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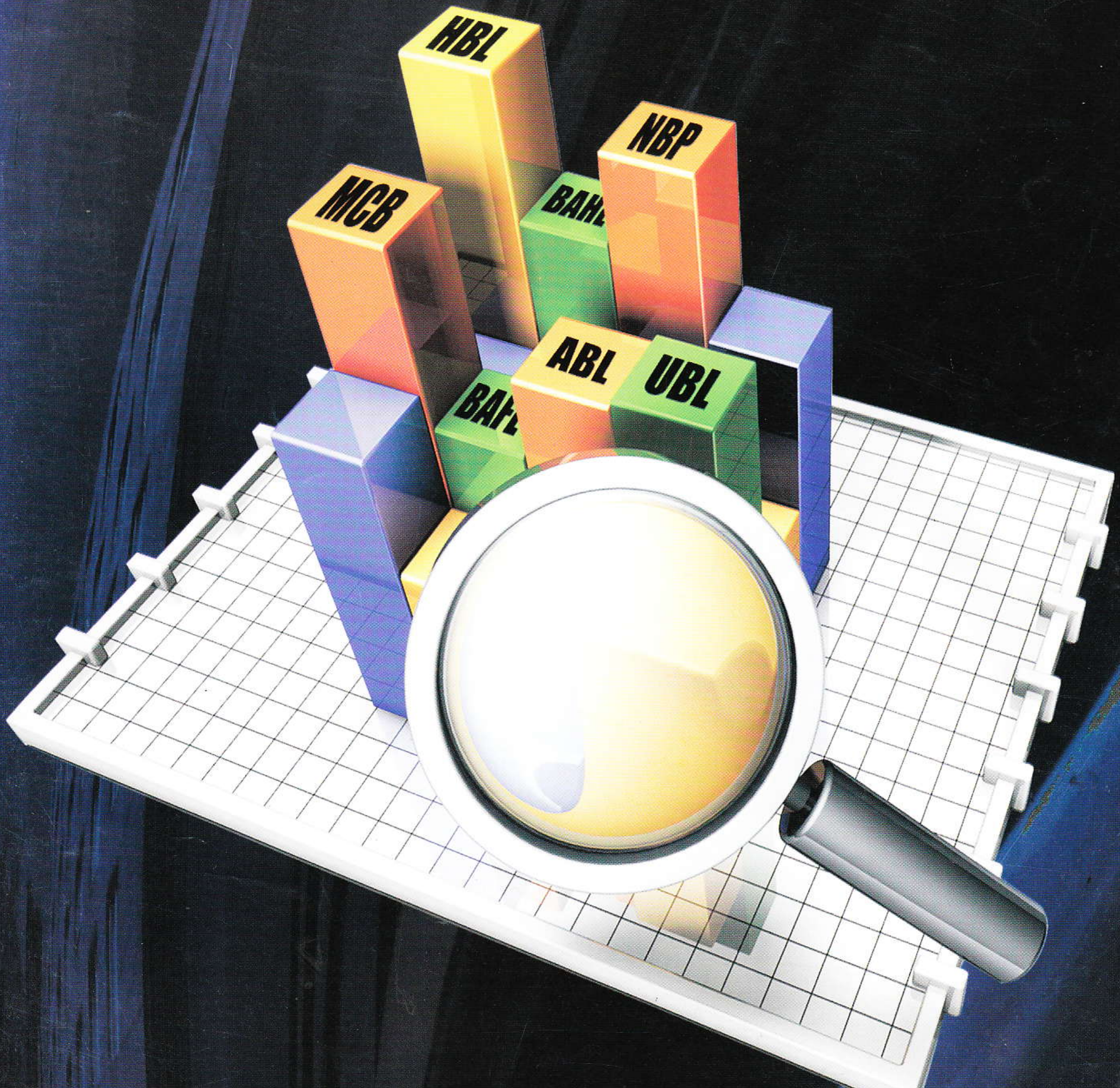
- Mobile banking – 'fad' or 'to stay'
- Consumer banking in Pakistan – Once bitten, twice shy
- The right way to conduct credit analysis of corporates...
- Internal audit – Partnering for success
- Compliance - New Areas of Focus



Financial Performance of the Banks

A look at the 2011 numbers

Contributors

Adnan Dilawar

Mr. Adnan Dilawar is associated with PACRA and heads their Research and Analytics Division.

Rehan Raza

Rehan Raza works in the Investment Banking area and is currently associated with MCB Bank Limited.

Mansoor Murad

Mansoor Murad is a Chartered Accountant by qualification, and works in the Retail Banking function of a large local bank. In his spare time, he is a freelance contributor to Dawn.

Terence Mauri

Terence Mauri is a leading management trainer and consultant with DC Gardener with over 15 years of international experience in the banking sector.

Simon Thompson

Simon Thompson is the Chief Executive of the Chartered Banker Institute, UK.

Zahir Ali Quettawala

Zahir Ali Quettawala is associated with Faysal Bank Limited and heads their Information Technology Security and Risk Management division.

Usman Majid

Usman Majid is associated with HBL as a Senior Manager for ATMs and Web Portals.

Keith Aitken

Keith Aitken is an award-winning journalist, author and broadcaster. He is a freelance writer specializing in business and political affairs.

Shona Macdonalds

Shona Macdonalds is associated with Editions Financial as a Senior Publishing Manager.

Zulfikar Causer

Zulfikar Causer is a Chartered Accountant and a Partner at BDO Ebrahim & Co. Chartered Accountants specializing in assurance and risk advisory services.

M A Khan

M A Khan has been a career banker with over 41 years of experience in Pakistan and overseas. He is currently associated with IBP as a trainer.

Mir Mohammad Alikhan

Mir Mohammad Alikhan has been an investment banker since the last 20 years, running an investment banking firm with operations in 7 countries. Mir currently is a consultant.

Saad Hashmey

Mr. Saad Hashemy is Chief Economist at Allied Bank. Saad has been associated with different organizations (local and international) for over 11 years in financial and economic research roles.

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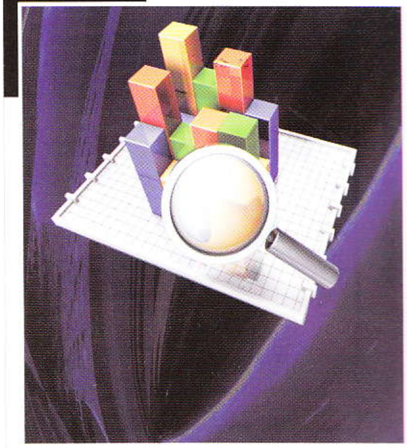

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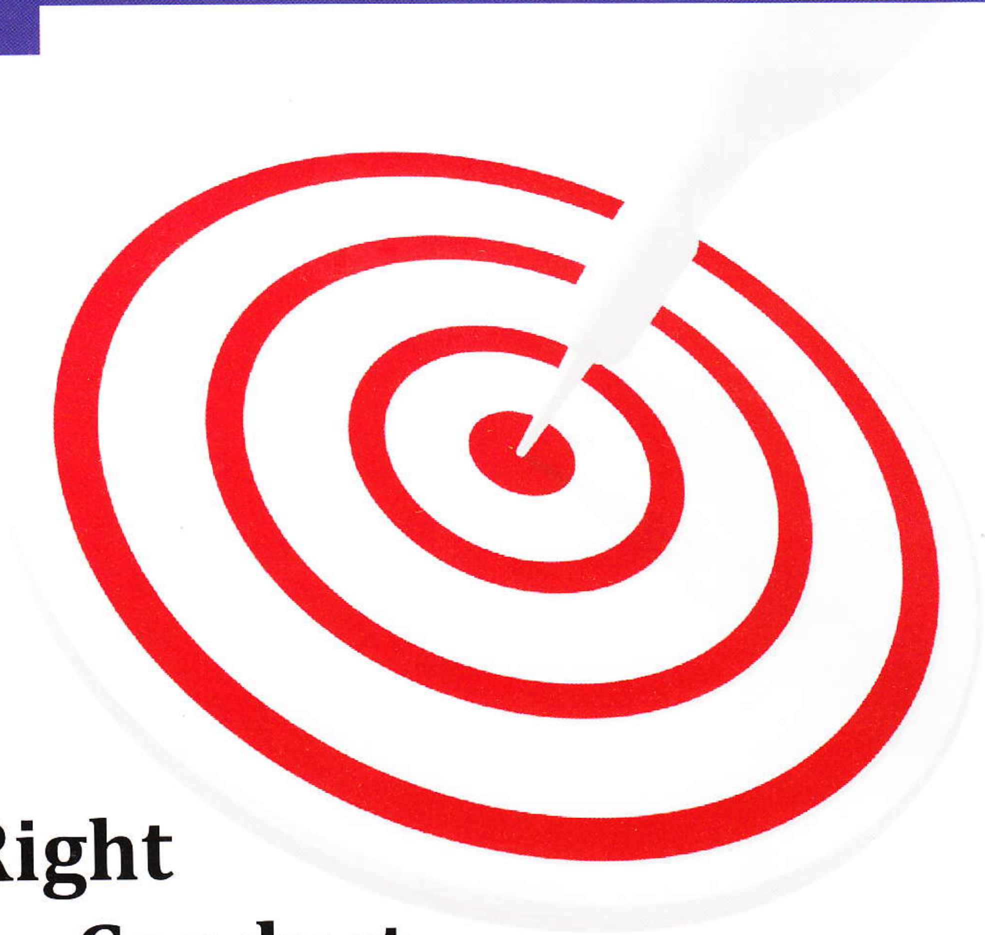


The Right Way to Conduct Credit Analysis of Corporates

A Rating Agency's View

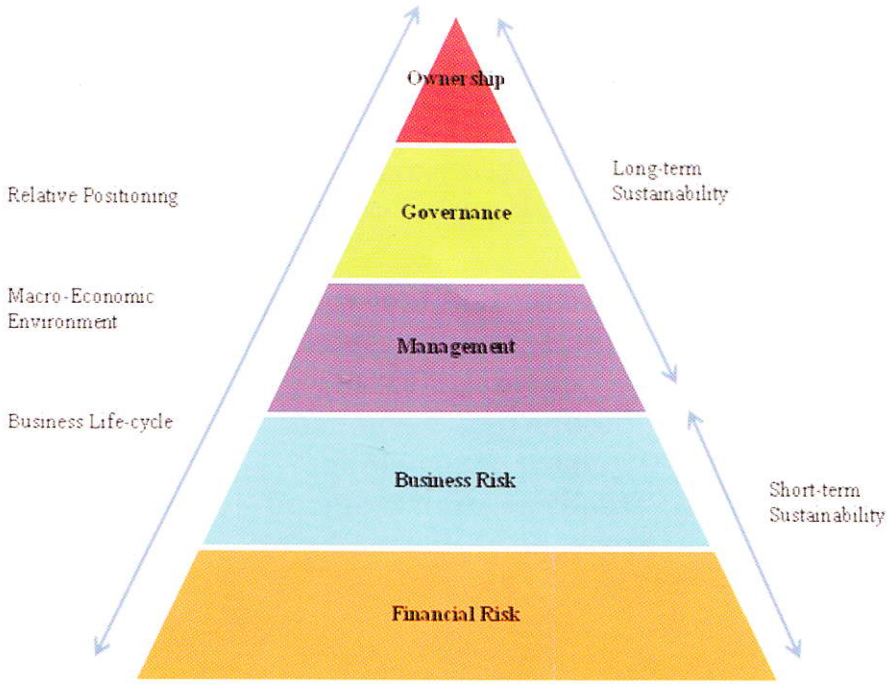
"Rating is an opinion that depicts the relative credit worthiness of an entity".

This, in varying forms and words, seems to be the mantra of credit rating agencies (CRA) across the globe. Let's try to demystify the phenomenon.

By Adnan Dilawar

Although rating is an opinion, it is the essence of several *qualitative* and *quantitative* factors analyzed carefully. CRAs conduct credit analysis with the aim to capture all the risks that can affect the financial strength of an entity and, in turn, its ability to meet its financial obligations. These risks could be systemic, idiosyncratic, stand alone or interconnected. Another point to consider is that ratings are prospective by nature. This elicits that relevance of past trends and ratio analysis is only valid if they have a significant impact on the future prospects of the entity. Thus, credit analysis of an entity should incorporate all the broad factors, which may transpire into material risk, going forward. Let's follow a top down approach to look at critical factors from this perspective. Some of these factors impact the long-term sustainability of the entity, while others can have immediate repercussions.

Ownership: Here it is important to distinguish between the *"owners"* and *"sponsors"* of an entity. Owners refer to the major shareholders of the entity. This could be another group company, small stakeholders or other entities depending on the corporate structure. Sponsor is an individual(s) in whom the eventual ownership of the entity terminates. S/he is the *"person at the last mile"* or where ultimately the buck stops. The ability and willingness of the sponsors to support the entity in time of duress is a critical factor while assessing the creditworthiness of the underlying entity.



Governance: It is the medium where owners/sponsors, minority shareholders, management and other stakeholders interact and manage their relationships. Governance is the mechanism through which companies are controlled and monitored. Corporate governance factors that should be examined from a credit analysis view include: composition of the Board of Directors (BoD), Independence and effectiveness of the BoD, transparency of BoD practices, and finally, BoD's ability to comprehend and monitor inherent risks. All things being equal, strong corporate governance ensures long-term sustainability and growth of the company, hence curtailing its credit risk.

Management: These are the people who actually run the show. It is a well documented fact that management quality and performance of an entity are directly correlated. So it becomes crucial to gauge the quality of human resource of an entity while forming an opinion of its financial strength. In this regard, properly defined organization structure, background and track record of key personnel, cohesion of the management team, stability in the management structure and proper succession planning can have substantial bearing on the prospects of the entity.

Business Risk: Business risk is the probability of loss inherent in an entity's operations and environment that may impair its ability to generate profits. Each entity is expected to have its own business risk profile comprising unique characteristics. Profit and Loss account statement is a microcosm of business risk factors and should be scrutinized item by item to quantify internal as well as some of the external risk factors. Meanwhile, identification of right industry, its correlation with the overall macroeconomic environment and relative competitive positioning of the entity within the industry are essential to truly capture the business risk and resultant credit worthiness of the entity.

Financial Risk: The dreaded "F" word may be the most used terminology in the financial sector. Yet, there is no universal approach to capture it. From a credit analysis perspective, financial risk primarily emanates from balance sheet structuring (leveraging). Here, the most critical aspect is to identify any maturity mismatches that may arise. The cash flow statement reflects the coverage available against this risk. The age old mantra of *"Cash is King"* still holds true today. Adequate internal cash generation ability is considered the best safeguard against financial risk. Thus, free cash flow to firm is the most meaningful denominator for any coverage ratio calculation.

Another aspect to determine is the current life cycle/business cycle of the entity. The above factors would have varying criticality for each stage (initial, growing, mature, decline) of an entity. Moreover, entities do not operate in isolation. They are affected by external environment, especially competition. So the law of relativism applies and credit analysis cannot be confined to standalone basis only.

It is fair to say credit analysis is not an exact science. In fact, it is as much art as science and an optimal balance of the two leads to best results.