

ICRA Lanka Rating Methodology for Banks

ICRA Lanka's rating assesses the credit risk of a bank which is a function of the business and financial risk as well as the likelihood of external support available to the bank in case of any financial stress. The report discusses the key parameters that ICRA Lanka uses for assessing the business and financial risk of a bank. ICRA Lanka makes use of publicly available financial data as well as the bank's own statistical information for its credit evaluation. ICRA Lanka makes appropriate adjustments to the financial data to ensure conformance with the generally accepted accounting principles. The ratings are determined on a "going concern" basis rather than on a mere assessment of the bank's financials as on a particular date.

This note is not an exhaustive discussion on all the aspects that go into rating of a bank, but outlines a broad framework that ICRA Lanka uses during the rating process. The key factors considered in the rating process are as follows:

Business Risk

- Operating and Regulatory Environment
- Ownership Structure and Govt. Support
- Governance Structure
- Franchise
- Management, Risk positioning, Systems and Strategy

Financial Risk

- Asset Quality
- Diversity of funding and Liquidity
- Profitability
- Capital Adequacy

Operating Environment

The assessment of a bank's operating environment is one of the most important parameters for the credit risk evaluation of a bank, as it could affect growth, asset quality and its earnings. The operating environment of a bank is studied through an analysis of the prevailing economic conditions, growth prospects (GDP growth rate), the likely deposits and credit growth, structural constraints in the economy (such as a large fiscal deficit and the necessity of banks to invest in Statutory Liquidity Ratio (SLR) papers/instruments) as well as the impact of economic and regulatory environment on the credit risk profile. ICRA Lanka also evaluates the likely policy changes to combat these challenges.

Additionally, political risks and the legal system of the country are also evaluated to assess the asset quality of banks as well as their ability to recover from delinquent accounts. An evaluation of the structure of the financial market, stages of development and intensity of competition forms an important part of the evaluation of a bank's operating environment.

Regulatory Environment

A well regulated and supervised system is the backbone for credibility and stability of banks even when the operating environment is unfavourable. ICRA Lanka's evaluation of the regulatory system involves evaluation of norms related to capital and other countercyclical measures to absorb risk, prevent related party transaction; the extent of regulatory supervision and regulatory changes in the past in response to the macro environment; key norms (such as NPA recognition, provisioning, capital adequacy, liquidity, expansion and directed lending) and prospective regulatory changes (driven by financial sector reforms as well as international environment/leanings).

The degree to which the central bank is likely to allow new entrants in banking and open the banking system to further disintermediation could increase competition from new banks and non-bank lenders. Further development of the capital market could allow potential and existing clientele to access capital markets directly, thus making product innovation an important criterion for future performance. As for the international environment, the global meltdown has triggered several regulatory changes for higher core capital and better liquidity under Basel III. ICRA Lanka also evaluates the likely impact of these changes on the business plans and performance of banks.

Ownership Structure and Government Support

The Sri Lankan banking system consists of public sector banks, private sector banks, foreign banks and specialized banks. While ICRA Lanka draws comfort from the sovereign ownership of public sector banks, the credit view on some of the private sector banks would depend on the ability of the bank to raise capital from promoters/other key shareholders/market, as and when required.

Apart from ownership, the bank's importance in the domestic financial system has a bearing on the possibility of government support at times of financial duress. Apart from balance sheet size, proxies for a bank's systemic importance could include share of business in region of operation, participation in payment systems and scale of quasi-fiscal responsibilities (such as directed lending) carried out for the government. ICRA Lanka focusses on the existence of explicit or implicit government guarantees to depositors against default or insolvency.

Governance Structure

ICRA factors a bank's governance structure in the rating process by conducting an assessment of the structural and functional aspects of its Board and committees. ICRA believes that an appropriate governance structure is important to ensure that banks operate independently, with the interest of deposit holders not being

compromised for other stakeholders such as related party lending and lending to vulnerable sections. A good governance structure also ensures that the powers given to line managers at a bank are exercised in accordance with the established procedures and that these procedures conform to the broad policy guidelines and strategic objectives of the bank.

Franchise

The franchise strength of a bank determines its capacity to grow while maintaining reasonable risk adjusted returns and resilience of earnings. ICRA Lanka evaluates the franchise strength of a bank in terms of scale of operations and market share for various activities at the macro level or business niche; performance and strengths relative to competition; complexity of key segments and special government support or privileges relative to other banks. ICRA Lanka also takes into account the brand recognition, history and background of banks under its franchise strength analysis.

Management Systems and Strategy and Risk Management

ICRA Lanka lays special emphasis on governance issues; quality of management; systems and policies; shareholder expectations; the strategy followed to manage these expectations and accounting quality, as these aspects form the foundation of a bank's credit risk profile. The importance of these factors is even higher for a new bank or one with a shorter track record. Usually, a detailed discussion is held with the bank's management to understand its business objectives, plans and strategies, views on past performance and outlook on the industry. ICRA also assesses the shareholders expectations and their impact on the credit profile of a bank. Some of the other points assessed are:

- Experience and commitment of the promoter/management to the line of business concerned
- Attitude of the management to risk taking and containment
- The bank's risk management policies (credit risk, market and operational risk)
- The ability and willingness of the promoters to support the bank through measures such as capital infusion, if required

In addition, ICRA Lanka also evaluates the quality, depth, timeliness and relevance of information available to the bank's management. Our analysis of system adequacy encompasses the quality of the communications network; levels of computerisation and integration within the bank; systems for accounting control; management information for monitoring performance; business development and statutory reporting. ICRA Lanka lays considerable emphasis on the effectiveness of the bank's risk management systems and systems for strategic planning. For accounting control aspects such as accounting quality, balancing of books, inter-branch and inter-bank reconciliation, ICRA Lanka draws on sources such as the Long-form Audit Report and the Central Bank Inspection Report, apart from reviewing the bank's internal reports and controls.

Risk Management

A careful evaluation of the risk management policies of the bank is conducted, as it provides an important guidance for the future liquidity, profitability, asset quality and capitalisation of the bank concerned. The risk management of the bank is evaluated for the following:

- **Credit risk**
The risk of loss resulting from the failure of a client or counterparty to meet its contractual obligations; this risk could arise from the credit book as well as the investment book
- **Market risk**
The risk of loss resulting from changes in market variables, mostly emanating from investment portfolio, although credit book could also contribute to it.
- **Operational risk**
The risk of loss resulting from inadequate or failed internal processes, people and systems, or from external causes

The evaluation of a bank's risk management focusses on its ability to assess, control/mitigate and disclose the aforesaid risks. This is done by evaluation of norms and tolerance limits, roles and responsibilities, relative importance and independence of risk function as compared to operating lines and systems to implement the risk management framework.

Financial Performance

Financial performance analysis is one of the key parameters used to compare a bank's performance over a period of time and across its peer group. ICRA Lanka conducts a detailed financial analysis of the banks being rated. The key parameters that ICRA Lanka focusses on include:

- Asset Quality
- Liquidity
- Profitability
- Capital Adequacy

Asset Quality

The asset quality of a bank is a reflection of its risk appetite; depth of its franchise and effectiveness of its management, strategy, systems and processes. Asset quality holds the potential to affect 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 asset quality evaluation includes the loan book as well as the non-SLR portfolio of a bank. The key aspects of asset quality evaluation are discussed below

- ICRA Lanka assesses the quality of a bank's credit appraisal process and lending/investment norms, the riskiness of its loan mix, the availability of data to

facilitate credit decision-making and its track record in managing its loan book through lifecycles. Further, the extent of diversification is also an important indicator of a bank's asset quality. In assessing diversification, the common factors include loan mix, portfolio granularity, sectoral/geographical diversification and borrower profile. Segmental and regional NPA analysis is performed to gauge the extent of the bank's credit concentration to a single company, group, industry or region. High levels of diversification can shield a bank from the impact of downturn in any one segment. At the same time, diversification into riskier segments may not improve resilience and, therefore, may not translate into superior ratings. However, a bank's ability to manage diversification, especially in multiple businesses and/or new geographies is as important an issue as management depth and ability to adopt the skills and techniques needed to run different businesses.

- ICRA Lanka also assesses the quality of credit administration as reflected in design and implementation of appraisal and loan pricing methodologies and adherence to periodic review.
- ICRA Lanka assesses the risk of devolvement of obligations onto a bank from its underperforming subsidiaries. The devolvement may arise legally or due to the publicly perceived moral obligation of a parent to support a subsidiary organisation.
- ICRA Lanka also studies the distribution of credit across various rating categories for corporate credit to judge the likelihood of future NPA generation.
- Asset classification: The advances are classified into standard and non-performing assets (NPAs). NPAs are further classified into substandard, doubtful and loss assets, depending on the time period for which an asset has been an NPA. ICRA Lanka examines the provisioning requirements (according to the Central Bank guidelines) versus provisions made by the bank as well as the expected quantum and time frame of recovery. The accent is on estimating prospects of recovery, or further deterioration, that eventually affects the bottom line and financial position of the bank. Key asset quality indicators for a bank are its Fresh NPA generation rate, Gross NPA percentage, Net NPA percentage and Net NPAs in relation to its network.

Diversity of Funding and Liquidity

ICRA Lanka conducts a study of the funding profile of the bank in terms of the sources and mix of funds as well as the cost of funds to the bank, along the following lines:

- Classification of deposits that is wholesale or retail. CDs and bulk deposits from the corporate and institutional depositors are typically more volatile than retail and household deposits. In its rating process, ICRA Lanka views positively a higher proportion of retail deposits in the total mix.

- Demographic classification of deposits that is a proportion of rural and urban deposits. Typically, rural deposits display lower fluctuation than urban deposits, thus reflecting the lower availability of investment options as compared to the options available in urban areas.
- Cost of funds: The cost of funds is determined by the mix of deposits (current, savings and time deposits), the tenure of deposits and the bank's market standing that influences its interest rate structure. Other factors include the bank's reliance on money market funding, (from call money markets, CDs, refinance lines and the like), and the money market conditions prevalent and foreseen in future.
- Payment services: The near-monopoly in operating the payment systems provides banks a stable and low-cost base of settlement balances. ICRA Lanka assesses the banks' ability to offer value-added payment services (often driven by technology), which will hold the key to a bank retaining the benefits from this natural service.

ICRA attempts to capture the liquidity of a bank by analysing the following qualitative and quantitative parameters:

- Market perceptions of the bank: Perceptions affect a bank's ability to access funds during a crisis. An indicator of such perceptions could be relative cost of funds for a bank in the inter-bank market.
- The degree of the bank's reliance on volatile funds in relation to total assets: Some short-term funding sources are more sensitive than others to adverse developments. ICRA Lanka views inter-bank funding by domestic banks and domestic deposits by non-bank depositors in descending order of confidence.

Bank's liquidity position: ICRA Lanka studies factors such as the overall match between the maturity profile of its assets and liabilities; the level of readily saleable securities and securities against which repo facilities are available, committed lines of liquidity available that include revolving lines of credit and refinance facilities. ICRA Lanka analyses the possibility of stakeholder support in case of a crisis. ICRA Lanka places considerable emphasis on the implicit backing arising from the significant shareholding of a strong entity in the bank. This benefit naturally accrues to all public banks.

Earning Stability and Prospects

A bank's ability to generate adequate returns is important from the perspective of its shareholders as well as debt holders. The purpose of ICRA Lanka's evaluation here is to assess the level of future earnings and quality of earnings of the Bank concerned by analysing its interest spreads, fee income, operating expenses and credit costs.

The profitability of a bank is evaluated by analysing its interest spreads (yields minus cost of funds) and the likely trajectory of the same in the light of the changes in its operating environment, its liquidity position and its overall strategy. ICRA Lanka also assesses the ability of the bank to complement its interest income with fee income. A large fee income

allows greater diversification, which in turn can improve a bank's resilience of earnings and earning profile. The trading income of the bank is also evaluated to assess the sustained level of income/losses under an adverse interest rate scenario. After assessing the income stream, ICRA Lanka evaluates the Bank's operating efficiency (operating expenses in relation to total assets and cost-to-income ratio) and compares the same with that of its peers. Finally, the credit costs are estimated on the basis of the bank's asset quality profile and the profitability indicators compared across peers. Importantly, a very high return on equity may not necessarily translate into a high credit rating, given that the underlying risk could be very high or leveraging could be excessive as well; and being so, it could be more volatile or difficult to predict.

Capital Adequacy

Capital provides the second level of protection to debt holders (earnings 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. In evaluating the bank's true capital in relation to the risks in its business, ICRA Lanka focusses on the following aspects:

- Regulatory capital, risk-based approach and conformance with prescribed norms: As per the guidelines of the Central Bank, banks are required to achieve and maintain the ratio of total capital funds to risk weighted assets (both on and off balance sheet) at 10%. Regulatory adequacy apart, the adequacy of capital is also assessed from other standpoints such as present and prospective asset quality, risk rating of the portfolio, risk strategy or risk appetite of the bank and interest rate sensitivity of the balance sheet.
- Quality of capital and ability to raise capital: A higher percentage of core Tier I capital is viewed more favourably, given its greater permanence, followed by hybrids and subordinated bonds. In addition to these, ICRA Lanka evaluates the internal capital generation capacity of the bank and the leeway available to augment capital to support growth or withstand the stress.

Conclusion

The credit ratings assigned by ICRA Lanka are a symbolic representation of its current opinion on the relative credit risk associated with the issuer/instruments rated. ICRA Lanka arrives at this opinion by conducting a detailed evaluation of the bank's business and financial risks and using such an evaluation to project its future financial performance in various likely scenarios. While several parameters are used to assess the risk profile of a Bank, the relative importance of each of these qualitative and quantitative parameters can vary across banks, depending on its potential to change the overall risk profile of the bank concerned.

