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Banking Regulation and Policy Department

Bangladesh Bank
Head Office
Dhaka

BRPD Circular No- 01

Date: January 01, 2014 / Paush 18, 1420

Chief Executives
All Scheduled Banks in Bangladesh

Dear Sir,

Amendment of Guidelines on Risk Based Capital Adequacy (RBCA).

(Revised Regulatory Capital Framework for banks in Line with Basel II)

Please refer to BRPD Circular No. 35 dated December 29, 2010 regarding the issuance of Guidelines on Risk Based Capital Adequacy (RBCA) for banks.

As per RBCA guidelines, the capital requirement for credit risk is based on the risk assessment made by External Credit Assessment Institutions (ECAIs) recognized by BB for capital adequacy purposes. Banks are required to assign risk weights to all their on-balance sheet and off-balance sheet exposures. Risk weights are based on external credit rating which will be mapped with the BB rating grade or a fixed weight that is specified by BB.

Recently BB has given recognition to 'The Bangladesh Rating Agency Limited' (BDRAL), a new rating Agency only for rating the Small and Medium Enterprises (SMEs). The credit risk assessment in this segment requires a specific approach, as the factors affecting the creditworthiness differ from those compared to large corporate entities and other institutions. Hence, BB has developed a '**Credit Rating Methodology for Small and Medium Enterprises'** (Annexure-1) which will ensure uniformity, larger levels of transparency of external credit assessment and thereby determine the relative creditworthiness of entities belonging to this segment and thus establish credit discipline in the banking industry. In this manner, BB has launched SME ratings for banks in Bangladesh.

For the aforesaid purpose, the following amendments have been made to the guidelines on RBCA, December 2010:

1. A new Para 2.2.9.1 will be added for definition of Claims on SME above 2.2.10 and after 2.2.9 in the chapter 2 of the RBCA Guidelines. Consequently, Para no. 2.2.9, 2.2.10 and 2.3.1 will be rephrased as follows for incorporating the said inclusion:

2.2.9. Claims on corporate: Loans and advances to and investments (excluding equity exposure) in corporate. "Corporate" refers to any proprietorship, partnership or limited company that is neither PSE, bank, NBFI nor borrower within the definition of retail portfolio.

Para 2.2.9.1. Claims on Small and Medium Enterprises (SMEs): Small and Medium Enterprises (SMEs) will be defined in line with the Industrial policy 2010 and Bangladesh Bank's SME & SPD circular no.1 dated 19th June, 2011 or any changes thereof made from time to time.

Exposure limit: Any exposure will fall under this category but the risk weight of 75% will be applicable in case of unrated small enterprise Clients having the exposure limit of BDT 10,000 to BDT 30,00,000 and 100% for exposure of BDT 30,00,000 and above. Any exposure against Medium Enterprise may be considered for Credit rating and risk weight of 100% will be assigned against unrated Medium Enterprise clients.

Para 2.2.10. Claims categorized as retail portfolio: Claims (including both fund and non-fund based) that meet all the four criteria listed below may be considered as retail claims for regulatory capital purposes and included in a regulatory retail portfolio.

Qualifying criteria

Orientation criterion: The exposure to an individual person or persons.

Product criterion: The exposure takes the form of any of the following product types:

a) Revolving credit and lines of credit (including overdrafts)

b) Term loans and leases (e.g. installment loans, vehicle loans for manufacturing /production and leases, student and educational loans, micro business facilities and commitments).

The following claims, both fund and non fund based, will be excluded from retail portfolios:

a) Exposures by way of investments in securities (such as bonds and equities), whether listed or not;

b) Mortgage loans to the extent that they qualify for treatment as claims secured by residential property (section 2.2.12) or claims secured by commercial real estate (section 2.2.13);

c) Loans and advances to bank's own staff which are fully covered by superannuation benefits and / or mortgage of flat/ house;

d) Consumer finance;

e) Capital market exposures; and

f) Venture capital funds.

Granularity criterion: Exposures under this category must be sufficiently diversified to a degree that reduces the risks. In order to meet this criterion, aggregate exposure without considering Credit Risk Mitigation (CRM), to one counterpart should not exceed 0.2% of the overall exposures under this category excluding past due loans. 'To one counterpart' means one or several entities that may be considered as a single beneficiary

Exposure limit: The maximum aggregate exposure to a person(s) or entity (ies) will be limited to BDT 1.00 (One) crore.

Para 2.3.1 External Credit Rating Agency:

Bangladesh Bank has recognized eight credit rating agencies i. e. Credit Rating Agency of Bangladesh (CRAB) Ltd., Credit Rating Information and Services Limited (CRISL), National Credit Ratings Ltd. (NCRL), Emerging Credit Rating Ltd. (ECRL), ARGUS Credit Rating Services Limited (ACRSL), Alpha Credit Rating Limited (ACRL), WASO Credit Rating Company (BD) Limited and The Bangladesh Rating Agency Limited (BDRAL) which met the eligibility criteria of ECAIs guidelines (BRPD Circular no. 35/2010) of BB.

BB has also decided that banks may use the ratings (if available) of the following international credit rating agencies for the purposes of risk weighting their exposure at abroad:

a) Fitch,
b) Moody's, and
c) Standard & Poor.

2. The Table 1 of the RBCA Guidelines regarding ‘ECAI’s Credit Rating Categories Mapped with BB Rating Grade’ will be replaced for incorporating the mapping of 07 rating agencies (Annexure -2) and a separate Table (Table:1.1) will be added including mapping of SME rating scales with BB’s SME rating grades. (Annexure -3)

3. The Following table will be inserted as SL. No. h (1) between Sl. No. h and Sl. No.- i in the Table: 2: Risk Weight for Balance Sheet Exposure and in the reporting format at chapter -8, working sheet 1 and 2 accordingly.

SL. No.	Exposure Type	BB Rating Grade	Risk Weight (%)
h (1)	Claims on SME	SME 1	20
		SME 2	40
		SME 3	60
		SME 4	80
		SME 5	120
		SME 6	150
		Unrated (small enterprise & <BDT 3.00m)	75%
		Unrated (small enterprise having ≥ BDT 3.00m & Medium enterprise)	100%

However, the SME rating may not be treated as mandatory.

Please acknowledge receipt.

Yours Sincerely,

SD/-

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General Manager
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Enclosure: 9(nine) pages.

Annexure-1

2013

Credit Rating Methodology

For Small and Medium Enterprise (SME)

Banking Regulation and Policy Department
Basel II Implementation Cell

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Background:

As a move towards facilitating development of Small & Medium Enterprises (SMEs) in the country and encourage larger levels of transparency and credit discipline, BB proposes to launch SME Ratings in Bangladesh. The credit risk assessment in this segment requires a specific approach, as the factors affecting the creditworthiness differ from those compared to large corporate entities. Hence, to further support the growth for this sector and help the investors to determine the relative creditworthiness of entities belonging to this segment, SME Ratings will play a helping hand.

Concepts and Definition of SMEs

The Industrial policy 2010 and accordingly Bangladesh Bank's SME & SPD circular no.1 dated 19th June, 2011 defines small and medium enterprises in terms of the value of fixed assets with replacement cost excluding land and building or in terms the number persons employed as under-

Category	Industry Type	Value of Fixed Assets (Tk.)	Number of Persons Employed
Medium	Manufacturing	>1000 lacs -3000 lacs	100-250
	Service/ Trading	100-1500 Lacs	50-100
Small	Manufacturing	50 -1000 lacs	25-99
	Service/ Trading	5-100 Lacs	10-25

Objectives of SME rating

Banks and financial institutions are migrating from an individual's opinion based credit review process toward a systematic and scientific process with an emphasis on objective inputs. The main reason for this shift is the need for faster, more accurate, uniform and timely credit decisions. This can only be possible when highly productive and easy to use tools are provided to them to help them in their decision-making. There was a need to enhance the existing credit assessment system with additional features:

a. Comply with Standardized approach of Basel II requirements
b. Creation of risk rating system
c. Help to automate Credit Origination, credit approval process, risk administration and monitoring functions and management of Non Performing assets
d. Help to provide data feeds for management reporting.

RATING METHODOLOGY

Both quantitative and qualitative factors should be considered in assessing the SME operation. The methodology is comprehensive where assessment area concentrates five broad categories– Financial Risk, Business/Industry Risk, Management Risk, Bank Relationship Risk, Financial Security Risk and others. Although, the above concentration areas are in line with corporate rating methodology, the relative weightage for different parameters may differ in between the two sectors. The financial position (i.e. Balance Sheet and Income Statement) and Cash flow Statement may be collected as per accounting Standard provided by concerned regulators that may either be audited or signed by the appropriate authority.

A. FINANCIAL RISK:

SMEs are typically set up as, Proprietorship, partnership or private limited companies. Each category of SMEs will prepare their own yearly financial statement (B/S, Profit and Loss A/C, Cash Flow Statement, statement of WC utilization etc.) in a structured format applicable for them and the same will be provided to the Rating Agencies. Bank transaction statement will also be provided which may be a good support to justify and assess its business volume.

Assessment of financial risk includes identification of net worth, asset size, liability, turnover, cost pattern, profitability, cash flow adequacy to debt repayment, and other important performance indicators (profit margin, ROE, ROA, leverage, liquidity etc). The ratio calculation is same as in the corporate ratings but adjustment may be made as per the nature of the business. Analysts are basically entrusted with the responsibility to frame opinion about the entity's ability in debt repayment based on its cash flow assessment. The future cash flow estimation against the debt obligation is also important in SME rating framework.

In addition to above, assessment of the flexibility of the entity in fund arrangement; especially the relationship with the bank and Assessment of the expected financial support from the sponsors in any distressed position may be considered. In view, the sponsor(s)' personal assets may be assessed specially for sole proprietorship and partnership business.

B. BUSINESS RISK/INDUSTRY RISK:

Business risk/Industry Risk can be termed as "a risk of direct or indirect loss arising due to deficient or unsuccessful internal systems, process, people or external factors.''

Business risk arises due to change in market situation and from its own operation infrastructure. Under the business risk, the sustainability of the business in the changing market situation will be assessed. Due to the limited scale of operation, business nature differs in different mode like manufacturing & marketing in a specific geographical region or functioning as support service to large scale manufacturers or trading of goods through import or local procurement, or even at agro-based level. A significant number of SMEs are doing their business as the backward operation of the formal sector; hence, rarely have control over pricing or fully market dependent. Even market competition is very high due to large number of SMEs in the same business.

Thus, customer group, performance track record, relationship with the suppliers, business network and the necessary infrastructures are important in market positioning of an enterprise. In case of new project in SME sector, the same key consideration factors in the project finance will be followed but in limited scale. SME project rating Framework would include parameters like: project viability in respect of market situation, estimated project cost, cost overrun, implementation plan, competence of the sponsor in implementing new project, estimated cash generation from the project and also the project location and availability of necessary manpower.

The industry related risks might have impact on the operation of related SMEs. So, the factors like the scope of diversification, industry size, supply gap, government policy towards the industry, nature of the product, social desirability, entry and exit barriers etc should be considered while rating SMEs broadly. As SMEs have presence in majority of the economic sectors of the economy, these types of enterprise operate as linkage and supportive to the industry either by products or by services.

C. MANAGEMENT RISK:

SMEs are typically managed by one or two entrepreneurs mostly related as family members or members from the known community. Unlike corporate, SMEs are rarely managed by qualified professionals; hence, performance of the enterprise is highly dependent on the experience and expertise of the entrepreneur in managing the business. A good number of entrepreneurs do not have formal education, however, involved in the business as inheritance. In assessing the competence of the promoters, track record and risk taking capacity is an important consideration in SME rating framework. However, the capacity of the support employees in many cases to handle the business efficiently may also be considered. Working condition and relationship between the employer and employees is an important consideration factor. Generally lenders have good control over the borrowers in SME sector, however, willingness to repay loan is an important characteristics even having good ability to pay its obligations which is being reflected by his/her track record. In addition to those, assess the performance of the entrepreneurs in other business, experience in the same or different line of business, succession of the entrepreneurs etc. should be assessed rigorously.

D. BANK RELATIONSHIP RISK:

Review of banking relationship is very important in SME rating process. The analyst team must visit the respective branch to meet with the bank professionals to collect information about the loan payment history, reason against the delay in payment, utilization performance of the loan limit, security against the loan, control over the security, and related issues. Any loan classification may create problem to the respective entity in further borrowing from the bank.

E. Financial Security Risk:

Although security against a loan is a post-default event and has bearing only in recovery rating, security offered against an SME loan plays an important role in the repayment behavior of the borrower even in the process of loan repayment. Loan coverage through FDR, hypothecation, guarantee, collateral, third party guarantee etc. will be considered in the rating evaluation process.

F. OTHER FACTORS:

Other than the above broad areas, other parameters like legal or environmental issue, disaster management capacity, impact of subsidies/tax waiver by the government, sudden business loss, impact of non insurance or inadequate insurance of assets, extraordinary or windfall gains and losses, impact of the new monetary or fiscal policies or significant development in the industry should thoroughly be assessed on case to case basis.

Credit Rating Methodology

For Small and Medium Enterprise

(SME)

Methodology should cover analysis of following risks parameters (Score 100)		Maximum Score	Score achieved by the client
i) Financial Risk (Business Performance and Profitability)		30	
1	Leverage (Less than 0.25-More than 2.75 times)	6	
2	Liquidity ((Greater than 2.74-Less than 0.70 times)	6	
3	Profitability (Greater than 25%-Less than 1%)	5	
4	Coverage ratio (More than 2.00 times-Less than 1.00 times)	3	
5	Additional Risk Parameters to be assessed (Profit Margin -Gross & Net, Return On Assets , Return on Equity, Equity Development Trend (Last 3 years), Trend of Operating cash flow (OCF), Business as well as personal net worth)	10	
ii) Business/Industry Risk		23	
6	Size of Business (Yearly sales in BDT) Medium-(1 crore or More) Small-(25 Lacs or More) Micro-(5 Lacs or More)	4	
7	Age of Business (>5 years -<2 years)	2	
8	Business Outlook (Favorable-Cause for concern)	2	
9	Business Growth compared to Industry (Strong-No Growth)	3	
10	Market Competition (Dominant Player-Highly Competitive)	3	
11	Entry/Exit Barriers to Business (Difficult-Easy)	1	
12	Additional Risk Parameters to be assessed (Level of Technology/Service, Infrastructure Facility, Government Policy Toward Industry, Nature of the Product & potentialities /Social Desirability, Dependency on suppliers/clients, Trade mark/Patent/copy right, Franchise/dealership, Marketing strategy)	8	

Methodology should cover analysis of following risks parameters (Score 100)		Maximum Score	Score achieved by the client
iii) Management Risk		18	
13	Track Records of the sponsors(Excellent- Not Satisfactory)	3	
14	Educational Qualification, Experience & technical know-how of sponsors/stuffs (5 years or more in the related line of business - No experience)	4	
15	Risk Taking Capacity of Sponsor(s) (Assessment would be made on the basis of past experience of sponsors) (High-Low)	2	
16	Personnel Policy & Internal Control System	3	
17	Succession (Ready Succession - Succession in question)	2	
18	Working Environment/Team Work (Very Good- Regular Conflict)	2	
19	Income Tax/VAT payment History	2	
iv) Bank Relationship Risk		12	
20	Relationship with bank (Maintain accounts for 3 (three) years or more with faultless record- Account(s) says Frequent Past dues & Irregular dealings)	4	
21	Current Status of Loans(Regular-Classified)	3	
22	Compliance of covenants/conditions-If any (Full Compliance - Non Compliance)	3	
23	Personal Deposit (Personal accounts of the key business Sponsors are maintained with banks) (with significant deposits - No depository relationship)	2	
v) Financial Security Risk		10	
24	Security Coverage(Primary) (Capable for fully pledged /cash cover/ Reg. Mortgage – Not capable to provide security)	3	
25	Collateral coverage (Property Location) (Capable for Registered Mortgage on Municipal corporation /Prime area property- Not capable for providing such collateral)	2	
26	Support/Guarantee (Capable Personal guarantee or Corporate Guarantee - Not capable for Support/ Guarantee)	3	
27	Legal Intervention regarding security Coverage (Fair-Disputed)	2	
VI) Other Factors		7	
28	Legal /Environmental Issue (Complied- Not Complied)	2	
29	Disaster Management capacity (Excellent- Not Satisfactory)	2	
30	Insurance (yes- No)	1	
31	Govt. Subsidies/Tax Waiver(Favorable - unfavorable)	1	
32	Any other Material risk factor	1	
	Total	**100**	

N.B: 1. Each External Credit Assessment Institutions (ECAIs) should prepare the sector wise industry average of SME on all risk parameters and this industry average will be considered while assigning score for the purpose of rating of the client.
2. Each Qualitative Factor related to rating report requires further explanation.

Annexure-2

Table: 1-ECAI's Credit Rating Categories Mapped with BB Rating Grade

BB Rating Grade	Equivalent Rating of S&P and Fitch	Equivalent Rating of Moody	Equivalent Rating of CRISL	Equivalent Rating of CRAB	Equivalent Rating of NCRL	Equivalent Rating of ECRL	Equivalent Rating of ACRSL	Equivalent Rating of ACRL	Equivalent Rating of WASO
1	AAA to AA	Aaa to Aa	AAA, AA+, AA, AA-	AAA, AA1, AA2, AA3	AAA, AA+, AA, AA-	AAA, AA+, AA, AA-	AAA, AA+, AA, AA-	AAA, AA+, AA, AA-	AAA AA1, AA2, AA3
2	A	A	A+, A, A-	A1, A2, A3	A+, A, A-	A+, A, A-	A+, A, A-	A+, A, A-	A1, A2, A3
3	BBB	Baa	BBB+, BBB, BBB-	BBB1, BBB2, BBB3	BBB+, BBB, BBB-	BBB+, BBB, BBB-	BBB+, BBB, BBB-	BBB+, BBB, BBB-	BBB1, BBB2, BBB3
4	BB to B	Ba to B	BB+, BB, BB-	BB1, BB2, BB3	BB+, BB, BB-	BB+, BB, BB-	BB+, BB, BB-	BB+, BB, BB-	BB1, BB2, BB3
5	Below B	Below B	B+, B, B-, CCC+, CCC, CCC-, CC+, CC, CC-	B1, B2, B3, CCC1, CCC2, CCC3, CC	B+, B, B-	B+, B, B-	B+, B, B-, CC+,CC,CC-	B+, B, B-, CCC	B1, B2, B3, CCC
6			C+, C, C-, D	C, D	C+, C, C-, D	D	C+, C, C-, D	CC+,CC, CC-, C+, C, C-, D	CC1, CC2, CC3, C+, C, C-, D
Short-Term Rating Category Mapping									
S1	F1+	P1	ST-1	ST-1	N1	ECRL-1	ST-1	AR-1	P-1
S2	F1	P2	ST-2	ST-2	N2	ECRL-2	ST-2	AR-2	P-2
S3	F2	P3	ST-3	ST-3	N3	ECRL-3	ST-3	AR-3	P-3
S4	F3	NP	ST-4	ST-4	N4	ECRL-4	ST-4	AR-4	P-4
S5,S6	B,C, D		ST-5, ST-6	ST-5, ST-6	N5	D	ST-5, ST-6	AR-5, AR-6	P-5, P-6

Annexure-3

Table: 1.1-ECAI's Credit Rating Categories Mapped with BB's SME Rating Grade.

BB's SME Rating Grade	Equivalent rating of BDRAL
SME 1	SE1, ME 1
SME 2	SE2, ME 2
SME 3	SE3, ME 3
SME 4	SE4, ME 4
SME 5	SE5, ME 5
SME 6	SE6, SE7, SE8, ME 6 ME 7, ME 8