CARE Ratings AFRICA

CARE RATINGS
(AFRICA) PRIVATE LIMITED.

Prelude

#1		Mané	Liverpool FC	352 1VS1 INDEX
#2		Virgil	Liverpool FC	348 1VS1 INDEX
#3		Mahrez	Manchester City	346 1VS1 INDEX
#4		Salah	Liverpool FC	346 1VS1 INDEX
#5		de Bruyne	Manchester City	343 1VS1 INDEX

Quick Questions:

- Did the Club position matter ?
- Will the score remain same across the seasons ?
- Can scores of players across leagues be compared ?
- Does these scores/rankings have an impact on their contract signings ?

Prelude

Why is Risk Based Pricing Required ?

- Compensate the bank for providing loans to high risk customers.
- Reward good customers with lower risk profiles by lending to them at lower rates of interest.
- Allow the Bank to factor in all costs related to loans advances.
- Promote Credit Consciousness and Discipline.

- Application Scorecards/Rating Models – Bureau /Rating Agencies
- Behavioural Scorecards/Models
- Shouldn’t be a black box
- Constant Monitoring – Back testing, model Validation
- Model Recalibration

- Risk based pricing involved computing the minimum interest rate to be applied based on the trade-off between transaction level RAROC and hurdle rate, which represents the minimum RAROC that must be achieved from the loan.
- Interest Rate =

  [(Hurdle Rate * Incremental Capital) + Cost of Funds + Operating Expenses + Expected Loss]

  Total Value of Loan

- **Hurdle Rate**
  - Hurdle rate is the minimum rate of return on a loan at which the bank will extend loans or make an investment.
  - Weighted Average Cost of Capital (WACC) is usually considered as the Hurdle Rate.
  - Alternately, benchmark rates such as treasury bond rates can be considered as the Hurdle Rate instead of WACC.

- **Incremental Capital**
  - Incremental capital is the additional capital which will be required to be set aside for the loan to be given under the regulatory capital computation requirements.
  - Credit Risk Weight Asset amount is considered as the incremental capital amount.
- **Cost of Funds**
  - Cost of Funds is the cost of funding the loan amount which the bank encounters.
  - Cost of Funds can be computed at tenor level, product level and business unit level based on the structured and policy of the bank.
  - Cost of funds is derived using the Marginal Cost of Funds (MCoF) computation.

- **Operating Cost**
  - Operating Cost is the share of common operating expenses which are attributable to the loan which is being advanced to the customer.
  - Operating Cost can be computed at a product level or business unit level based on how the relevant expenses are maintained/recorded at a bank .
- **Expected Loss**
  - Expected loss is the amount of loss the bank may encounter as a result of advancing a particular loan
- There are 2 main approaches for considering Expected Loss in the Risk Based Pricing Computation
  - Credit Risk IRB Expected Loss.
  - IFRS 9 Expected Credit Loss.
- In absence of the above two, asset provisions based on prudential guidelines.

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1

Rate on Loan must be high

Enough to cover costs of funding

2

Rate on Loan must be sufficient

to cover administration costs (cost of origination and monitoring the loan)

3

Rate of Loan provide

adequate compensation for the credit risk, liquidity risk and interest rate risk

CARE RATINGS (AFRICA) PRIVATE LIMITED.
P. O. BOX 76176,
00508.
Nairobi, KENYA

+254 7203 45351

kenya.craf@careratingsafrica.com

http://www.careratingsafrica.com/