ARGUS CREDIT RATING SERVICES LIMITED

RATING METHODOLOGY:

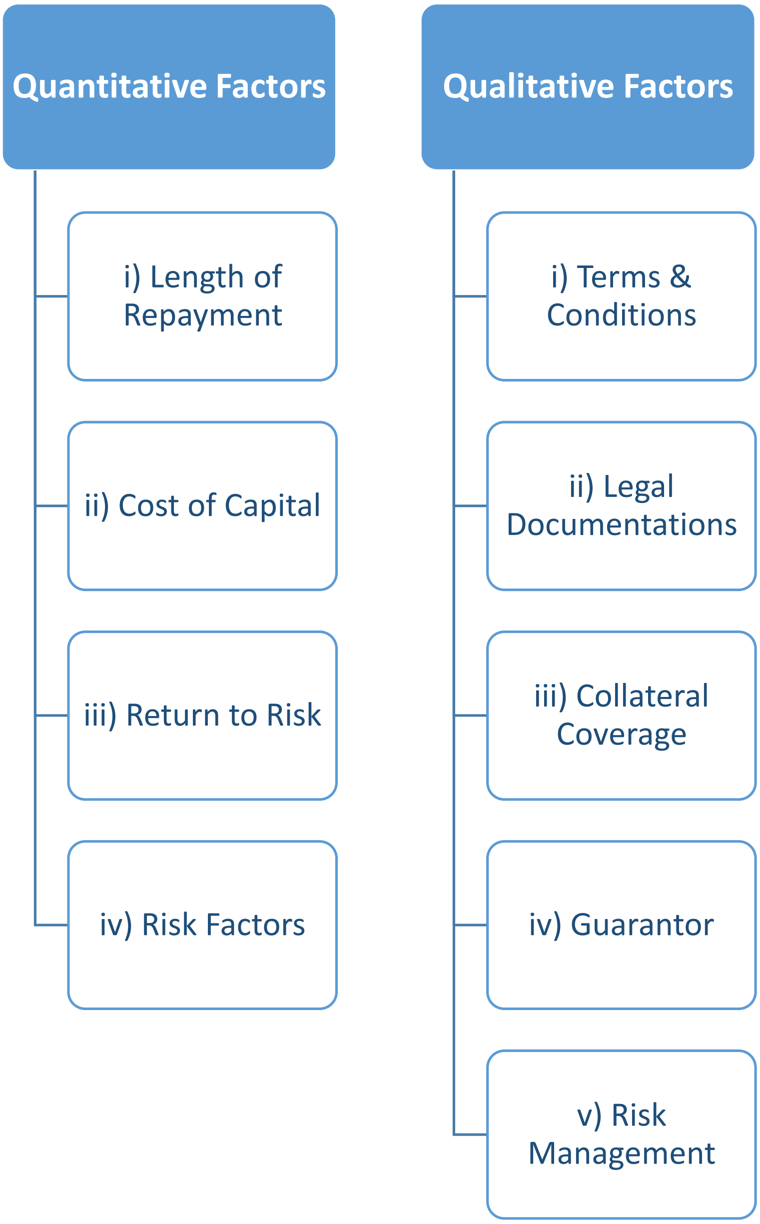
INSTRUMENT RATING

RATING PROCESS FLOW

1. Primary Document Collection
2. Agreement Signing
3. Preliminary Assessment
4. Management Meeting
5. Assessment by IRC
6. Final Rating by RC
7. Publish Report

ACRSL's Rating Methodology – Instrument Rating

This methodology describes ACRSL's approach to rating Long-term and short-term debt instruments. The debt instrument rating takes into account the probability of default on a particular instrument only. ACRSL uses the credit rating of the issuing entity (referred to as "issuer") as a baseline for determining the rating of the debt instrument of such entity. It then goes on to incorporate the unique characteristics of the instrument into its analysis. These include, seniority of the debt instrument relative to other obligations of the issuer, underlying collateral and credit enhancements, if any exist. When rating short-term for debt instruments, ACRSL additionally considers the liquidity and financial flexibility of the issuer. Based on ACRSL's analysis of these factors, the instrument is either notched same or lower than the issuer's rating.



INTRODUCTION: DEBT INSTRUMENT MARKET

Bangladesh has a relatively small debt instrument market. Financing through bank loans is the preferred route for corporates, rather than utilizing capital markets to raise funding through issuing debt instruments like bonds. Therefore, when instruments are issued, they are secured by the assets of the company. Retail investors have also been tapped but generally the instruments are the domain of institutional investors – banks, mutual funds, and retirement benefit schemes. Instrument denominations and tenor also remain on the lower side. Given relatively small base and held to maturity stance of most investors, secondary market is yet to evolve in a meaningful platform.

KEY TYPES OF DEBT INSTRUMENTS

Types of debt instruments can be differentiated mainly on the basis of:

(i) Maturity (money market vs. capital market debt instruments)
(ii) Issuing entities (government, financial institutions, corporates, etc.)
(iii) Markets in which they are issued (conventional vs. Islamic)
(iv) Accessibility (listed vs. privately-placed)
(v) Security (secured, unsecured or subordinated)

ACRSL has evolved mechanism and methodologies to cater to the distinct features of structured debt instruments, and Basel-III Compliant debt instruments.

RATING DEBT INSTRUMENT

- A debt instrument rating is an assessment of a specific debt issue of an entity and provides an opinion on the issuing entity's ability to meet on a timely basis its principal and interest obligations pertaining to the debt instrument being rated. For the purpose of the rating assessment, both the payment of interest and repayment of principal are considered "contractual obligations" by ACRSL.

- ACRSL undertakes debt instrument ratings for all kinds of short-term and long-term instruments. For any given debt instrument rating, the entity rating of the issuer is used as a baseline (also called issuer rating). The debt instrument rating is then notched either "same" or "lower" compared to its corresponding issuer rating.

- While forming an opinion on an issuer, ACRSL evaluates the underlying entity as per the specific methodology applicable to it. For instance, for an industrial corporate issuer, Corporate Rating Methodology would apply, while, for a Bank, Bank Rating Methodology would be used to arrive at entity rating of the issuer.

Rating Notch

The primary factors impacting notching of the debt instrument, relative to the issuer profile, are:

(i) Relative seniority of the instrument, compared to the issuer's other obligations,
(ii) Underlying collateral, since these can impact recovery prospects in case of default.

A summary of notching guidance is presented in the table below:

Instrument Type	Likely Rating Notch Impact
Secured Instrument	0
Unsecured Instrument	-1
Subordinated Instrument	-1, -2

Relative Seniority of the Instrument: A senior unsecured instrument carries the same rating as its issuer. Meanwhile, notching for legally subordinated instruments is minus one for high-rated issuers. However, minus two notches may be applied in case of lower rated issuers where the instrument is deemed to be deeply subordinated (i.e. represents a small share of the issuer's total debt).

Collateral: Where an instrument is secured, the extent of notching is also influenced by the quality of the underlying collateral it is secured against, since this determines recovery prospects in case of default. ACRSL looks at the following features of the collateral:

- Current valuation and associated volatility thereof; the more volatile the value of a security is deemed to be, the less favorable the notching impact.
- Liquidity/marketability; the higher the likelihood of the security being monetized in a timely manner with minimal premium, the more favorable the notching impact.

In certain cases, ACRSL's ratings may differ from the notching guidance specified in the table above. For example, where an issuer maintains an unbalanced capital structure whereby the particular instrument comprises either a very significant or insignificant proportion of total debt, and/or where there is significant complexity in the legal structure of the terms of the instrument, among other considerations.

Credit Enhancements: The presence of certain structural features may enhance the rating of a particular debt instrument relative to its issuer or its issuer's other debt instruments. Two common forms of such features are third party guarantees and cash collection mechanism.

Third Party Guarantees: The debt instruments that carry third party guarantee to make good the amount obligated to the lenders by the issuer may provide additional support to its rating. In this case, in determining the rating of the instrument, key factors to assess are the financial profile of the guarantor (or its credit rating, where available) and the extent of coverage it provides to the instrument holders.

Cash Collection Mechanism: Few debt instruments are secured by a cash collection mechanism, whereby cash flows generated from a particular stream of revenue are used to fund the debt service reserve or fund. While arriving at its rating opinion, ACRSL's assessment incorporates the issuer's operational viability to continue to serve its customers from whom the cash flows are expected to generate. In this case, ACRSL attempts to assess the financial profile of these customers and the level of diversification in related customer base. Provision of any upfront liquid asset/cash collateral may also improve instrument's rating.

In local environment, banks usually issue unsecured and subordinated debt instruments; though secured instruments can be issued but with specific permission of the regulator. In these cases, ACRSL follows its respective entity rating methodology (e.g. Financial Institution Rating Methodology, Microfinance Institutions Rating Methodology, Corporate Rating Methodology among others) to arrive at entity rating opinion.

This is then notched according to collateral. Meanwhile, ACRSL considers how these can impact the rights of instrument holders given underlying entity's projections for growth and regulatory capital adequacy requirement over the tenor of the instrument.

ADDITIONAL CONSIDERATIONS FOR SHORT-TERM INSTRUMENTS

ACRSL's approach to rating short-term debt instruments is similar to that used for long-term debt instruments. However, two factors are given more focus when rating short-term debt instruments, namely:

(i) Short-term liquidity position
(ii) Financial flexibility of issuer

Short-term Liquidity Position: When assessing short-term liquidity, ACRSL focuses mainly on the cash flow and working capital management of the issuer to assess repayment ability. In addition to this, an important factor is reviewing unutilized working capital lines of credit from financial institutions. This is essential for assessing the cushion available to an issuer to avoid a liquidity shortfall at the time of instrument maturity.

Financial Flexibility: Here, ACRSL looks at the alternative sources of liquidity available to an issuer, apart from the ones discussed above. While one aspect of financial flexibility is the issuer's capital structure (thoroughly assessed when analyzing issuer profile), alternative liquidity sources include support available from sponsor (in the form of a line of credit, or otherwise) and availability of unencumbered liquid investments and/or other liquid current assets.

Linkage between Short-term and Long-term: ACRSL focuses on the sustainable liquidity profile of an issuer. Herein, long-term credit quality plays a key role, thus creating a linkage between short-term and long-term ratings. This is due to two main reasons. Firstly, an entity with higher long-term credit quality has a stronger ability to refinance, and/or gain access to other sources of funding. Secondly, many short-term instruments tend to get rolled over and, therefore, call for a longer-term rating view. Thus, long-term ratings cannot be disregarded when assigning short-term ratings.

SURVEILLANCE

Once a debt instrument is issued, ACRSL provides an independent research report for investors by monitoring and reporting on its performance. In this regard, relationship with trustee of each instrument is established. Each profit and principal payment is confirmed from the trustee. The surveillance frequency depends on payment terms and frequency of payments. However, a formal review is undertaken once in every year.

The rating process is ultimately an assessment of the fundamentals and the probabilities of change in the fundamentals. Rating determination is a matter of experienced and holistic judgment, based on the relevant quantitative and qualitative factors affecting the credit quality of the issuer.

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