ICRA LANKA RATING METHODOLOGY FOR BANKS

This rating methodology updates and supersedes ICRA Lanka's earlier rating methodology note of March 2012 on banks and also takes into consideration the new regulatory requirements that have been brought in by the Central Bank of Sri Lanka.

ICRA Lanka's rating is an opinion on the credit risk of a bank, which in turn, is a function of its exposure to business and financial risks as well as the likelihood of it receiving extraordinary financial support from the parent (or an affiliate) in case of distress. The broad list of rating factors that ICRA Lanka assesses while analysing banks is covered in this methodology note. While these do not necessarily represent an exhaustive set of factors that ICRA Lanka considers while assigning credit ratings, these are intended to provide an overall perspective to lenders, investors and other market participants on the rating considerations that are usually considered the most important. The key factors considered in the credit analysis are:

Business Risk Analysis

- Operating Environment
- Regulatory Environment
- Franchise
- Management, Governance, Information Systems and Strategy
- Risk Management
- Ownership Structure

Financial Risk Analysis

- Asset Quality
- Diversity of Funding and Liquidity
- Profitability, Earnings Stability and Prospects
- Capital Adequacy and Management

Business Risk Analysis

Operating Environment

The assessment of the operating environment is one of the most important parameters for the credit risk evaluation of a bank, as it could affect its growth, asset quality and earnings. The operating environment is a reflection of prevailing economic conditions, Gross Domestic Product (GDP) growth prospects, deposits and credit growth outlook as well as the legal environment.

Besides the above, the structure of the financial market, its stages of development and competitive intensity also form 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 unfavorable. ICRA Lanka's evaluation of the regulatory system involves evaluation of norms related to capital and other countercyclical measures to absorb risk and prevent related party transactions; the extent of regulatory supervision and changes in response to the macro environment; key norms (such as Non-Performing Asset (NPA) recognition, provisioning, capital adequacy, liquidity, benchmark lending rate, 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, quality of non-equity capital and better liquidity under Basel III.

Franchise

The franchise strength of a bank determines its capacity to grow while maintaining a reasonable cost to income ratio and profitability, thereby providing resilience of earnings. ICRA Lanka evaluates the franchise strength of a bank in terms of scale of operations and market share for various activities across the country or business niche; performance and strengths relative to competition; complexity of key segments; diversification across various performance metrics like branches, advances, liabilities, sources of other income etc. and access to special Government support or privileges relative to other banks. A strong franchise of the bank is expected to result in a granular asset and liability base. ICRA Lanka also considers the brand recognition, history and background of banks under its franchise strength analysis.

Management, Governance, Information Systems and Strategy

Quality of management and governance, information systems and the strategy followed to manage the stakeholders' expectations are evaluated on the following parameters:

Quality of management and governance:

- Size and constitution of the board of directors: A board consisting of qualified and independent members with effective oversight is a positive factor and is reflected in the operational and financial performance of the bank.
- Management depth and breadth: Presence of qualified and experienced professionals and track record of a stable top management.
- Established policies: Established policies on factors such as capital cushions vis-à-vis regulatory levels, stressed asset provisioning beyond regulatory minimum levels,

calibrated growth while maintaining liquidity and improving diversification are some positive attributes.

Information system and strategy:

Quality of disclosures: A well-established information system is a pre-requisite for adequate disclosures. Some of the positive attributes of quality information disclosures include timeliness, disclosures beyond the minimum regulatory requirements to improve transparency and consistency of such disclosures.

- Financial reporting and systems: A well-established information system also supports accuracy in financial reporting on a consistent basis and limited instances of regulatory non-compliances. High instances of regulatory non-compliances or divergence in financial reporting vis-à-vis regulatory audits reflect weakness in information systems and are negative attributes.
- Credit monitoring: A strong information system enables efficient monitoring of asset quality while generating early warning signals. Management's opinion on corrective action plans on potential stressed assets form a key part of the discussions by ICRA Lanka.
- Strategy: A well laid-out business plan with regular disclosures on strategy and progress on goal achievements are some positive attributes.

Risk Management

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

Credit risk: Discussion is held with management on quality of fresh exposures, performance of vulnerable accounts with corrective action plan and movements in concentration of exposures.

Market risk: Discussion is held with management on their interest rate outlook, the positioning of the investment portfolio as well as the sensitivity of the investment portfolio to interest rate risks and cushion available in the investment book to absorb losses because of adverse movements.

Operational risk: Instances of frauds and amount involved in such frauds and corrective actions to strengthen the system are discussed with management.

Ownership Structure

The Sri Lankan banking system consists of public sector banks (PSBs), private sector banks (PVBs), foreign banks, and other specialized banks. While ICRA Lanka draws comfort from the sovereign ownership of public sector banks, the ability of the banks to raise capital from promoters/other key shareholders, as and when required, is an important credit driver. ICRA Lanka views a public- sector bank favourably that has Government of Sri Lanka (GOSL) shareholding well in excess of 51%.

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 stress. Apart from balance sheet size, proxies for a bank's systemic importance could include share of business in the region of operation, participation in payment systems and scale of quasi-fiscal responsibilities (such as directed lending) carried out for the Government.

Financial Risk Analysis

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

Asset Quality

A bank's asset quality reflects 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 internal capital generation or in extreme situations (loss) could weaken the capital or impact a bank's ability to raise capital from external investors). Asset quality evaluation includes the loan book as well as the non-Statutory Liquidity (SLR) investment portfolio of a bank. Key aspects of asset quality evaluation are discussed below:

Credit underwriting: ICRA Lanka assesses the quality of a bank's credit appraisal process and lending/investment norms; the riskiness of its exposure mix; the availability of data to facilitate credit decision-making and its track record in managing its loan book through lifecycles. ICRA Lanka also assesses the quality of credit administration as reflected in the design and implementation of appraisal and loan pricing methodologies and adherence to periodic review.

Diversification of portfolio: 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 mix, geographical diversification, share of domestic and overseas exposure and borrower profiles. The bank's exposure to top borrowers and groups is analysed to gauge the extent of the bank's credit concentration. High levels of diversification can shield a bank from the impact of a downturn in any one segment/industry. 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. Some of the key measures of diversification/concentration are:

a) Share of top/top group exposures to total exposures

b) Share of top/top group exposures as a percentage of Common Equity Tier 1 (CET1) capital

c) Share of top industries as a percentage of total exposure

d) Share of top geographies as a percentage of total exposure

A comparison of the above parameters with the industry average provides an indication of potential asset quality issues. An analysis of the trend over the years helps in understanding the bank's strategy towards various sectors.

- **Secured vs unsecured:** The share of secured and unsecured exposure in the overall portfolio helps determine the provisioning levels and expected loss in case of defaults.
- **Rating wise distribution:** ICRA Lanka also studies the movement in distribution of exposure across various rating categories for corporate credit to estimate the asset quality trends in overall credit portfolio and likelihood of future asset quality stress.
- **Asset classification and provisioning:** Advances are classified into standard, standard restructured 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 incremental provisioning requirements (as per ageing of the portfolio in accordance with CBSL guidelines or based on ICRA Lanka's assessment of vulnerability of large exposures) versus provisions made by the bank. The purpose is to estimate further provisioning or recovery that eventually affects the bottom line and financial position of the bank.
- **Extent of divergence reported by the bank:** As per CBSL's guidelines, banks are required to make adjustments for capital computations, if the accounting provisioning under IFRS is less than provisioning under CBSL guidelines. A high level of divergence in asset classification and provisioning on a consistent basis weakens the reliability of reported financials.
- **Vulnerability analysis:** ICRA Lanka does a vulnerability analysis of the top exposures of the bank to arrive at the expected loss (EL) on credit portfolio based on the probability of defaults (PD) and loss given default (LGD). Standard advances are classified based on their external rating for computation of PD, while LGDs are based on expected losses in the underlying accounts in the event of default. This EL, along with the EL on other stressed assets, like NPAs, restructured assets and security receipts, are arrived at to estimate the overall vulnerability as a percentage of the credit portfolio for relative benchmarking across peers. The EL on the assets is also adjusted from the CET1 to estimate the adjusted CET1 for the bank. Capital cushion over and above the adjusted CET1 reflects the strength of the bank against unexpected loss and is considered a credit strength.
- **Growth rate of advances/exposure:** ICRA Lanka monitors growth in advances/exposure for the bank compared to the industry average and in relation to its base. Higher-than-industry growth is monitored closely to understand the quality of the incremental borrowers, the borrower segments and impact on granularity/concentration because of incremental lending. Higher growth while compromising the quality of the portfolio is perceived negatively.
- **Movement in risk weighted assets (RWAs):** RWAs are an outcome of credit exposure,

investment exposure and operational risks, with credit exposure forming a major portion of risk weighted assets. RWAs, in relation to advances/exposures, is analysed in relation to peers and reasons for sharp movements in RWAs in relation to advances/exposures are also analysed.

- **Performance on targeted segment lending:** Banks are required to lend a part of their advances to certain priority sectors as identified by the regulatory guidelines. These sectors include agriculture, small scale industries and the weaker sections of society. Ability of banks to meet these targets requires a trade-off between asset quality and profitability. The asset quality in these segments can be relatively weaker and, hence, if lending targets are achieved, the ability to also maintain good asset quality can be a challenge.
- **Performance of subsidiaries:** 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. While weak-performing subsidiaries may be a drag on a bank's financial position, well-performing subsidiaries or investments can provide a cushion to a bank's profitability in events of stress.

Key financial indicators for measuring asset quality of a bank are its fresh NPA generation rate, Gross NPA percentage, stressed advances percentage (Gross NPA percentage + standard restructured percentage + advances under regulatory forbearance schemes of RBI + security receipts), Net NPA percentage, provision coverage and Net NPAs in relation to net worth.

Diversity of Funding and Liquidity

ICRA Lanka analyses 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:

- **Deposit mix:** Of the deposits, current and savings accounts (CASA) are low cost and sticky in nature. Certificate of Deposits (CDs) and bulk deposits from corporate and institutional depositors are typically more volatile than retail and household deposits. A higher portion of retail deposits also lends stability to earnings as the cost of these tends to be less volatile than bulk deposits. In its rating process, ICRA Lanka views positively a higher proportion of retail deposits in the total mix. Further, the quality of the deposit base is measured by some of the following parameters and is benchmarked with peers:
    a) CASA growth and share of CASA in overall deposits
    b) Share of retail deposits in overall term deposits
    c) Share of bulk deposits/certificate of deposits in term deposits
    d) Top 20 depositors in overall deposits
- With deregulation in interest rates on savings accounts, some banks have been able to improve their CASA balances by offering higher interest rates on savings deposits. Such CASA deposits may exhibit relatively higher volatility in terms of flow compared to normal CASA deposits. Accordingly, CASA balances are analysed in relation to the deposit rates offered on these products.

- **Demographic classification of deposits (i.e. mix of rural, urban and metropolitan deposits):** Typically, rural deposits display lower fluctuation than urban and metropolitan deposits, thus reflecting the lower availability of investment options compared to the options available in urban and metropolitan areas.
- **Cost of interest bearing funds:** The cost of interest bearing funds is determined by the mix of deposits (current, savings and time deposits) and other borrowings of the bank. The tenure of deposits and the bank's market standing influences the interest rate structure that it offers on deposits and borrowings. Other factors include the bank's reliance on bulk deposits, money market funding (from call money markets, CDs, refinance lines and the like), and money market conditions prevalent and foreseen in future. Banks with overseas operations may have foreign currency deposits, which typically have differentiated cost compared to domestic deposits and the same is suitably adjusted to arrive at peer comparisons.
- **Payment services:** Despite the commencement of various payment services like digital wallets, payment banks etc, banks continue to have a near-monopoly in operating the payment systems, which provide banks with a stable and low-cost base of settlement balances. ICRA Lanka assesses the bank's ability to offer value-added payment services like bill payments, online transfer facility, investment facilities etc (often driven by technology), which hold the key to a bank retaining the benefits from these services.

A strong deposit base which is granular, stable and low-cost in nature is a reflection of the bank's deposit franchise and is an outcome of not only its branch network but also its customer service, level of trust with depositors, competitive pricing and brand image. A sustained effort on these fronts is critical to maintain this competitive advantage and also critical for long-term liquidity. ICRA Lanka attempts to capture the liquidity of a bank by analysing the following qualitative and quantitative parameters:

- **Bank's statement of structural liquidity:** ICRA Lanka studies the asset liability mismatch (ALM) statement of the bank and the associated assumptions in the ALM statement to analyse the overall match between the maturity profile of its assets and liabilities across various time frames, trends over the past few years and the comparison of the same with peers.
- Liquidity coverage ratio (LCR): Banks are required to maintain an LCR in accordance with the CBSL guidelines. The trends in a bank's LCR are analysed for comfort on the liquidity position.
- **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. 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 state owned banks, as the GOSL has demonstrated its support over the years by infusion of equity or directed measures to bail out banks.
- **Degree of the bank's reliance on volatile funds in relation to total assets:** Some short-

term funding sources like bulk deposits 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.

Profitability, 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. Adequate operating profitability of a bank helps in absorbing credit costs and other losses emanating from the various risks that a bank is exposed to. The bank’s historical performance is analysed for stability and quality of earnings. 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 future 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, loan mix and its overall strategy. ICRA Lanka also assesses the bank’s ability 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. However, sustainability of the income is an important parameter. Any one-off income like gain on sale of investments is, therefore, factored in our assessment. After assessing the operating 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, credit costs are estimated on the basis of the bank’s asset quality profile and management’s guidance on target provison cover against NPAs. The ability of the operating income to absorb credit losses is an important parameter. The trading income of the bank, which is typically volatile in nature, is evaluated to assess the sustained level of income/losses under an adverse interest rate scenario. The profitability indicators are 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.

Capital Adequacy and Management

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 focuses on the following aspects:

- **Conformance with regulatory capital requirement:** As per the Basel III guidelines, banks are required to achieve and maintain capitalisation ratios as mentioned below:

Table 1: Regulatory capital requirements under Basel III as % of risk weighted assets

<table>
<tr><th colspan="2" rowspan="2">Capital items</th><th colspan="3">Banking sector (direction issued on 29.12.2016)</th></tr>
<tr><th>Jul 2017</th><th>Jan 2018</th><th>Jan 2019</th></tr>
<tr><td colspan="2">Common Equity Tier I</td><td>4.50</td><td>4.50</td><td>4.50</td></tr>
<tr><td colspan="2">Additional Tier I</td><td>1.50</td><td>1.50</td><td>1.50</td></tr>
<tr><td colspan="2">Capital Conservation Buffer</td><td>1.25</td><td>1.875</td><td>2.50</td></tr>
<tr><td colspan="2">Capital Charge on Domestic Systemically Important Institutions (D-SII)</td><td>0.50</td><td>1.00</td><td>1.50</td></tr>
<tr><td rowspan="2">Minimum Tier I</td><td>Without D-SII</td><td>7.25</td><td>7.875</td><td>8.50</td></tr>
<tr><td>With D-SII</td><td>7.75</td><td>8.875</td><td>10.00</td></tr>
<tr><td rowspan="2">Minimum total capital ratio</td><td>Without D-SII</td><td>11.25</td><td>11.875</td><td>12.50</td></tr>
<tr><td>With D-SII</td><td>11.75</td><td>12.875</td><td>14.00</td></tr>
</table>

ICRA Lanka also assesses the capital cushion available on the regulatory requirement and the internal policy of the bank to maintain a cushion over and above the regulatory requirement.

- **Adequacy of capital and its sustainability:** Besides evaluating a bank's conformance to regulatory capital requirements, ICRA Lanka assesses the adequacy of capital in relation to its growth plans, its internal capital generation, its present and prospective asset quality, which may impact capitalisation, the bank's risk appetite and interest rate sensitivity of the balance sheet. Based on this, the bank's medium term capital requirement is computed. A stress analysis is done at various growth levels and internal capital generation.
- **Ability to raise capital:** The capitalisation of the bank can be enhanced by internal capital generation or by raising fresh equity capital or hybrid instruments. ICRA Lanka evaluates the internal capital generation capacity of the bank and the ability and leeway available to augment capital to support growth or withstand the stress. For public sector banks, capital support announced by the GOSL to the sector is an important aspect. Also, considering the Government shareholding is required to be at least 51%, ability of the bank to meet its capital requirements without any dependence on GOSL is analysed. For private banks, ability to meet the capital requirements from the markets is analysed. A bank can also look at other options such as divestment of non-core investments and reduction in risk weighted

assets to meet its capital requirements.

- **Quality of capital:** A higher percentage of core Tier I capital (more specifically common equity Tier I capital) is viewed more favourably, given its greater permanence, followed by hybrids and subordinated bonds. ICRA Lanka also analyses any hidden reserves (such as unrealised gains on investment book, revaluation reserves on fixed assets), which may help boost the capital.
- **Ability to raise additional tier I instruments:** Additional Tier 1 (AT1) instruments are debt capital instruments with loss absorption features and comprise Tier I capital for banks under Basel III regulations. Due to the loss absorption features of these instruments and the coupon payments restricted from either current year profits or reserves created through appropriation of profits, the bank's profitability, distributable reserves and capitalisation profile determines the attractiveness of AT1 bonds to investors. Weak performance on these parameters may constrain the bank's ability to raise AT1 bonds.
- **Solvency profile:** This is calculated as the extent of Net NPAs of the bank in relation to its net worth. It measures the capital coverage for the unprovided portion of the bank's NPAs.

Summing up

ICRA Lanka's credit ratings are a symbolic representation of its opinion on the relative credit risk associated with the entity and instruments being 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 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.

July 2018