Ratings Methodology – Banks

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CareEdge RATINGS AFRICA
A subsidiary of CARE Ratings Limited, India

Background

Banking sector is highly dependent on the overall economic environment prevailing in the country and has high correlation with the growth in the economy. In Mauritius, banks continue to dominate the financial services space thereby constituting a critical part of the economy. As a result of their importance to the overall economy and financial markets, Mauritius banks continue to be highly regulated by the Bank of Mauritius (BOM).

CareEdge Africa (CRAF) ratings on the banks are an opinion on the relative ability and willingness of these banks to make timely payments on the specific debt obligations over the life of the instrument.

The key factors considered by CRAF while rating debt instruments of banks are described below.

QUANTITATIVE FACTORS

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

A) Capital Adequacy

Capital Adequacy is a measure of the degree to which a bank's capital is available to absorb possible losses. It also indicates the ability of the bank to undertake additional business. Maintaining capital adequacy ratio above the prescribed regulatory threshold is critical for a bank as breaching of such benchmarks may lead to regulatory action, whereby restrictions are put on lending as well as operations of a bank.

CRAF examines the conformity of the bank to the regulatory guidelines on capital adequacy ratio and the available capital cushion over and above the minimum regulatory requirement that a bank maintains. A higher proportion of Tier I capital (i.e., core capital) in the overall capital is viewed favourably. Furthermore, CRAF analyses capital raising track record of an individual bank which indicates the financial flexibility of the bank.

CRAF also works out the 'stressed capital adequacy' on the basis of expected erosion of capital arising as a result of factors such as:

- Additional provisioning for NPAs
- Possible losses from restructured assets
- Possible losses from other weak assets

B) Asset Quality

Asset quality of a bank relates to the recovery along with the risk priced return that a bank can generate from the loans and investments it has done. While analysing the asset quality of a bank, the bank's experience of loan losses and write off/provisions and percentage of assets classified into standard, substandard, doubtful or loss and the track record of recoveries of the bank are examined closely.

A large quantum of assets which are non-performing entails higher credit costs as well as reversal of interest earned on NPAs which impacts the profitability of the bank.

The overall asset quality is assessed by the proportion of NPAs that a bank has vis-à-vis its advances and the internal accrual. Further, the net worth cover that it has to absorb losses from these NPAs is also examined. The portfolio diversification, level of concentration to certain groups / individual borrowers and exposure to troubled industries/areas is evaluated to arrive at the level of weak assets.

Additionally, sector-wise exposures of the bank are evaluated to assess existing and potential level of stress. An analysis of the restructured assets as well as quantum of identified weak assets in the bank's total exposure are also taken into account to arrive at the potential NPAs of the bank.

While assessing the asset quality of a bank, CRAF also examines the bank's credit risk management framework.

C) Resources

Deposits is a major resource for banks, and raising deposits at competitive cost is the core of banking business. A bank's resource base is analysed in terms of cost and composition while rating a bank. Apart from deposits, the banks have access to raise funds from multilateral agencies (domestic as well as international) which provide refinance to banks. However, deposit raising / funding remains core to the functioning of a bank.

CRAF studies the franchise built by the bank over the years which helps a bank garner deposits as well as granularity of the depositor base. The proportion of low-cost deposits in total deposits and retail / wholesale deposit mix is examined. Deposit growth rates and their rollover rates which indicate stability of the funding profile of a bank are also analysed.

The average as well as incremental cost of funds is examined in the context of prevailing interest rate regime. The ability of the bank to raise additional resources at competitive rates as well as its dependence or concentration in depositors is examined critically.

D) Liquidity

Lack of liquidity can lead to a bank's failure, while strong liquidity can help even an otherwise weak institution to remain adequately funded during difficult times. CRAF evaluates the internal and external sources of funds to meet the bank's requirements.

The liquidity risk is evaluated by examining the assets liabilities maturity (ALM) profile, deposit renewal rates, proportion of liquid assets to total assets and the liquidity coverage ratio (LCR). The short-term external funding sources in the form of refinance facilities from BOM and the inter-bank borrowing limits available along with sources of reserve liquidity.

E) Earnings Quality

CRAF analyses the composition of income of a bank by segregating it into those generated from fund-based activities and fee-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.

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 the bank's earnings is also influenced by the level of interest rate and foreign exchange rate risks that the bank is exposed to.

A bank may be profitable operationally, however, deterioration in asset quality requires higher credit cost in terms of provisioning requirement and write-off of bad debts which could severely impact the overall profitability of a bank. A trend in the impact of credit costs on the profitability in terms of return on assets and return to shareholders' funds is analysed.

Evaluation of quantitative factors is done, not only of the absolute numbers and ratios, but their trends and volatility as well. The attempt is to determine core, recurring measures of performance. CRAF also compares the bank's performance on each of the above discussed parameters with its peers. A detailed inter-bank analysis is done to determine the relative strengths and weaknesses of the bank.

QUALITATIVE FACTORS

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

a. Ownership

An assessment of ownership pattern and shareholder support in a crisis scenario is critical. In case of public sector banks, the stated intent and willingness of the government to provide capital support is an important consideration along with a demonstrated track record.

b. Management Quality

Quality of management is an intangible yet a very important factor while evaluating a bank. While analysing management quality and governance, the composition of the board, frequency of change in the top management team and the organisational structure of the bank are considered. The bank'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 management's approach towards risk is gauged by understanding their stance in terms of product segments /sectors the bank intends to target and the rate at which it intends to grow such segments.

The adequacy of the information systems used by the management is evaluated in terms of quality and timeliness of the information made available to bank managers. The extent of frauds committed in the bank is taken as an indication of the imperfections of the control systems.

CRAF focuses on the modern banking practices and systems, degree of digitalisation, capabilities of senior management, personnel policies and extent of delegation of powers. The track record of labour relations is also examined.

c. Risk Management

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 bank.

The bank'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. CRAF also assesses the extent to which the bank has assets denominated in one currency with liabilities denominated in another currency. The derivatives and other risk management products used by the bank are examined. Banks are subject to supervision by the BOM and are required to disclose divergence in asset classification and provisioning if the incremental provision required as assessed by BOM exceeds 15% of published net profit for the year and / or additional Gross NPAs assessed by the BOM exceed 15% of the published computation for the year. High amount of divergences and its impact on the financials of the bank is considered.

d. Compliance with statutory requirements

CRAF examines the track record of the bank in complying with Liquidity Coverage Ratios and priority sector lending norms as specified by the BOM as disclosed by the bank.

e. Accounting Quality

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

f. Size and Market Presence

The established franchise of a bank provides it with a deposit base and reach through its branch network and can have a bearing on the bank’s competitive position. Large banks with established franchise tend to gain competitive advantage in terms of access to a stable base of low-cost funds and greater geographical reach, whereas small banks typically would either be geographically restricted or would have challenges in ramping up their deposit base necessitating a different approach to its business model.

Various financial ratios considered while analysing banks can be found in the “Financial Ratios – Financial Sector” paper on CRAF website, viz., www.careratingsafrica.com

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 intention of long-term ratings is to look over a business cycle and not adjust ratings frequently for what appear to be short-term performance aberrations. The quality of the management and the competitiveness of the bank are of greater importance in long-term rating decisions.

The rating process is ultimately a search for the fundamentals and the probabilities for change in the fundamentals. The assessment of management quality, the bank's operating environment and its role in the nation's financial system are used to interpret current data and to forecast how well the bank is positioned in the future. The final rating decision hinges on thorough analysis of the bank's position over the term of the instrument with regard to business fundamentals. The rating determination is a matter of experience and holistic judgement of the Rating Committee, based on the relevant quantitative and qualitative factors affecting the credit quality of the issuer.

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About:

CareEdge is a knowledge-based analytical group that aims to provide superior insights based on technology, data analytics and CARE Ratings (Africa) Private Limited (CRAF) is the first credit rating agency to be licensed by the Financial Services Commission of Mauritius in May 2015. It is also recognized by Bank of Mauritius as External Credit Assessment Institution (ECAI) from May 2016. CRAF is also licensed by Capital Markets Authority of Kenya to operate as a Credit Rating Agency in Kenya. CRAF intends to expand across other geographies in Africa with Mauritius as its hub of operations. With an equitable position in the Mauritius capital market, CARE Ratings (Africa) Private Limited provides a wide array of credit rating services that help corporates to raise capital and enable investors to make informed decisions backed by knowledge and assessment provided by the company.

CRAF's shareholders are CARE Ratings Limited, African Development Bank, MCB Equity Fund and SBM (NFC) Holdings Limited.

CRAF gets its technical support in the areas such as rating systems and procedures, methodologies, etc. from CARE Ratings Limited on an ongoing basis. CARE Ratings Limited, with an established track record of rating companies over almost three decades, follows a robust and transparent rating process that leverages its domain and analytical expertise backed by the methodologies congruent with the international best practices.

CRAF's Rating Committee consist of full-time members comprising of Senior Rating officials from CARE Ratings Limited and a panel of experienced professionals from Mauritius and African Development Bank.

CRAF has had a pivotal role to play in developing bank debt and capital market instruments including MMIs, corporate bonds and structured credit.