

RATING METHODOLOGY

Development Credit Guarantee Institutions

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BACKGROUND

Over the last three decades, infrastructure deficit in developing countries has widened. International Finance Corporation estimates that about \$2 trillion is needed to bridge the infrastructure gap in developing countries. Unfortunately government revenue has been insufficient in providing the necessary infrastructure. On the other hand, political instability, high population growth and weak institutions have discouraged private investment in long term infrastructure projects in developing countries. Given the heightened credit risks, interest rates on funds available for infrastructure development has been high while the tenures have been short.

Development Credit Guarantee Institutions (DCGI) have evolved to address the infrastructure challenge in developing countries. DCGIs are formed by sovereigns and or by Multilateral Financial Institutions (MFIs) with a mandate of providing guarantees for infrastructure projects in order to make them attractive to investors. It is expected that the guarantee will support the development of a robust market for long term infrastructure funding at low-interest rate. Financial products created are expected to appeal to pension funds, foundations, sovereign wealth funds, endowments, insurance companies and other investors with long duration portfolio. The primary aim of a DCGI is to bridge the infrastructure gap in developing countries. The institution can either be profit-oriented or solely focused on its developmental objectives.

Agusto & Co. recognises that DCGIs are not banks and they are not subject to banking industry regulations of any country. They are governed by the regulations set by their board of directors and sponsors. Agusto & Co also take into cognisance the fact that DCGIs do not support developmental projects by disbursing cash but provide comfort for financiers and investors in the form of guarantees. The DCGI can fully or partially guarantee the credit risk in the underlying transaction solely or in collaboration with other MFIs.

An **Agusto & Co. Development Credit Guarantee Institution Rating** is an independent assessment of the credit quality of a DCGI. An Agusto & Co.'s rating of a DCGI takes into cognisance the credit assessment (underwriting) standard of the Institution as well as the support of sponsors. The vulnerability of guaranteed projects to changes in the political and macroeconomic environment will also be taken into consideration in view of the long term nature of guaranteed projects and the volatile political environment in developing countries. In addition, we also attach importance to the institution's guaranteed projects relative to the capital base (leverage position) in determining the risk profile of the institution. Available callable/contingent capital will also be taken into consideration.

The ownership of the DCGI by any of the developed countries as well as the highly-rated MFIs will be viewed positively by Agusto & Co. We will also assess the level of support and the ability of sponsors in a period of weak capitalisation. We will view such support from the context of callable/contingent capital.

Agusto & Co will review the governance of the institution in the context of ownership strength, separation of powers, transparency, quality of board members and effectiveness of the board of directors. We will also examine the ability of the board to provide the right support for the DCGI in view of the high-risk environment in developing countries. Our requirements for corporate governance is explained further in section 6.

The rating is not an audit or an equity opinion and therefore does not assess the ability of the DCGI to create value for its shareholders. It is merely a forward-looking evaluation of the ability of the DCGI to meet its obligations as and when due. We are therefore not liable to any third party who relies on our opinion.

Our track record in providing independent ratings dates back to 1993 when we initially rated all 129 banks in existence in Nigeria at that time on an unsolicited basis. In 1997, we discontinued our unsolicited ratings of banks and requested Nigerian banks to solicit an independent rating from Agusto & Co. Limited. From 1998, the scope of our rating expanded to include the full gamut of financial institutions - Discount Houses, Insurance Companies, Finance & Leasing Companies, Primary Mortgage Institutions, Asset Managers, Mutual Funds, Municipal bonds, Corporate bonds, Financial Institution bonds – Industrial Companies and Structural Finance.

Agusto & Co. ratings are acceptable both locally and internationally. Users of our rating publications include major supranational and international banks such as International Finance Corporation, The World Bank, African Development Bank, FMO Holland, HSBC, Standard Chartered Bank, Barclays Bank, Credit Suisse, US EXIM Bank, Bank of Japan, Reserve Bank of South Africa, European Investment Bank, Commonwealth Development Corporation, JP Morgan Chase, ING, BNP Paribas, Citigroup etc. as well as major reinsurance companies and insurance brokers such as Munich Re, Swiss Re, African Re, J. B, Borda, Alexander Forbes e.t.c. These are in addition to all the Pension Fund Administrators, Treasurers of Nigeria's major companies, Treasurers of insurance companies, reinsurance companies, as well as a diverse spectrum of local and foreign investors and Issuing Houses

Over the years, these institutions and many more have relied on the high quality of our credit ratings and our opinions to make their decisions.

RATING OBJECTIVES

Our principal objectives in analysing and rating the DCGIs are to:

- Assist the DCGI's investors and other stakeholders better understand the risk(s) attributable to investing in the institution
- Provide an independent opinion on the credit quality of the DCGI.

Each rating report contains:

- Background information on the DCGI
- Financial indicators of the DCGI and sponsors
- Corporate governance
- Assessment of compliance with the developmental mandate
- Underwriting standards
- Risk management
- Competence and expertise of management and staff
- Analyst's comments on the DCGI's ability to meet its financial obligation
- A risk rating indicating the date of issuance and the expiry date.

RATING PHILOSOPHY

Agusto & Co. ratings are based on both quantitative and qualitative criteria. These include an evaluation of audited financial statements, un-audited management account and other information provided by the Institution. We analyse the financial condition of the Institution over a three year period, using the current year as the focal period and we assess other issues which we consider necessary before arriving at a rating.

We understand the need to converse with management and obtain additional information which may not be available in the public domain to arrive at a meaningful rating. Therefore, we seek both historical and forward-looking information from management on issues, pertinent to arriving at an appropriate rating for the DCGI concerned. All confidential information obtained through this process is used solely for the purpose of arriving at the rating and will not be published or otherwise disclosed to third parties without the prior consent of the DCGI.

In recognition of the changing circumstances that may quickly invalidate a current rating, we review our ratings in instances where there are significant subsequent events. These reviews will be based on both published financial statements and possibly un-audited interim financial statements. The rating may be changed, suspended, or withdrawn at any time. However, the reason for the change, withdrawal or suspension will be communicated to the DCGI in advance.

OUR RESPONSIBILITY

The relationship between the rated DCGI and Agosto & Co. is contained in a standard letter of engagement, which is addressed to Agosto & Co. by the DCGI. The letter sets out the contractual relationship between the DCGI being rated and the rating agency.

THE RATING PROCESS

Our rating exercise commences with information gathering using our standard questionnaire and an analysis of the financial condition of the DCGI. After meeting with the principal officers of the institution, reviewing market focus, strategies, performance and post reporting date events, a draft rating report is then prepared on the DCGI being reviewed. This will contain background information and comments on (but not limited to):

- Capital
- Asset quality and underwriting standards
- Earnings
- Leverage
- Liquidity and funding
- Corporate governance
- Investment management
- Business structure, ownership, management and staff
- Risk management

The draft Rating Report (without a rating) is sent to the management of the DCGI. We then meet with management to discuss this report and:

- correct factual errors
- exclude any information which the financial institution may consider confidential
- note any opinion(s) expressed in the report which they disagree with and reason(s) for the disagreement.

The corrected Rating Report is then presented to our Rating Committee. The Rating Committee will also be informed of any areas of disagreement with the DCGI's management during the draft Rating Report review.

The Rating Committee is provided with the scores of the DCGI and any other qualitative information that may be relevant to the approval of a rating; the analyst will also include a rating recommendation.

The Rating Committee then assigns a rating to the DCGI keeping in mind that the rating is forward-looking and assessing the financial condition and the ability of the financial institution to meet its obligations as and when due. It also takes into account macro-economic and industry information at its disposal.

The Rating Report (with a rating) is then sent to the DCGI's management. Our analyst(s) will once again meet with the management of the institution to discuss the report and justify the rating if required.

The DCGI may disagree with its rating even after a justification meeting. There is the opportunity for one appeal to the Rating Committee. It is expected that the appeal will be accompanied with new/additional information that will assist the Rating Committee in arriving at a decision on the appeal. The decision of the Rating Committee on the appeal shall not be subject to another appeal.

Monitoring

The rating assigned to a DCGI is monitored throughout its life. Changes in the macro-economic, political climate, and/or the organisation may make us change an assigned rating. The reason for the change is usually communicated to the institution's management.

RATING METHODOLOGY

Agusto & Co employs a top-down approach in carrying out a rating, as outlined below.

Analysis of Sponsors

As an integral part of our DCGI rating, we assess the ability of sponsors (sovereign and MFIs). To review this support, we analyse the financial strength of the sovereigns as well as the MFIs over the last three years. In addition, the macroeconomic environment and political issues in sponsoring sovereigns will also be analysed. Furthermore, issues that could impact the ability of sponsors in providing proposed support will also be reviewed. At the end of the analysis we assess the:

- Capital adequacy of each sponsor
- Earnings and profitability
- Liquidity
- Allowable exposure of each sponsor
- Other factors that can impact the sponsor's ability to honour promised support.
- Macroeconomic policies of sponsoring sovereigns
- Stability of the political climate
- Demography, education and structural factors
- Labour market environment

- Structure of output and trade

We use the information above to obtain an indicative Agosto & Co. rating for each sponsor. In cases where such data are not readily available, we may use publicly available ratings of reputable international rating agencies for each sponsor.

Company Analysis

We consider both objective and subjective criteria. We have specific benchmarks in the following broad areas which we apply across the board:

1. Capital

Our criteria for determining the adequacy of capital focuses on the institution's ability to meet capital requirements to support its business. In analysing the DCGI, we look at the support from the shareholders and rank them on the basis of their commitment

- Shareholders' funds
- Callable/contingent capital
- Paid-up capital as a proportion of total capital
- Capital as a proportion of total assets
- Capital as a proportion of outstanding guarantees issued
- Developmental Exposure

When assessing capital adequacy, Agosto & Co places more weights on paid-in capital and equity than callable/contingent capital. Nonetheless, the availability and adequacy of callable capital are taken into cognisance in the analysis of sponsors. Although DCGIs are not subject to regulatory capital adequacy ratios such as the Basel standards, we recognise that most DCGIs have internal minimum capital adequacy ratios in line with international best practices. Agosto & Co considers these ratios in assessing the adequacy of the DCGI's capital.

2. Asset Quality and Underwriting Standards

In forming an opinion on asset quality, we focus on the asset mix and quality of the institution's guarantee portfolio.

- The size and quality of the guarantee portfolio
- The quality of obligors
- The developmental role of projects
- The vulnerability of projects to political and macroeconomic changes
- The sectoral, obligor and geographical concentration
- The underwriting standards applicable to different sectors
- The called guarantees and recoveries

3. Earnings

Agusto & Co. places significant emphasis on the sustainability of earnings and the institution's operating profitability. Given the developmental role of DCGIs, less emphasis is placed on high profitability ratios. Nonetheless, we consider positively stable growth of earnings.

- Earnings mix
- Sustainability of income
- Revenue and expense trends
- Performance ratios

4. Leverage

We consider leverage to be a key rating factor and place emphasis on this criterion. The leverage ratios are assessed against the internal benchmarks of the DCGIs and are subject to review based on risks inherent in the guarantee portfolio and the macroeconomic conditions of the country of operation.

- Adjusted core capital to total guarantees issued
- Callable/contingent capital to total guarantees issued
- Profile of co-guarantors
- Debt portfolio

5. Liquidity & Funding

We are particularly interested in the institution's liquidity profile, policies and contingency plans. In addition, the quality of liquid assets is imperative.

- Funding mix
- Asset and liability management
- Portfolio of liquid assets to total assets

6. Corporate Governance

We believe effective corporate governance is imperative to the success of the DCGI particularly as the institution is self-regulated.

- Ownership structure
- Likelihood of support
- Independence of the board of directors
- Technical skills and support of the board
- Board appointment and processes
- Remuneration of board members
- Responsibility and accountability of the board
- Board committee

7. Investment Management

We also analyse the investment portfolio with a focus on liquidity and its risk profile.

- Investment philosophy
- Investment mix
- Credit risk
- Liquidity risk
- Market risk
- Diversification by asset class and industry sector

8. Business Structure, Ownership, Management & Staff

Our review of the DCGI's organisational structure seeks to determine its ability to exercise timely and organised control over the activities involved in the performance of its obligations. We also review the adequacy of staffing and the ability of the institution to retain its staff and staff productivity.

- Quality of executive management
- Track record of executive management
- Compliance with internal regulation
- Stability of key staff
- DCGI's experience/years of business history

9. Risk Management

Our review examines the DCGI's risk management structure i.e. the practices and processes the DCGI adopts to manage its business risks. This includes tools and processes used to assess and monitor investment-oriented risks in the portfolios it manages.

- Existence & strength of risk management
- Strength of credit underwriting guidelines
- Adherence to approved credit underwriting standard
- Adequacy of the risk management framework
- Operational risk management framework
- Market risk framework

In addition to these criteria, we may also use the following criteria to upgrade or downgrade the rating;

- **Management/shareholder conflict**

A Development Credit Guarantee Institution will be downgraded if there is open conflict between members of management and/or shareholders and we believe that this may have (or has had) an adverse effect on the DCGI's financial condition.

- **Significant changes in ownership**

We may downgrade the Development Credit Guarantee Institution if there is a significant change in ownership and there are uncertainties about;

- (1) The character of the new owners, and/or
- (2) The ability of the new owners to sustain a good track record or turn around an ailing institution.

- **Credit Rating of Sponsors**

Agusto & Co. also reserves the right to modify an assigned rating on the basis of changes to the credit rating of sponsoring sovereigns and MFIs. This is particularly relevant where the institution's callable capital is concentrated in a few MFIs.

- **Other factors**

A rating is an opinion of the quality of risk presented by a particular Development Credit Guarantee Institution. This risk is affected by a variety of factors which no one can predict at a particular point in time. Accordingly, where any issues come to our notice which we believe will significantly affect the financial condition of the DCGI or the level of risk inherent in such an institution, we will take such factors into account in arriving at a rating.

RATING DEFINITIONS

Agusto & Co. rating categories conform to an internationally recognizable designation for rating categories. A comparison of our rating category is shown below.

Agusto & Co	Fitch's Equivalent	Moody's Equivalent	S & P's Equivalent
Aaa	AAA	Aaa	AAA
Aa	AA	Aa	AA
A	A	A	A
Bbb	BBB	Bbb	BBB
Bb	BB	Bb	BB
B	B	B	B
C	C	C	C

Aaa A Development Credit Guarantee Institution of impeccable financial condition and overwhelming capacity to meet obligations as and when they fall due.

Aa A Development Credit Guarantee Institution of very good financial condition and strong capacity to meet its obligations as and when they fall due.

A A Development Credit Guarantee Institution of good financial condition and strong capacity to meet its obligations.

Bbb A Development Credit Guarantee Institution of satisfactory financial condition and adequate capacity to meet its obligations as and when they fall due.

Bb Financial condition is satisfactory and the ability to meet obligations as and when they fall due exists. The Development Credit Guarantee Institution may have one or more major weaknesses.

B Financial condition is weak but obligations are still being met as and when they fall due. Has more than one major weakness and may require external support, which, in our opinion, is not assured.

C Financial condition is very weak. Net worth is likely to be negative and obligations may already be in default.

D In default

The first four categories of ratings are investment grade, while the last four are speculative grade. The ratings from Aa to Ccc may be modified by the addition of a plus or minus sign to show relative standing within the category.

BENEFITS

The benefits of a rating include the following:

- Our rating report is a ready reference document on the ability of each DCGI to meet its obligations. Subscribers can use the rating reports to form quick opinions on each DCGI, whilst saving the time that detailed analysis would have taken. It is not a substitute for the decision-maker's analysis but can be used when an immediate decision is required, or to form a preliminary opinion.
- It provides independent information to treasurers, credit risk managers or other persons who have responsibility for setting risk acceptance criteria, setting and reviewing placement lines and monitoring the financial condition of other financial institutions.
- It provides independent information to investors who would like to know what supranational institution to select to manage their investments/charitable donations.
- Our publication of the rating on our Internet site and a national newspaper provides a wide usage and publicity for the rated institution.