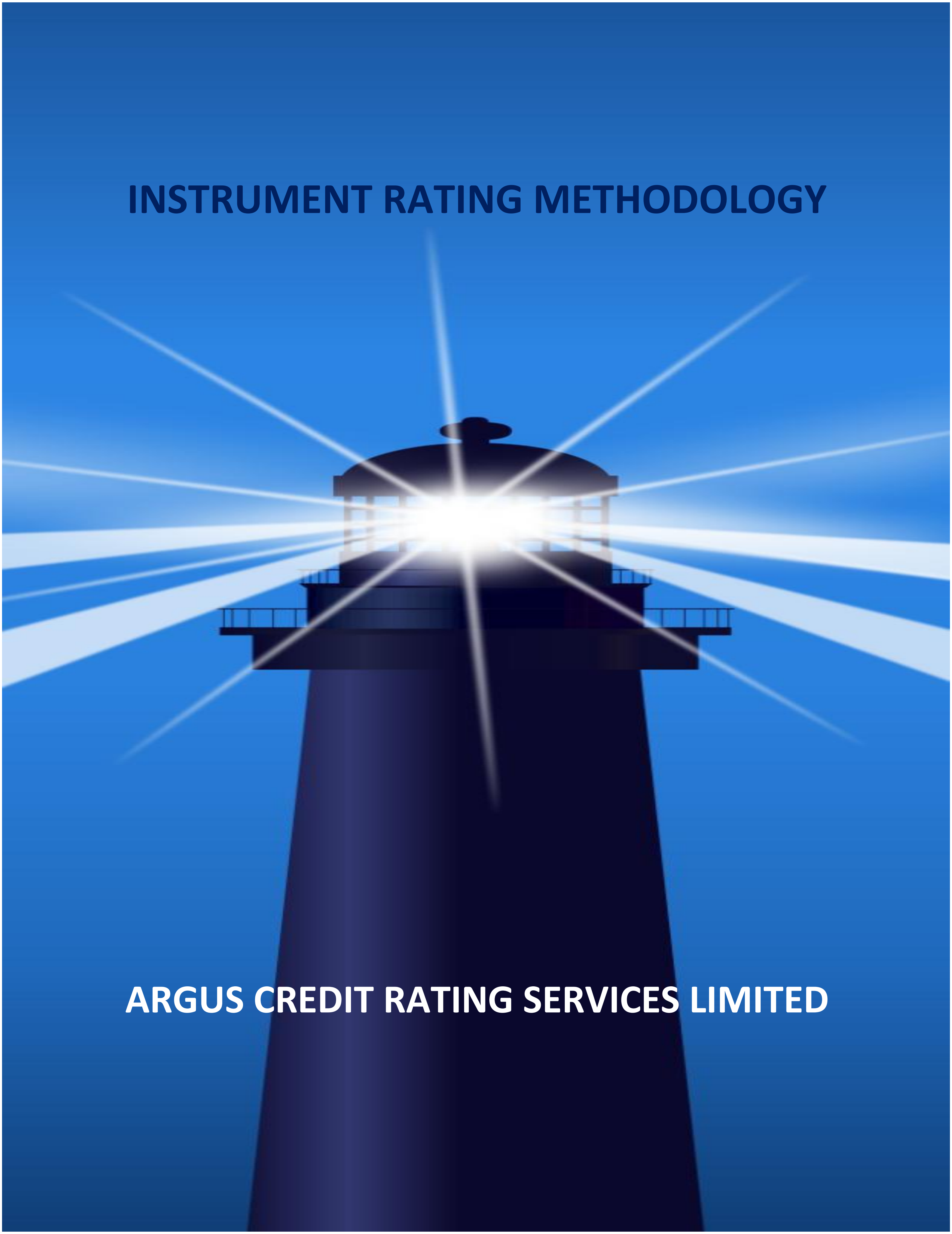
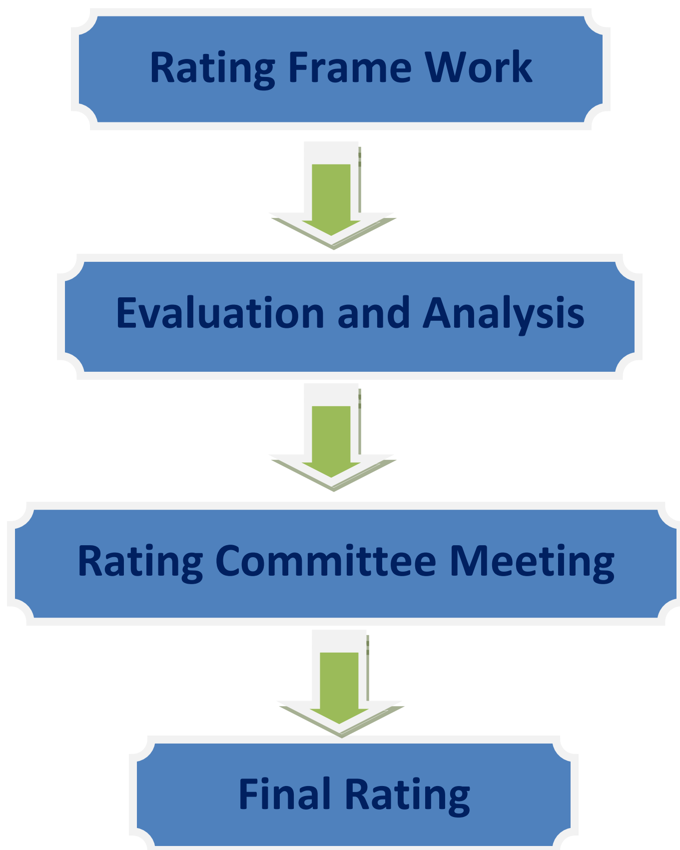
INSTRUMENT RATING METHODOLOGY



ARGUS CREDIT RATING SERVICES LIMITED

RATING PROCESS FLOW



ACRSL's 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. 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 higher or lower than the issuer's rating.

Basic Principal for Instrument Rating

Issuer Rating
(Methodology : Entity Rating)

Qualitative Factors:

- Terms & Conditions
- Legal Documentation
- Supervisory Conditions
  - Regulatory aspect
  - Trustee
- Collateral Coverage
- Guarantor
- Management Risk
  - Corporate Governance
- Market Risk
  - Product Life Cycle
  - Completion Risk
- Industry Risk
- Strategic Risk
  - Technology Risk

Rating Notch

Quantitative Factors:

- Length of Repayment
- Cost of Capital
- Return to Risk
- Risk Factors
  - Financial Risk
    - Asset Risk
    - Liquidity
    - Accounting Quality
    - Ratio Analysis
  - Business Risk
  - Operational Risk
  - Capital Structure
  - Earnings Quality

Issue Rating
(Methodology : Issue Rating)

1. Introduction

1.1 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.

1.2 Key Types of Debt Instruments : Key types of debt instruments can be differentiated 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 & methodologies to cater to the distinct features of structured debt instruments, and Basel III Compliant debt instruments.

2. Rating Debt Instrument

2.1 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.

2.2 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 "higher" or "lower" compared to its corresponding issuer rating.

2.3 Issuer Profile: 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. Broadly, the rating criteria applied is as follows:

3. QUALITATIVE FACTORS

Some of the qualitative factors that are deemed critical in the rating process are:

3.1 Regulatory aspect

Instruments are usually a direct unsecured obligation of the issuer and thus the level of regulatory support the issuer receives has an effect on its stability. Moreover, regulatory support in terms of a provider of liquidity of last resort also plays a role in evaluating the credit quality of the obligation.

ACRSL is mindful that issuances may come from segments where the regulatory framework is still evolving. In this case, ACRSL would look at mechanisms that may be able to afford cash flow stability to the investor, irrespective of the regulatory framework. As these instruments are new to the market, the regulatory view on instruments is still in the early stage of development. Further developments in this area could form a very important part of the analysis. ACRSL will monitor regulatory developments and assess the impact on the rating accordingly.

3.2 Ownership

An assessment of ownership pattern and shareholder support in a crisis is significant. In case of issuers, the willingness of the government to support the issues is an important consideration.

3.3 Management quality

The composition of the board, frequency of change of CEO and the organizational structure of the issuer are considered. The issuer's strategic objectives and initiatives in the context of resources available, its ability to identify opportunities and track record in managing stress situations are taken as indicators of managerial competence. The adequacy of the information systems used by the management is evaluated in terms of quality and timeliness of the information made available to issuers. The extent of frauds committed in the bank is taken as an indication of the imperfections of the control systems. ACRSL focuses on the modern banking practices and systems, degree of computerization, capabilities of senior management, personnel policies and extent of delegation of powers. The track record of labour relations is also examined.

3.4 Management Risk

The management stance on risk and the risk management framework is examined. Credit risk management is evaluated by examining the appraisal, monitoring and recovery systems and the prudential lending norms of the issuer. The issuer's balance sheet is examined from the perspective of interest rate sensitivity and foreign exchange rate risk. Interest rate risk arises due to differing maturity of assets and liabilities and mismatch between the floating and fixed rate assets and liabilities. ACRSL also assesses the extent to which the issuer has assets denominated in one currency with liabilities denominated in another currency.

3.5 Management Evaluation

Management evaluation is one of the most important factors supporting an entity’s credit standing. An assessment of the management’s plan in comparison to those of their industry peers can provide important insights into the entity’s ability to sustain its business. Capability of the management to perform under stress provides an added level of comfort. Meetings with the top management of the entity are an essential part of ACRSL’s rating process. Some key dimensions of management evaluation are:

Track record

The track record of the management team is a good indicator for evaluating the performance of the management. Management’s response to key issues/events in the past like liquidity problems, competitive pressures, new project implementation, expansions and diversifications, etc. are assessed.

Corporate Strategy

The entity’s business plans, mission, policies and future strategies in relation to the general industry scenario are assessed. An important factor in management evaluation is assessment of the management’s ability to look into the future and its strategies and policies to tackle emerging challenges, in addition to succession planning.

Performance of group concerns

Interests and capabilities of the group concerns belonging to the same management give important insights into the management’s capabilities and performance in general.

Organizational structure

Assessment of the organizational structure would indicate the adequacy of the same in relation to the size of the entity and also give an insight on the levels of authority and extent of its delegation to lower levels in the organization. The extent to which the current organizational structure is attuned to management strategy is assessed carefully.

Control systems:

Adequacy of the internal control systems to the size of business is closely examined. Existence of proper accounting records and control systems adds credence to the accounting numbers. Management information systems commensurate with the size and nature of business enable the management to stay tuned to the current business environment and take timely, judicious decisions.

Personnel policies

Personnel policies laid down by the entity would critically determine its ability to attract and retain human resources. Incidence of labour strikes/unrest, attrition rates etc., are seen in perspective of nature of business and relative importance of human capital.

Corporate governance

Extent of transparency in the entity's dealings with various stakeholders, financial prudence and compliance with extant laws and regulations is seen closely.

3.6 Economy and Industry Risk

ACRSL's analysis of industry risk focuses on the prospects of the industry and the competitive factors affecting the industry. The economic/industry environment is assessed to determine the degree of operating risk faced by the entity in a given business. Investment plans of the major players in the industry, demand-supply factors, price trends, changes in technology, international/domestic competitive factors in the industry, entry barriers, capital intensity, business cycles etc. are key ingredients of industry risk. ACRSL also takes into account the economy-wide factors which have a bearing on the industry under consideration. The strategic nature of the industry in the prevailing policy environment, regulatory oversight governing industries etc., is also analyzed.

The rating process is ultimately a search for the fundamentals and the probabilities for change in the fundamentals. The assessment of management quality, the issuer's operating environment and its role in the nation's financial system are used to interpret current data and to forecast how well the issue is positioned in the future. The final rating decision is made by the Rating Committee after a thorough analysis of the bank's position over the term of the instrument with regard to business fundamentals.

4. QUANTITATIVE FACTORS

The starting point in reaching a rating decision is a detailed review of key measures of financial performance and stability:

4.1. Business Risk

Against the backdrop of economy and industry risk, ACRSL assesses the entity's position within the industry. Some of the key parameters used to assess business risk are discussed below:

Diversification

For the issues that operate in several industries, each major business segment is analyzed separately. The contribution of each business segment to the entity's overall profitability is assessed. While diversification results in better sustainability in cash flows, ACRSL also analyses the suitability and adequacy of management structure in such scenarios and forward and backward linkages present.

Seasonality and Cyclicality

Some industries are cyclical in nature with their performance varying through the economic cycle. Moreover, certain industries are seen to exhibit seasonality. ACRSL's ratings aim to be stable across seasons and economic cycles and are arrived at after deliberating on the long-term fundamentals.

Size

Small size presents a significant hurdle in getting higher ratings commensurate with an entity's financials. Presence in selected market segments, limited access to funds leading to lack of financial flexibility etc., result in lower protection of margins when faced with adverse developments in business areas. Large firms, on the other hand, tend to have higher sustaining power, even during troubled times.

Cost structure

The cost factors and efficiency parameters of the existing operations are assessed with respect to expenditure levels required to maintain its existing operating efficiencies as well as to improve its efficiency parameters in a competitive scenario. Nature of technology may also influence the cost structure.

Market share

An entity's current market share and the trends in market share in the past are important indicators of the competitive strengths of the entity. A sustained leadership position leads to ability to generate cash over the long term. A market leader generally has financial resources to meet competitive pricing challenges.

4.2. Financial Risk

Financial risk analysis involves evaluation of past and expected future financial performance with emphasis on assessment of adequacy of cash flows towards debt servicing.

ACRSL's analysis is mainly based on audited accounts of the entity although unaudited accounts are noted. A review of accounting quality and adherence to prudential accounting norms (if any, set by local regulations) are examined for measuring the entity's performance. Accounting policies relating to depreciation, inventory valuation, income recognition, valuation of investments, provisioning/write off etc. are given special attention. Prudent disclosures of material events affecting the entity are reviewed. Impact of the auditors' qualifications and comments are quantified to the extent possible and analytical adjustments are made to the accounts, if material. The rating team meets the auditors to understand their comfort level with the accounting policies, systems and controls within the entity and his assessment of the management of the entity.

Off-balance sheet items are factored into the financial analysis and adjustments made to the accounts, wherever necessary. Change of accounting policy in a particular year which results in improved reported performance is analyzed more closely.

4.3. Financial ratios

Financial ratios are used to make a holistic assessment of financial performance of the entity, as also to see the entity's performance with its peers within the industry. They are not an 'end' in itself but a 'means' to understanding the fundamentals of an entity. ACRSL follows a standard set of ratios for evaluating manufacturing companies. These can be divided into five categories:

- Growth ratios
- Profitability ratios
- Leverage and Coverage ratios
- Turnover Ratios
- Liquidity Ratios

4.4. Liquidity Risk

Future debt obligations are required to be met by cash and hence only a thorough analysis of cash flow statements would reveal the level of debt servicing capability of an entity. Cash flow analysis forms an important part of credit rating decisions. Availability of internally generated cash for servicing debt is a more comforting factor in a credit perspective as compared to dependence on external sources of cash to cover temporary shortfalls. Cash flow adequacy is viewed by the capability of an entity to finance normal capital expenditure, as well as its ability to manage capital expenditure programmes as per envisaged plans apart from meeting debt servicing requirements.

4.5. Financial flexibility

Financial flexibility refers to alternative sources of liquidity available to the entity as and when required. The entity's contingency plans under various stress scenarios are considered and examined. Ability to access capital markets and other sources of funds whenever required is reviewed. Existence of liquid investments, availability of support (implied or demonstrated) from strong group concerns to tide over stress situations, ability to sell idle assets quickly, deferment of capital expenditure etc. are favourably considered.

4.6. Validation of projections and sensitivity analysis

The projected performance of the entity over the life of the instrument is critically examined and assumptions underlying the projections are validated. The critical parameters affecting the industry and the anticipated performance of the industry are identified. Each critical parameter is then stress-tested to arrive at the performance of the entity in a stress situation. Debt service coverage for each of the scenarios would indicate the capability of the entity to service its debt, under each scenario.

4.7. Accounting Quality

Rating relies heavily on audited data. Policies for income recognition, provisioning and valuation of investments are examined. Suitable adjustments to reported figures are made for consistency of evaluation and meaningful interpretation.

4.8. Asset Risk

Asset Quality review begins with the examination of the bank's credit risk management framework. The overall asset quality is assessed by evaluating the sector by sector loan and guarantee exposures. The bank's experience of loan losses and write off/provisions are studied carefully. The percentage of assets classified into standard, substandard, doubtful or loss and the track record of recoveries of the bank is examined closely. The portfolio diversification and exposure to troubled industries/areas is evaluated to arrive at the level of weak assets. Restructured assets in banks total exposure are also taken into account to arrive at the potential NPAs of the bank.

4.9. Earnings Quality

ACRSL analyzes the composition of income of the bank by segregating it into those generated from fee based and fund based activities. Core earnings are also identified by excluding non-recurring income from total income. Each business area that contributes to the core earnings is assessed for risks as well as for its earning prospects and growth rate.

Profitable operations are essential for banks to operate as an ongoing concern. Yield on business assets as also on investments are viewed in conjunction with cost of funds to arrive at the spreads earned by the bank. Operating efficiency is also examined in terms of expense ratios. 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.

Finally, the overall profitability is reviewed in terms of return on assets and return on shareholders funds.

Evaluation of quantitative factors is done, not only of the absolute numbers and ratios, but their volatility and trends as well. The attempt is to determine core, recurring measures of performance. ACRSL also compares the issuer's performance on each of the above discussed parameters with its peers.

5. 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	+1
Unsecured Instrument	0
Subordinated Instrument	-1, -2

5.1 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).

5.2 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.

5.3 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.

5.4 **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.

5.5 **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.

5.6 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. Bank Rating Methodology, Microfinance Institutions Rating Methodology, Corporate Rating Methodology, etc.) 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.

6. Additional Considerations for Short-term Instruments

6.1 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.

6.2 **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.

6.3 **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.

6.4 **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.

7. Surveillance

7.1 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.

[Last updated on February 2021, Next review due in January-June 2022]