NCC Bank
नेपाल क्रेडिट एण्ड कमर्स बैंक लि.
Nepal Credit & Commerce Bank Ltd.

Internal Credit Risk Rating Guideline

2072

(Approved by the Management Committee (Board) Meeting No. 531 held on February 23, 2016)

1. INTRODUCTION

As per the directives of Nepal Rastra Bank it is required to develop an internal credit risk grading system by bank for its loan and advances.

1.1 Credit risk ratings are designed to reflect the quality of a loan or other credit exposure, and thus – explicitly or implicitly – the loss characteristics of that loan or exposure. This guideline contains guidance both on the factors that should be considered in assigning a grade, and how these factors should be weighed in arriving at a final grade.

1.2 The borrowers of NCC Bank shall be categorized in the grades ranging from 'A' to 'D' as follows based on total weighted borrower risk points computed as per the methodology prescribed in the subsequent paragraphs.

Risk Grade	Total Weighted Risk Points	Risk Definition
A	>3.75 – 4.00	Low Risk
B1	>3.25 – 3.75	Medium Risk
B2	> 2.50 – 3.25	Satisfactory Risk
C	> 1.50 – 2.50	Watch list
D	Up to 1.50	Loss

Borrowers shall be categorized into four categories viz. A, B, C, & D. The B category clients shall further be subdivided into B1 and B2. Borrower which falls under A categories are considered "Excellent" clients with very low risk of default. B categories of clients are good clients and are considered to have low default risk. Our strategy shall be to Maintain/Grow relationship with the clients of A and B categories. C categories of clients are those which are to be put on watch list and require constant follow up and monitoring. This category of clients has a high probability of default. D categories of clients are problematic borrowers/defaulters or are in Banks recovery process. These clients need to be exited from our books as soon as possible. No new relationship shall be established with the borrowers which fall under C and D grading except for non willful defaulters.

Person responsible for Risk Grading:

Relationship officers shall be responsible to complete the Risk Grading Form as per annexures (as applicable), for the individual customers and the same shall be supported by respective Branch Managers and needs to be reviewed by Credit Risk Department at the time of sanction of the credit facilities.

2. BORROWER RISK GRADE FOR SMEs

Risk grading for SME borrowers shall be on individual account basis as per followings:

Type of security	Risk Weight %	Risk points			
		4	3	2	1
Real estate collateral	20	167% and above	140% - 166%	100% - 139%	Below 100%
Current Ratio	10	Above 3:1	Above 2.5:1	Above 1.5:1	Above 1:1
Leverage Ratio (times)	10	Below 0.5	Below 1.0	Below 2	Above 2
Interest Coverage Ratio (times)	10	Above 3	Above 2.5	Above 2	Above 1
Management Quality	30	Minimum 5 years experience in related field	Minimum 3 year experience in related field	Minimum 1 years experience in related field	New entrant
Past Track Record	20	3 years and above with satisfactory repayment history	2 years and above with satisfactory repayment history	1 year and above with satisfactory repayment history	Payment not made on or before due date

Additional consideration in the case of real estate collateral:

- *Type of property: Residential, commercial, Real estate, cultivated agricultural or non cultivated land*
- *Ownership of property: Self-owned, family member, joint ownership*
- *Right of Lessee in case of Leasehold Property*

3. BORROWER RISK GRADE SCORES FOR CORPORATE/BUSINESS ACCOUNTS

The weights to be awarded to each factor, their parameters, and the points of the defined parameters shall be as below mentioned.

a. *Collateral Coverage (weight 30%)*

Type of security	Risk points			
	4	3	2	1
Real estate	167% and above	140% - 166%	100% - 139%	Below 100%
Hypothecation over Fixed Assets	-	132% and above	111% - 131%	Below 111%
Hypothecation/pledge over Current Assets	-	132% and above	111% - 131%	Below 111%
Share	200% and above	168% - 200%	100% - 167%	Below 100%
Vehicle	-	143% and above	111% - 142%	Below 110%
Personal/ Corporate guarantees	-	Very good	Good	Fair

The prevailing provisions of NRB directives/ circulars shall be adhered for considering market value of share (for e.g., *lower of* last closing price *and* average price of preceding 180 days)

Personal/ Corporate guarantees as mentioned in the above table shall be considered only for those borrowers not offering other forms of security (such as real estate, fixed assets, current assets etc.). Therefore, analysis of personal/corporate guarantee is not required where these are obtained in addition to other form of securities.

Additional considerations in case of real estate collateral security:

- While considering real estate collateral for security purpose of the loan, following factors needs to be considered apart from the security coverage.
- Type of property: residential, commercial, agricultural, or vacant land.
- Ownership of property: self owned, family members.
- Where the borrower provides multiple securities, the percentage of total security coverage need to be calculated which shall be matched with the lowest weight given security type from the table given above (conservative approach).

For example:

Loan amount NPR 100,000 (50% WC Loan and 50% TL)

Security:

Hypothecation over Current Assets NPR 80,000
Registered Mortgage NPR 50,000
Hypothecation over Machinery NPR 40,000

In above case, the total value of security given for a loan amount of NPR 100,000 is NPR 170,000 which is 170% of the loan amount. The scoring has to be taken from the hypothecation over current assets as this has low score among other security. Hence, in this case, the score is 0.3.

b. *Capacity - Financial Strength (total weight 30%)*

Factors	Weight	Risk Points			
		4	3	2	1
Net Worth	7.5%	P + 51% and above	P + (25% - 50%)	P + (0 – 24%)	-ve
Debt Service Coverage Ratio	7.5%	> 2	>1.5 – 2	1 – 1.5	Below 1
Operating Profit/Sales	5%	10% and above	7% and above	5% and above	Below 5%
Debt/ Equity Ratio (Gearing or Leverage)	10%	Below 1	1 - 2	>2-4	Above 4

Note: P – Paid up Capital
For example, if the reserve & surplus of any unit is 51% (or more) of paid up capital, then the score is 4.

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Explanations:

1. Net worth of a company is computed as "total assets minus total liabilities' or "Share capital plus reserves & surplus". Net worth is an important determinant of the value of a company, considering it is composed primarily of all the money that has been invested since its inception, as well as the retained earnings for the duration of its operation.
2. The debt service coverage ratio calculates the amount of cash available to meet debt obligations. Excluding tax considerations, Debt service coverage ratio = [Net Income + Depreciation & Amortization + Interest Expense]/[Interest Expense + Principal Payments].
3. Operating profit is defined as gross profit minus all regular (operating) expenses, excluding tax considerations.

   The operating profit margin reflects the borrower's ability to control the operating costs or overheads.
4. The Debt/Equity ratio indicates the proportion of assets invested in the business that are financed by the borrowing. In theory, the higher the level of borrowing (gearing) the higher are the risks to the business, since the payment of interest and repayment of debts are not optional in the same way as dividends. However, gearing can be a financially sound part of business's capital structure particularly if the business has strong, predictable cash flows.

c. ***Credibility of Business (total weight 15%)***

Factors	Weight	Risk Points			
		4	3	2	1
Past track record with the bank	5%	Excellent relationship over last five years or more with interest/ principal payment overdue for none of the months/ quarters	Good relationship over last three years or more with interest/ principal payment overdue occasionally without willful intent.	Possibly a good customer. No significant departure from the arrangements over last 35 months or lower. The new customers shall fall under this category.	Account downgraded for at least two quarters during last 12 months.
Relationship with other group members (supplier/ customer relationship)	3%	Very strong. Always able to set terms and conditions	Strong. Well established relationships with the ability to influence terms and conditions	Price taker. Not able to influence terms of business	Restricted supply arrangements imposed. Difficulty in paying creditors and collecting

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					debtors.
Market positioning	3%	Undisputed leader or above 60% market share	Dominant in principal market or strong player. Recognized advantage in product quality or cost. (20% - 60% market share)	Fair position in the market. Limited advantage in product quality or cost. (5% - 20% market share)	Declining with clear weaknesses and limited capability to alter position. (<5% market share)
CIB Information	3%	No evidence of defaults.	Occasional defaults but subsequently regularized within max 3 months.	Occasional defaults but subsequently regularized within 3 to 6 months	Frequent defaults. Un-acceptable
Reference from other Banks	1%	No evidence of defaults.	Occasional defaults but subsequently regularized within max 3 months.	Occasional defaults but subsequently regularized within 3 to 6 months	Frequent defaults. Un-acceptable

d. Capacity of Management (total weight 15%)

Factors	Weight	Risk Points			
		4	3	2	1
Qualification of CEO/ Management Team	6%	Graduation	Intermediate / 10+2	SLC	Below SLC
Experience / Track Record	6%	Experience of key executives above 30 years	Experience of key executives above 15 to 30 years	Experience of key executives above 3 to 15 years	Experience of key executives up to 3 years
Succession Plan	3%	Well structured succession plan	Some evidence of succession plans	Succession loosely planned or un-arranged	No succession plans

e. *Conditions – SWOT (total weight 10%)*

Factors	Weight	Risk Points			
		4	**3**	**2**	**1**
Strengths/ Weaknesses	5%	Very Good	Good	Fair	Poor
Opportunity/ Threats	5%	Very Good	Good	Fair	Poor

SWOT analysis is a strategic planning method used to evaluate the Strengths, Weaknesses, Opportunities, and Threats involved in a project or in a business venture. It involves specifying the objective of the business venture or project and identifying the internal and external factors that are favorable and unfavorable to achieve that objective.

The Strengths, Weaknesses, Opportunities and Threats vary with nature of business as well as the conditions of related governing factors. As an exhaustive list of factors related with SWOT suitable to all industry cannot be specified, this guideline allows the concerned Relationship Officers/Managers to make rationale judgment based on the most probable situation to which the borrowers' business or project is expected to be exposed and assign risk points for possible SWOT conditions identified.

Many factors may have to be considered in SWOT analysis for risk grading. Each factor should be classified into four parameter for each risk point (i.e.; 4, 3, 2, & 1) and be awarded. The breakdown of each factor as mentioned in the table above shall be assigned with equal weights.

<u>*For example:*</u>

While evaluating Opportunity/Threats of any borrower, some factors may be evaluating the current conditions of the industry/ market and environmental threats to which the business of the borrower belongs to. The possible parameters for such factors may be:

Factor	***Risk Points & Parameters***			
	4	***3***	***2***	***1***
Industry/Market	*Stable, excellent, growth prospects*	*Growing and effective or growth potential in next 3 to 5 years*	*Mature, limited or no growth potential*	*Mature and in decline with aggressive rivalry*
Environmental Threats	*No threats in the long term*	*No external threats in next 3-5 years*	*No short term threats however susceptible to economic cycles / conditions*	*Very limited capability to meet further competitive / economic pressures*

Therefore, the concerned RO/RM selects the most appropriate risk point with full justification.

Some of the factors which may fall under SWOT conditions, amongst others, are as follows:

1. Business cycle analysis of industry to which the business of the borrower belongs to.
2. Production & distribution capacity of borrower's business
3. Competition faced by borrower's business
4. Market reputation of borrower
5. Demand – Supply situation of borrower's business
6. Size of business of borrower.

4. RISK GRADING SYSTEM FOR HOME LOAN/AUTO LOAN/EAZY LOAN

Risk Grading for above loans that are guided by the respective Product Papers, shall be done on following basis. Though, these loans are security based lending, to mitigate the default risk and concentration risk, the security coverage, loan amount and repayment capacity/history has been taken into consideration:

Type of security	Risk Weight %	Risk points			
		4	3	2	1
Real estate collateral	40	167% and above	140% - 166%	100% - 139%	Below 100%
Past Track Record	10	Repayment made on or before due date	Repayment made within 30 days of due date	Repayment made within 60 days of due date	Repayment made within 90 days of due date
*UMI:EMI	40	Above 3:1	2.5:1 to 2.99:1	2:1 to 2.49:1	1.5:1 to 1.99:1
Loan Amount	10	Up to 5M	5M to 10M	10M to 15M	Above 15M

**UMI=Uncommitted Monthly Income*

5. EXEMPTION FROM RISK GRADING ANALYSIS

The risk grading analysis of following borrowers are exempted and shall be directly assigned as stated therein.

a. *Risk grade "A" borrowers:*

The borrowers offering following collateral/ security shall always be classified as grade "A" without any other analysis:

- gold and silver;

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- lien over fixed deposit receipts of NCC Bank;
- bonds, treasury bills or guarantees issued by Government of Nepal, Nepal Rastra Bank; or the government/central bank of the foreign country.
- export letter of credits.

However, the exemptions shall not be granted in case the above collateral/security is obtained as an additional security only.

b. Risk grade "D" borrowers:

The borrower whose facility is downgraded as loss or doubtful based on any or all of the criterion of the directives issued by Nepal Rastra Bank and the facilities downgraded by the supervisor/external auditor during the course of supervision/audit to loss and doubtful category shall always be classified as grade "D", without further analysis of any other factors.

c. Downgrade in Risk Grade:

The borrower whose facility is downgraded as Substandard based on any or all of the criterion of the directives issued by Nepal Rastra Bank shall be downgraded to next lower risk grade without further analysis of any other factors.

6. ARRIVING AT THE FINAL SCORE

The points should be awarded for each of the parameters according to the quantification provided on the guideline, wherever applicable, and on the basis of best judgment on the qualitative factors considering the areas defined therein, with full justification. The points so arrived at are multiplied to the weights assigned to each factors by this guideline to arrive at the weighted score. The weighted risk points for each factor should be summed up and risk grade should be assigned based on clause 1.2 of this guideline. The Credit Appraisal Memorandum prepared for each borrower shall accompany the sheets of computation of their risk grades in the format of "Risk Grade Scorecard" given as annexure 1 of this guideline.

7. REVIEW OF RATINGS

The risk ratings should be reviewed, if not assigned, by independent credit risk management or loan review personnel both at the inception of a transaction and periodically over the life of the loan. Thus, the ratings assigned by the concerned relationship officers to each borrower will be reviewed and may direct for change in grade, by the Credit Risk Department at the time of initial sanction/renew or review of Credit Appraisal/renew/review Memorandum. Also, the concerned Branch Manager or Credit In-charge, the Credit risk management unit/department/committee, Credit Manager, Chief Risk Officer, Chief Executive Officer, the Credit Committee, Board of Directors and/or the Internal Audit Department may review the customer grades assigned and direct to change the grades assigned by the relationship officer. Such direction to change the grades assigned by the relationship officer must be in written form along with full justification. Such independent reviews of individual ratings support the discipline of the rating assignments by allowing management to evaluate the performance of those individuals assigning and reviewing risk ratings. The management of the Bank, if deemed appropriate, may require independent external ratings of some of the borrowers from the rating agencies so as to facilitate comparison with the internal risk grades assigned to that borrower with an objective of ensuring that the

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Bank's internal risk rating system appropriately signifies the risk (such as bankruptcy) associated with the loan/facility exposures.

8. APPLICATION OF INTERNAL CREDIT RISK RATING SYSTEM

Robust internal credit rating systems are an important element in several key areas of the risk management process. This section briefly describes the principal areas of application of this guideline:

1. *Limits and approval requirements*: Different approval requirements and thresholds shall be set for different internal grades, allowing less scrutiny and greater latitude in decision-making for loans with lesser risk.

2. *Reporting to management on credit risk profile of the portfolio:* As part of reports analyzing the overall credit risk in the Bank's portfolio, information on the profile of actual outstanding, exposure, or both by internal risk grade shall be reported to top level management, risk management committee, credit committee and Board. Such information shall thus be one consideration - among others, such as concentrations in particular industries or borrower types - in evaluating the Bank's appetite for originating various types of new loans.

3. *Allowance for loan losses:* The makeup of the loan portfolio and the loss characteristics of each grade shall be considered, along with other factors, in internal analysis of the adequacy of the Bank's allowance for loan losses. The internal risk rating systems and supporting documentation should enable reconciliation of the Bank's internal risk ratings with the categories used by the Nepal Rastra Bank for those loans graded below "pass" (i.e., substandard, doubtful, and loss).

4. *Pricing and profitability:* Risk-rating-specific loss factors shall be incorporated to discipline the Bank's overall pricing practice across the portfolio in determining the minimum profitability requirements.

5. *Internal allocation of capital:* The internal risk grades shall be used as an important input in identifying appropriate internal capital allocations for evaluating profitability. Such internal capital allocations may also be considered as one input, if appropriate, into supervisory evaluations of capital adequacy.

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6. *Annexure 1: Risk Grade Score Card*

Risk Grade Scorecard

Borrower:	**Scores**	**Risk Grades**	
Group:	**>3.75 – 4.00**	**A**	**Aggregate score:** ______
Basel Code:	**>3.25– 3.75**	**B1**	**Risk Grade:** __________
Date of grading:	**>2.50 – 3.25**	**B2**	**Risk Definition:** _______
Next review date:	**>1.50 – 2.50**	**C**	**A/C Strategy:** _________
Date of financials:	**Up to 1.50**	**D**	
Completed By:			
Reviewed By:			
Reviewed By:			

	Factors	Weight		Actual Point	Weighted Score (Points * Weight)
1	**Collateral coverage**		30%		
2	**Financial Strength**		30%		
	2.1 Net Worth	7.5%			
	2.2 Debt Service Coverage Ratio	7.5%			
	2.3 Operating Profit/ Sales	5%			
	2.4 Debt / Equity Ratio	10%			
3	**Credibility of Business**		15%		
	3.1 Past track record with the Bank	5%			
	3.2 Relationship with other group members (supplier/ customer relationship)	3%			
	3.3 Market Positioning	3%			
	3.4 CIB Information	3%			
	3.5 Reference from other Banks	1%			
4	**Capacity of Management**		15%		
	4.1 Qualification of CEO/ Management Team	6%			
	4.2 Experience/ track record	6%			
	4.3 Succession plan	3%			
5	**Conditions : SWOT**		10%		
	5.1 Strengths/ weaknesses	5%			
	5.2 Opportunity/ Threats	5%			
	Total		**100%**		

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