation
- Adoption of modern banking practices and systems

The extent of frauds committed in the bank, rise in non-performing loans, increase in legislative attempt to cap Banks' lending rates are the challenges faced by the management which affect their bottom line are also examined.

b) Ownership Structure

The Nepalese banking system consists of public sector banks and private sector banks. While comfort is drawn from the sovereign ownership of public sector banks, the credit view on other banks would depend on the ability of the bank to raise capital from promoters / other key shareholders, as and when required. Also viewed positively, is public sector bank with GON shareholding well in excess of 51%, as it would have greater flexibility to raise capital by diluting GON's shareholding.

c) *Internal Control and Risk Management*

While Credit Risk Mitigation (CRM) reduces credit risk, it simultaneously may increase other risks to which a bank is exposed, such as legal, operational, liquidity and market risks. Therefore, it is important to deploy robust procedures and processes to control these risks.

Infomerics Nepal is focused on the following aspect for risk management:

- Appropriateness of the bank's capital assessment process;
- Identification of large exposures and risk concentration;
- Policies for hedging and/or mitigating risk and strategies, and processes for monitoring the continuing effectiveness of hedges/mitigants.
- Stress testing and analysis of assumptions and inputs.

d) *Statutory compliance*

Track record of the bank in complying with SLR/CRR, interest rate spread, capital adequacy ratio, priority sector lending and other norms as specified by the NRB are seen.

e) *Market size and positioning*

The scale of branch network of a bank determines its capacity & ability to grow, while maintaining reasonable risk adjusted returns and sustenance of earnings with resilience. Hence, the strength of a bank in terms of scale of operations vis-à-vis branch networking and market share for various activities along with business niche, positioning with reference to competition are evaluated. Brand recognition, complexity of key areas of work and special government support or privileges as compared to other banks are also captured.

f) Accounting Quality

The rating is based on the audited financial data submitted by the issuer. Consistent & fair accounting policies are a pre-requisite for financial evaluation and peer group comparisons. In evaluating Bank's accounting quality, the review is made with regard to the Bank's accounting policies, notes to the accounts, and auditors' comments in detail. Deviations from the Generally Accepted Accounting Practices are noted and the financial statements of the Bank are adjusted to reflect the impact of such deviations.

Financial & Operating Ratios

In order to evaluate the aforesaid quantitative factors, various financial & operating ratios are calculated to see how a particular bank is placed over a three to five years' time horizon on a standalone basis, as also with reference to its peers:

Growth

- Total Income
- Total Interest Income
- Profit After Tax (PAT)
- Deposits
- Advances (Gross)
- Investments (Gross)
- Total Assets

Profitability

- Operating Margin (%)
- PAT Margin (%)
- Return on Investment (RoI)
- Interest Spread (%)

- Net Interest margin (%)
- Return on Total Assets (ROTA %)
- Return on Net Worth (RONW %)
- Interest income /Average interest earning assets (%)
- Interest expenses/Average interest bearing liabilities (%)
- Operating Expenses/Average Total Assets (%)
- Cost of deposits (%)
- Cost to Income Ratio (%)
- Credit Deposit Ratio (%)
- Current Account Saving Account Ratio (CASA %)

Gearing

- Total Debt / Net worth (times)
- Capital adequacy (%)

Asset Quality

- Gross Non-Performing Assets (NPAs %)
- Net NPAs (%)
- Net NPAs/ Net worth (%)
- Provision Coverage Ratio (%)
- Credit Deposit Ratio (%)

In addition to these, Infomerics Nepal also considers the market positioning of the entity being rated. These parameters/ variables significantly determine the ability to manage risk, price fluctuation, while maintaining adequate capitalization to absorb losses and ensure credit growth.

BANK 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.

Rating Symbols	Rating Definitions
IRN AAA	Instruments with this rating are considered to have the highest degree of safety regarding timely servicing of financial obligations. Such Instruments 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. Such Instruments 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. Such Instruments 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. Such Instruments 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 in servicing of debt obligations.

Modifiers {"+" (plus) / "-"(minus)} can be used with the rating symbols for the categories IRN AA to IRN C. The modifiers 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.

Rating Symbols	Rating Definitions
IRN A1	Instruments with this rating are considered to have very strong degree of safety regarding timely payment of financial obligations. Such instruments carry lowest credit risk
IRN A2	Instruments with this rating are considered to have strong degree of safety regarding timely payment of financial obligations. Such instruments carry low credit risk.
IRN A3	Instruments with this rating are considered to have moderate degree of safety regarding timely payment of financial obligations. Such instruments carry higher credit risk as compared to instruments rated in the two higher categories.
IRN A4	Instruments with this rating are considered to have minimal degree of safety regarding timely payment of financial obligations. Such instruments 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 o maturity.

Modifiers {"+" (plus)} can be used with the rating symbols for the categories IRN A1 to IRN A4.

The modifiers reflect the comparative standing within the category.