# Rating Advisory Services for Banks in Emerging Europe

RATING DEVELOPMENTS

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# Topics

- What are Rating Advisory Services?
- The Rating Book
- Rating Advisory Methodology
- Red Flags

# Rating Advisory Service?

1990: First international ratings produced on Eastern European banks (BREE)

1993: First international ratings on Russian banks (BREE)

1995: Moody’s, Fitch and S&P start issuing ratings on Eastern European banks.

2003: Rating advisory services offered to EE banks (Rating Developments, GIA)

# Rating Advisor Tasks for Banks

Banks that...

…want to be reviewed confidentially by a ratings expert without requiring a credit rating.

... are considering granting a mandate to a rating agency.

...are preparing for a rating.

...are not satisfied with assessments by a rating agency.

# An Independent Rating Advisor?

Has no conflicts of interest:

► Your bank is the client

► Confidentially is assured

- Investment bank rating advisors are tied: their “free” service depends on clients issuing debt through them.
- Rating agencies can offer advice, but this is a conflict of interest for agency analysts.

# Confidential Pre-Rating Reviews

- Investors & creditors assess banks by using global credit standards.
- Internationally active banks need a good rating.
- clear, practical advice on how a bank can best present itself to rating agencies and counter-parties.
- communicate efficiently with top management about all aspects of banking operations.
- examines the non-financial aspects of bank operations that rating agencies usually do not explain to banks.

# Confidential In-House Credit Analysis

- For banks with or without international credit ratings
- An in-house credit analysis highlights operations where modest improvements could have a significant impact on a rating.
- The analysis also provides a basis for dialogue and negotiation with rating agencies.

# Assistance with Preparations for a Rating

- Rating agencies request banks to complete standard forms and to provide lots of background data.
- Assist banks to assemble their Rating Book for the agencies.
- Advise on which data are most important to agencies
  - what they are looking for
  - how to best present the data that they really need.

# Dissatisfaction with a Current Rating Proposal

- Rating analysts may over-emphasise negative developments or do not adequately recognise progress in strategies, resources or operations.
- A rating agency proposes a rating that is too low.
- A first rating may be too harsh according to the agency's own rating definitions.
- The bank is assigned a rating that is lower than those of comparable banks in its peer group.
- An agency may want to downgrade a rating when there has been no perceivable deterioration in bank performance or business environment.

# Appealing against Adverse Ratings

- The major rating agencies provide for an appeal process that allows for banks to present new data to the rating committee.
- We can assist by preparing an alternative analysis based on developments at the bank and comparisons with other banks in its peer group.
- Assistance can also be provided with the actual appeal presentation.

# What Rating Advisors Can and Cannot Do

- Rating advisors help clients obtain optimal ratings
- Our objective is to provide the best advice on ratings to our clients
- We are independent, work to the highest ethical standards and have no conflicts of interest
- Advisors can also provide advice an support on an annual retainer basis.
- No specific rating can be—or is—guaranteed.

# The Rating Book

- Single source of detailed information used by rating agencies
- It shows that Bank has anticipated all inquiries
- Includes confidential  information
- It answers sensitive questions rating agencies often do not ask
  - usually about governance

# Rating Book: Contents

- Business Profile (8 tables)
- Banking Market & Strategies (6)
- Asset Quality & Loans (12)
- Funding & Capital (7)
- Risk Management (11)
- Management & Governance (12)
- Financial Statements (5)

# Rating Book: Banking Market & Strategies

- The Banking Market
- Local Market Share
- Bank SWOT Analysis
- Bank Strategies
- Competitors
- Most Important Corporate Clients

# Rating Book: Asset Quality & Loans

- Loans by Category
- Loans by Economic Sector
- Loans by Region
- Loan Classification
- Non-Performing Loans by Economic Sector

- Largest:
- Exposures
- Non-Bank Borrowers
- Problem Credits
- Restructured Credits
- Connected Borrowers
- Bank Borrowers
- Analysis of Reserves for Bad Debts

# Rating Book: Funding & Capital

- Deposits
- Largest Depositors
- Balance Sheet Liquidity
- Asset-Liability Maturity Ladder
- Balance Sheet Currencies
- Derivative Instruments
- Capital Adequacy

# Rating Book: Risk Management

- Limits and Authorities
- Loan Approval Policies
- Exposure Management
- Balance Sheet Policies
- Capital Policies
- Budgetting

- Liquidity Management
- Treasury Market Risk
- Value at Risk (VAR)
- Dealing Room
- International Operations
- Response to Basel II

# Rating Book: Management & Governance

- Organization Chart
- Board of Directors/Shareholder Representatives
- Senior Managers
- Management Committee Members
- Governance
- Staff
- Information Technology
- Internal Audit
- External Auditors
- Relationship with Regulators
- Know Your Customer (KYC)
- Reputation Risks

# Choosing the Rating Agency

- International or national agency?
  - For foreign investors, clients or counter-parties?
  - …or local business?
- International agencies in emerging markets:
  - S&P: reputation
  - Moody’s: many bank ratings
  - Fitch: long bank experience; most bank ratings
  - CI: cheaper

# Rating Costs

Rating agencies standard fees vary between markets:

- Moody's Standard Issuer Cost: $17,250 per year (special emerging market banks price).
- S&P Standard Issuer Cost: $25,000 - $40,000, depending on the size and location of the issuer. Negotiable.
- Fitch Standard Issuer Cost: Similar to Moody's, although pricing can be flexible: $10,000 to $25,000.

# Presentation Tips

- Clear and concise.
- It is better to provide too much data.
- Acknowledge weaknesses, but first explain the good news.
- Bank must have strategies to remedy every weakness.
- All managers must understand the bank's overall strategies and their role within the master strategy

# Red Flags: Financial Examples (Bulgaria)

| Bulgaria Comparisons: FY2002 | Bio | Bul | BPB | DSK | FIB | Heb | RZB | UBB | Wtd Avg |
|---|---|---|---|---|---|---|---|---|---|
| Total Assets (€mns) | 480 | 1,392 | 371 | 1,041 | 370 | 251 | 302 | 844 | 870 |
| Provision Charge to Loans | -2.18 | -1.79 | 1.23 | 0.75 | 1.00 | -0.22 | 2.05 | 1.52 | -0.02 |
| Loan Reserves to Total Loans | 7.79 | 6.51 | 4.19 | 3.47 | 4.58 | 9.83 | 3.07 | 4.50 | 5.31 |
| Provision Charge to Operating Income | -42.39 | -9.42 | 33.90 | 15.47 | 16.84 | -4.74 | 67.55 | 19.01 | 7.27 |
| Est. BIS Capital Adequacy Ratio | 18.42 | 41.61 | 14.90 | 20.75 | 12.49 | 32.49 | 8.45 | 26.77 | 26.09 |
| Adjusted Capital Adequacy Ratio | 11.97 | 35.57 | 12.72 | 9.74 | 8.83 | 26.27 | 6.17 | 18.78 | 19.34 |
| Return on Average Assets | 2.84 | 2.90 | 1.03 | 1.66 | 2.40 | 1.36 | 0.62 | 2.11 | 2.12 |
| Underlying Profits on Avg Assets | 2.36 | 2.57 | 1.49 | 2.17 | 3.47 | 1.10 | 2.28 | 2.72 | 2.39 |
| Average Funding Cost | 1.35 | 1.02 | 1.61 | 2.20 | 3.79 | 1.34 | 1.43 | 1.06 | 1.59 |
| Underlying Interest Spread | 5.56 | 2.68 | 4.52 | 7.67 | 5.47 | 5.24 | 3.67 | 4.70 | 4.85 |
| Operating Expenses:Revenue | 68.62 | 39.94 | 72.92 | 69.32 | 52.36 | 78.30 | 60.01 | 57.60 | 58.11 |
| Net Loans to Total Deposits | 58.02 | 24.14 | 62.67 | 53.55 | 71.18 | 57.98 | 86.62 | 49.53 | 49.36 |
| Net Loans to Stable Funds | 52.31 | 21.21 | 60.02 | 50.68 | 77.65 | 47.62 | 93.43 | 44.98 | 46.83 |
| Liquid Assets to Short Term Liabilities | 34.29 | 38.50 | 29.35 | 33.05 | 44.37 | 38.73 | 20.99 | 38.45 | 35.69 |
| Asset:Liability Maturity Mis-Match | 10% | 6% | -28% | -14% | 13% | -18% | -32% | 3% | -4% |

# Red Flag Examples

- Difficult for one department to obtain information from another (poor top level management co-operation)
- Chaotic EDP room (probably reflects the bank)
- Early over-spending on premises (over-ambitious management strategies?)
- Powers of attorney granted to non-executives

# Beyond Red Flags

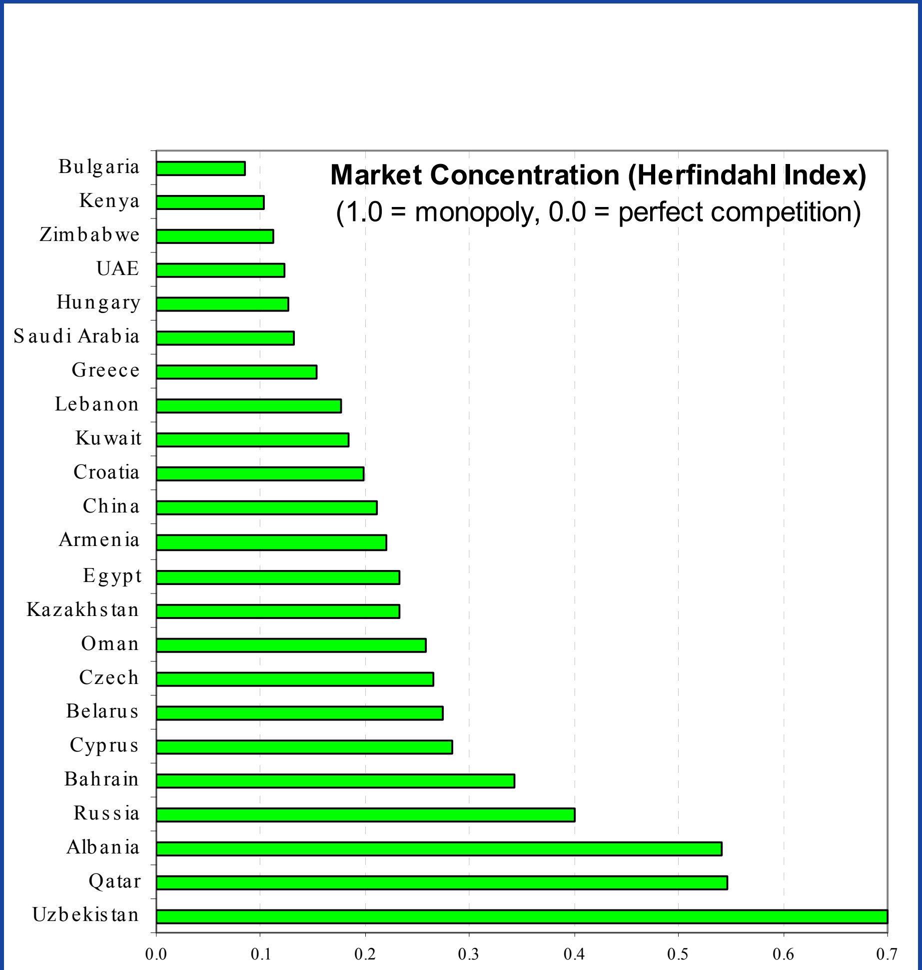
- Red Flags are indicators
- Analysts should examine if the warning indicators are really weaknesses
- Analysts sometimes do not look beyond Red Flags because of pressure of work

# Beyond Red Flags: Rapid Growth

- People and systems do not cope well with growth of >30% per year
  - New and existing exposures are <u>not monitored properly</u>.
- But Emerging European banking systems may grow at 40-60% per year
- There is <u>less stress</u> on the system if macroeconomic growth and banking infrastructure are <u>robust</u>.
- …and banks can safely grow faster than 30% p.a.
  - if management is <u>capable</u>

# Red Flag Examples: Rapid Growth 2

- It is more difficult to attract quality business in concentrated markets
- But what is “concentrated”?
- Economists use the Herfindahl Index to measure market share concentration.
- Therefore safer to grow rapidly in less concentrated markets.



# Red Flag Examples: Rapid Growth 3

- Above-market interest rates are a Red Flag
- Suggests that a bank does not have access to deposits at market rates.
- If bank borrowers pay more: are they good quality?
- But banks following a growth strategy often pay more to grow.
- For how long can they sustain higher rates?
- Clients will pay a premium for premium quality service.