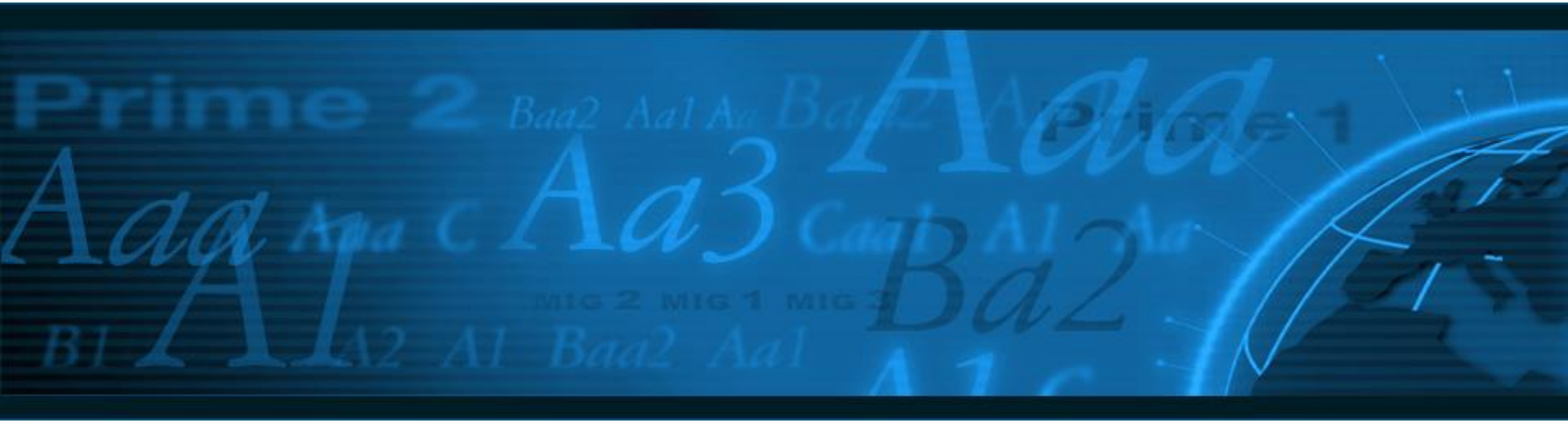
A Brief Introduction to MERIS Rating Services – Financial Institutions Ratings



MERIS

Middle East Rating & Investors Service

About MERIS

- **MERIS (Middle East Rating & Investors Service)** was established as a joint venture between **Moody's Ratings** (among the world's foremost credit rating agencies) and **FinBi** (Finance & Banking Consultants International).

- **MERIS** is supported by the technical assistance and expertise of **Moody's**. **MERIS** focuses on issuing independent credit ratings, opinions of the relative creditworthiness of issuers or issues, research and analysis to various corporate and banking market participants at the national level.

- **MERIS** is considered a platform for providing credit rating service, extensive credit rating analysis and credit research not only in Egypt, but also in other countries in the Middle East.

*Additional information about **MERIS** is available at*
www.merisratings.com

What Does a Credit Rating Mean?

- Credit rating provides an **accurate**, **independent** and **objective** credit opinion about an entity or about a fixed-income security. It is an assessment of the ability and willingness of an entity or an issuer to honor full and timely payments on its financial commitments.
- Credit rating provides a clear and easily understood **ranking** of the credit quality of a security across different countries and markets to facilitate **comparability**.
- The main and proper role of a credit rating agency is to enhance **transparency** and efficiency in the debt capital markets. Transparency is a key issue that **investors** are looking for in today's world.

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Credit Rating Concept

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- Applying for a credit rating signals a willingness by the issuer to be transparent.

National Scale Rating (NSR)

- A NSR is **an opinion of the relative creditworthiness** of entities and issues **in a particular country**.
- NSRs are not designed to be compared between countries, rather they address relative risk within a given country.

NSR Criteria:

- NSRs take into account the intrinsic financial strength of the obligor.
- External support factors to the issue may be taken into consideration.
- Balance between qualitative and quantitative analysis.

MERIS National Rating Scale

Quality of credit	long term	short term	
Highest Quality	AAA		Investment Grade
Very High	AA+ AA AA-	Prime-1	Investment Grade
Upper-Medium	A+ A A-		Investment Grade
Medium Grade	BBB+ BBB BBB-	Prime-2 Prime-3	Investment Grade
Weak Quality	BB+ BB BB-		Speculative Grade
Poor Quality	B+ B B-	Not Prime	Speculative Grade
Very Poor	CCC+ CCC CCC- CC C		Speculative Grade

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Principal Benefits of NSR - Issuers

- Higher level of transparency, which is a major requirement for today's capital markets and for investors.
- Can facilitate better access to the local & global capital markets and investors.
- Means of communicating creditworthiness to key counterparts from an internationally recognized neutral and independent body.
- Means of comparison to other institutions in the same country.
- May be useful to facilitate repeat issuance.
- Provides issuers with an independent assessment against which to benchmark their own creditworthiness.
- Rating may expand your investor base and decrease your cost of borrowing.
- Helps issuers to formulate internal capital plans and funding strategy.

Principal Benefits of NSR - Investors

- Increases transparency and reduces uncertainty.
- Access to the entity's inner information, giving investors greater confidence.
- Widens investment horizons.
- Independent indicator of credit quality.
- Helps understanding and managing credit risk.
- Objective and credible pricing benchmark to assist relative value analysis.
- Strategic tool for portfolio management techniques.
- Facilitates secondary market liquidity.

What a Rating will Not Tell You?

- Rating agencies do not make recommendations to buy or sell.
- Credit ratings are a measure of relative risk and not a measure of relative value.
- Rating agencies do not “price” debt.
- Rating agencies are not auditors or investigators. They depend on audited financial statements as well as on the information provided by the rated entity in the rating process.
- Rating is not a guarantee against loss. It is an opinion about the relative probability of default and loss.

Rating process
Typical Time Frame for a First-Time Rating

Week 1	Week 2	Week 3	Week 4	Week 5	Week 6	Week 7	Week 8

Processing Initial Information

Management Meetings

Rating Report

Rating Committee Discussion

Initial Rating

Press Release/ Rating Report

Note: This time frame applies as of the date of availability of information.

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Rating Process

- Initial Meeting – possible first glance???
- Execution of a Rating Agreement.
- Analytical team assigned consisting of minimum two analysts (lead and a backup).
- Preliminary Information Requirement List sent to client.
- Processing Initial Information.
- Management Meetings.
- Preparation of the Report.
- Rating Committee.
- Communication of the Rating.

Not a black box exercise, it is an open dialogue process.

Deliverables

- Credit Rating Report
- Rating Certificates
- Press Release
- Responses to inquiries from institutional investors, research needs, questions and/or information requirements

Once a Rating is Assigned….

- Rating and key credit opinion is made widely available.
- On-going monitoring of published ratings and annual review meetings with the company.
- Change the rating or confirm it whenever appropriate (i.e. issues such as M&A activity, debt issuance, etc. should always be discussed with the rating company).
- We promote continuous communication between **MERIS** analysts and rated companies.

Standards of MERIS Professional Conduct

- Protection of Confidential Information
- Independence, Objectivity and Accuracy
- Integrity
- Compliance with Applicable Laws and Regulations
- Real and Apparent Conflicts of Interest

Financial Institutions Rating Approach

Bank Ratings Products

- Financial Strength Rating
- Deposit Rating (Long and Short-Term)
- Debt Rating (Long and Short-Term)
- Entity Rating

MERIS Banks Ratings

Debt/Deposit Ratings

- Measure a bank's repayment ability.
- Answer the question "Will this bank be able to repay its debt obligations?" or "If I put a dollar with this bank, will I get it back"?

Financial Strength Ratings

- Measure a bank's stand alone strength (without reference to sovereign risk or support from third parties.)
- Answer the question, "Will this bank need to be supported by a third party at some point in the future?"

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The Seven Pillars of Bank Analysis

1. Operating Environment
2. Ownership & Governance
3. Franchise Value
4. Earning Power
5. Risk Profile & Risk Management
6. Economic Capitalization
7. Management Strategies

MERIS's Rating Approach Is Not Based On A "Checklist" Or "Scoring"

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1. Operating Environment

- **Health & structure of the economy**: macro-economic factors, depth & structure of the economy.
- **Trends in capital markets & level of disintermediation.**
- **Structure of the domestic banking system**: the "TBTF" philosophy (concentration /fragmentation), new banking law, privatizations of the Big Four.
- **Regulatory environment**: capacity & willingness of regulators to intervene and to enforce regulations, competence of regulators.
- **Transparency**: the extent of disclosure about a bank's operations and the macro-economy, the reliability of that disclosure (Simply put, is it true?).
- **Legal System**: quality of the legal system, speed, efficiency, enforceability, completeness, decree # 64 for 2004.

2. Ownership & Governance

- Knowing Who "Controls" is important for conducting Source of Strength "SOS" analysis.
  - Government/public sector
  - Private sector - with controlling shareholder
  - Private sector - widely held with/without controlling shareholders
- Public Ownership And Privatization.
- Bank Guarantee Schemes.
- Why Governance matters?

3. Franchise Value

- **A bank's franchise is its ability to generate earnings over the long term.**

- **Systemic sources (3 forces of Porter's Model):**
  - level of entry, exit & distribution restrictions
  - composition of competition within the market (price competition, service competition?)
  - level of substitute products (i.e. Internet, non-bank financial service providers)

- **Bank specific sources:**
  - Efficiency - driven by technology, product mix, staffing levels.
  - Big is beautiful ? Market position & strategy.
  - Market Share.
  - Value of different business franchises.

4. Earning Power

We attach importance to the "quality" of earnings, by which we mean that earnings should be sustainable and based on a bank's core competences.

- Retained Earnings Power (ERP): stability vs. volatility.
- Risk-adjusted revenue breakdown:
  - Net Interest Margin (NIM).
  - Non-Interest Income: fees and commissions, trading income, etc.
- Expenses and efficiency
  - Cost income indicators.
  - Fixed costs vs. variable costs.
  - Staff expenses.
  - Business line analysis.

5. Risk Profile & Risk Management

- **The Management of Risk:** a bank's risk profile does not evolve by chance. It is the product of management strategies…
- **Credit Risk**
  - Cyclical & Systematic Risk, The Bank's Own Credit Profile, Regulation, Collateral, Off Balance Sheet Risk,
  - Measuring Credit Risk:
    - Looking Back (NPLs, Run Rate, Provisioning Policy, Coverage ratios)
    - Assessing the Position today (Dead Bank Ratio)
    - Looking Forward (PPP/Net Loans, PPP/(Reserves+Equity)
- **Market Risk:** Trading, Liquidity, ALM.
- **Operational & Other Risks:** e.g. reputation risk, legal risk, etc.

6. Economic Capital Analysis

There is a common misconception that the more capital a bank has, the stronger the bank is, and by extension, the higher its rating.

- No direct correlation between **MERIS's** ratings and absolute or regulatory capital level.
- Appropriate level of capital may be quite different from regulatory requirement.
- Correlation between economic capital and overall risk profile.
- Silent reserves and capital generation power.
- "Economic capital" is difficult to quantify but what we mean by economic capital is funds which are permanent and immediately available to absorb losses before general creditors are affected in any way.

7. Management Strategies

Management: a key determinant of bank's financial strength

- Strong in depth
- Stable and consistent
- Clear strategy and planning
- Management Information Systems & Control

Franchise Strength Vs Strategies

- Banks with weak franchises embark on riskier strategies

nothing to lose

- Banks with strong franchises adopt more conservative strategies

a lot to lose / reluctant to <u>rock the boat</u>

MERIS: Ongoing Banking Sector Monitoring

- Permanent gathering and evaluation of information.
- Permanent communication with market participants.
- Permanent communication with Clients.
- Permanent communication with Regulator(s).

Why Do You Need A Credit Rating For Your Bank/Financial Institution?

- Credit Rating, both locally and internationally, provides ***Transparency*** to the outside world from an independently recognized body.
- A rating can facilitate access to a wider pool of debt capital market.
- Rating is a mandatory requirement for bond issuance according to Egyptian law. In most countries, credit rating is also a legal requirement for bond issuance.

Why Do You Need A Credit Rating For Your Bank/Financial Institution? ? - Cont'd

- Investment horizons are widening well beyond state boundaries. Credit worthiness, which is established by credit rating, is becoming ***a main investment criterion worldwide***. Investors, both foreign and local, deal with companies according to where these companies stand on both local and international Rating scales. Investors use credit ratings as benchmarks to compare between the creditability of companies; to invest, and then to customize their investment portfolios, to set credit risk limits, and to calculate their credit risk adjusted premiums.

- *The best* ***practice*** is to seek a credit rating irrespective of bond issuance – ***eases pressure and allows sufficient time and flexibility*****.** It is advisable not to seek a credit rating only in association with an issuance, whether local or international issuance (debt or equity). *It is* ***best to rate when not under pressure*****.**

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