Caribbean Information &
Credit Rating Services Limited

JUNE 2014

METHODOLOGY FOR BANKS & OTHER FINANCIAL INSTITUTIONS

The following rating methodology is the generalized version of the methodology that CariCRIS would use to analyse entities in the banking, non-banking finance and other financial services. The analysis of entities in specific sectors within the financial services spectrum will be based on slightly customized versions of this general methodology. The analysis of insurance companies will be based on a methodology designed specifically for that sector.

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The CariCRIS framework for analyzing banking and finance entities is an enhanced version of the traditional **CAMEL framework**. While the *CAMEL framework* comprises five (5) factors:

1. capital adequacy
2. asset origination ability
3. management quality
4. earnings
5. liquidity

The CariCRIS framework additionally incorporates the parameters of resource raising ability, risk management and operating efficiency.

An outline of the CariCRIS framework and the interplay among the parameters is represented below. It may be noted that the framework is designed to focus on the impact of each parameter on the assessed entity's ability to repay its debt obligations that is its creditworthiness.

A brief description of each assessment parameter follows:

Capital Adequacy

Capital exists to protect a financial intermediary from unforeseen consequences of past actions. These consequences are an inherent part of this business as it entails revenue generation by predicting borrower behaviour over a period of time. Thus, higher levels of capital provide greater protection against risk in the existing asset book. Moreover, regulatory capital requirements mean that capital levels also determine the ability of the rated entity to expand the asset book.

Asset origination ability

Financial assets are the revenue engine for any bank or finance entity. The strength of its business crucially depends on its ability to consistently generate assets that produce a positive return after expenses and write-offs. This, in turn, is a function of the strength of existing borrower relationships, the ability to offer the services that the market demands to build new relationships and the quality of operating skills like pre-lending credit appraisal, post-lending account monitoring and problem asset resolution techniques. Past performance of the asset book is often the most useful indicator of the business strength of the rated entity's lending business.

The inherent risk content of the asset book at a point in time is determined by its diversity across different asset segments - retail assets, corporate assets, government assets at one level and industry and customer concentrations at another level. The asset concentration levels are also an indicator of the risk propensity of the management.

Management Quality

This is perhaps the most important parameter in the analysis as it is a key determinant of all other parameters directly or indirectly. The *competence, risk propensity and strategy* of the incumbent management of any financial services entity have a profound impact on every aspect of its operations and consequently its credit quality.

Management competence directly determines the rated entity's skills with respect to consistently originating quality assets as well as raising adequate resources at an optimum cost. Management competence also determines the level of sophistication of the entity's operations in general and the use of information technology tools, in particular. This can have a profound impact on the efficiency of resource mobilization and asset deployment as indeed the efficacy of the risk management systems. Risk management systems and the risk content inherent in the entity's operations are also a function of the risk appetite of its management.

Earnings

Earnings are the end result of the rated entity's success in its core business of financial intermediation. Earnings are directly impacted by operational efficiencies and the skills of asset origination and deposit mobilization. Though revenue profile diversity determines its stability, in general, a distinction is made between relatively stable income streams like fee income vis-à-vis more volatile income streams like trading income. The level and stability of earnings in relation to the asset book is a crucial determinant of future capital adequacy.

Liquidity

The relative differences between the maturities of assets and liabilities are the primary determinants of liquidity cushion available to the rated entity to meet its need of funds. Other sources of liquidity in a contingency include access to capital or borrowed funds at a short notice.

Other factors such as likelihood of system support or support from group companies are factored into the rating on a case-by-case basis.

Resource raising ability

Access to stable and low cost resources (deposits, borrowings etc.) in adequate quantities is another crucial pillar of the financial intermediary business model. This factor not only impacts the availability of money to continue the lending cycle but also the ability to lend at rates that are low enough to attract the targeted borrower profile.

The ability to attract deposit resources is a function of depositor perceptions regarding deposit safety and the ability of the bank to offer the services that borrowers want. The ability to offer depositor services increasingly depends on the level of sophistication of the rated entity's information technology infrastructure. The ability to access non-deposit resources depends on the entity's acceptability in the capital markets.

Future stability of the resource profile is often determined by the proportion of retail deposits in the rated entity's resource mix as these tend to be less vulnerable to volatility over the short to medium term.

Operating efficiency

Operating efficiency refers to those internal factors that enable the rated entity to increase the gap between cost of liabilities and the returns from assets. These primarily include the use of information technology to reduce the cost of operations and enhance level of services to depositors and borrowers so that they are more willing to do business with the rated entity. Strong operating efficiency has a direct impact on earnings.

Risk Management

Risk management refers to the use of proactive techniques and frameworks to ensure that, on an aggregate basis, present actions do not have unacceptable future consequences. Key areas for risk management include market risk, credit risk and operations risk. Modern risk management techniques demand significant use of information technology and when effectively deployed can minimize the possibility of future capital shocks. Moreover, in view of the increasing globalization of financial markets, having a risk management system that is compatible with the requirements of the global financial architecture is key to any entity's ability to conduct its international business.

Related Research

(to be inserted if necessary)