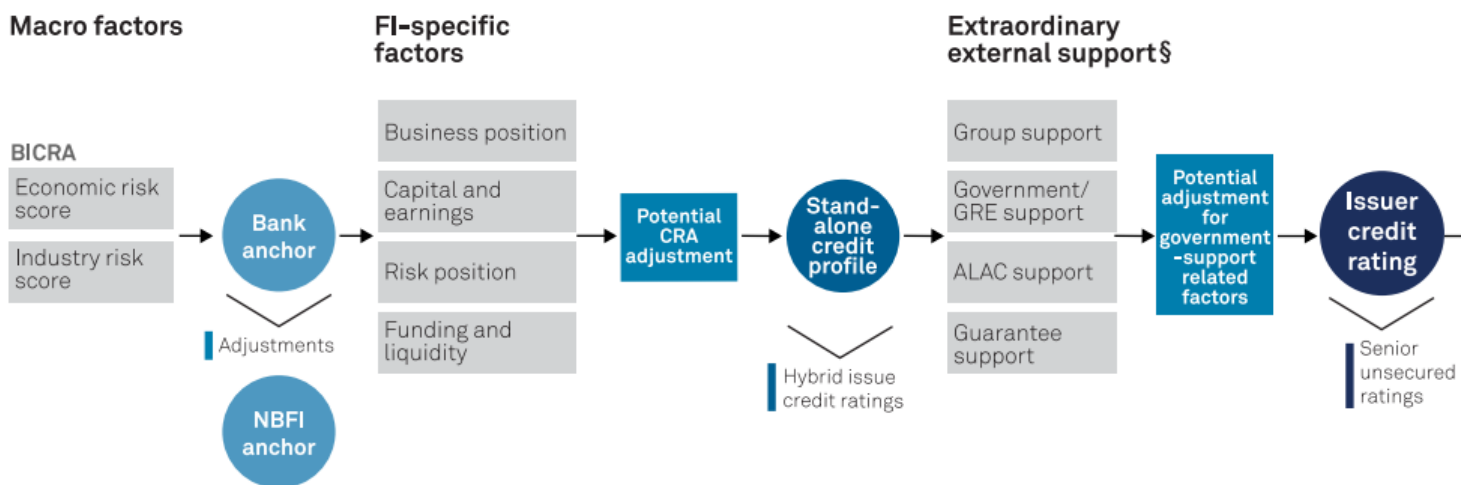


How We Rate Financial Institutions

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This article provides a summary of our financial institutions (FI) criteria. We apply our FI criteria to banks and nonbank financial institutions (NBFIs) to produce an issuer credit rating. The process starts with our Banking Industry Country Risk Assessment (BICRA) methodology, a macro analysis of economic and industry risk. Next, we look at FI-specific characteristics: business position, capital and earnings, risk position, and funding and liquidity. Finally, we assess the likelihood of extraordinary external support, including government and group support.

Financial Institutions Ratings Framework



BICRA--Banking industry country risk assessment. NBFI--Nonbank financial institution. FI--Financial institution.

BICRA Methodology: Macro Factors

Our BICRA methodology evaluates the strengths and weaknesses of global banking systems by assessing economic and industry characteristics in a standardized framework. This analysis incorporates an entire country's financial system, taking into account the impact of entities other than banks on the financial system. This allows for global comparison across all of the FIs we rate.

The BICRA methodology scores two components: economic risk and industry risk. We consider six factors in our economic and industry risk scores for each country. Combined, these produce an overall BICRA for a country. A factor that is assessed as high risk has greater weight in the BICRA.

A BICRA is scored on a scale from '1' to '10', ranging from the lowest-risk banking systems (group '1') to the highest-risk (group '10'). A BICRA score is based on a forward-looking time horizon of three to five years, but also incorporates factors beyond this horizon where we consider them to be relevant, material, and sufficiently visible.

The BICRA analysis incorporates a government's influence on the banking system, including existing emergency systemwide support programs. It excludes the potential for targeted government intervention and rescue of specific financial institutions.

The creditworthiness of a sovereign and its banking sector are, in our view, closely related. Many of the credit factors underlying a sovereign rating are important in determining a BICRA.

Economic risk

The BICRA economic risk score of a country captures the economic risk it faces. BICRA economic risk scores range from '1' to '10', from lowest to highest risk. Economic risk takes into account the structure, performance, flexibility, and stability of a country's economy; actual or potential imbalances in the economy; and the credit risk stemming from economic participants--mainly households and enterprises. The operating environment (economic, country, and industry) can have a strong influence on a bank's credit dynamics.

When an FI is active in more than one country, we calculate weighted-average economic risk. This is the average of the economic risk scores for the countries where the FI mainly operates, weighted by the proportion of its business that represents its main economic risks.

Industry risk

We determine a bank's industry risk based on the BICRA industry risk score for the country where it is domiciled and primarily regulated. For an NBFIs that is not subject to consolidated prudential regulation and that operates in multiple countries, we may use the industry risk of the country that we use as having the most influence on the entity's creditworthiness. The BICRA industry risk scores range from '1' to '10', from lowest to highest risk.

Industry risk assesses three structural features of a country's banking industry:

- The institutional framework, that is, the quality and effectiveness of bank regulation and the track record of authorities in managing financial sector turmoil;
- Competitive dynamics, that is, the competitive landscape and performance, financial products and practices, and the role of nonbank financial institutions; and
- Funding through the debt markets or government, including the role of the central bank and government.

The Anchor: Combining Economic Risk And Industry Risk

The BICRA economic and industry risk scores combined determine the anchor, which is the starting point for a rating. The anchor is a globally consistent, relative ranking of creditworthiness across national banking markets and ranges from 'a', the least risky, to 'b-', the riskiest.

We establish preliminary anchors for NBFIs sectors relative to the bank anchors in the same country. We then may apply a country/sector-specific adjustment or an entity-specific adjustment to arrive at the final anchor for an NBFIs. However, the final anchor for an NBFIs cannot be higher than the relevant bank anchor.

The SACP (Stand-Alone Credit Profile): The Result Of FI-Specific Analysis

The SACP results from adding or subtracting a number of notches to the anchor to take into account an FI's specific strengths and weaknesses in the following four areas:

- Business position,
- Capital and earnings,
- Risk position, and
- Funding and liquidity.

In addition, we may apply an adjustment of up to one notch in either direction to capture a more holistic view of creditworthiness by incorporating additional credit factors, which may be transitional or structural elements of an FI's creditworthiness that the criteria do not separately identify. In addition, we incorporate credit factors not fully captured in other SACP factors, which may be informed by peer analysis.

The assessment of each area (explained below) can raise or lower the SACP by one or more notches relative to the anchor, or have no effect in some cases. The result is an FI's SACP, an interim step in assessing overall creditworthiness.

Business position measures the strength of an FI's business operations. By strength, we mean specific operational features that add to or mitigate industry risk. The criteria group these features into three subfactors: governance, management, and strategy; business stability; and diversification. We assess relative strength through a number of indicators. Where they are relevant and available, quantitative metrics are used, though much of the assessment is qualitative.

Capital and earnings measures an FI's ability to absorb losses based on its level of capital and ability to replenish that capital through earnings and other sources. Thus, a capital and earnings cushion provides protection to senior creditors while the FI remains a going concern.

The analysis of capital and earnings comprises three steps:

- Assessment of compliance with regulatory requirements;
- Future risk-adjusted capital or, for some NBFIs, an alternative metric; and
- Assessment of strength and quality of capital and earnings capacity and quality.

We assess how an FI performs against its regulatory capital requirements, and when we believe it is at risk, subject to regulatory forbearance, or in breach, we cap the SACP at 'bb+', 'b-', and 'b-' respectively. The final SACP is no lower than 'b-' when applying this criteria.

The initial score for capital and earnings (subject to any cap that applied based on the outcome of our assessment of regulatory requirements) is generally based on the expected risk-adjusted capital (RAC) ratio before diversification. However, for some NBFIs, such as securities firms, debt to EBITDA may be applied when they have very limited credit and market risk associated with their business model and we believe they can operate on a going-concern basis without consolidated tangible equity. For finance companies, debt to adjusted total equity may be applied when we view a finance company's assets as materially riskier than a typical bank's assets in its jurisdiction.

We consider an adjustment to the initial score based on the impact of an FI's strength and quality of capital and earnings capacity and quality. The assessment of strength and quality of capital includes not only the composition of total adjusted capital (TAC) but also other factors such as approach to capital management and the relative strength or weakness of other capital metrics and financial flexibility. Our assessment of earnings capacity and quality reflects an entity's ability to absorb losses and build capital through stable earnings.

Risk position refines the view of an FI's actual and specific risks beyond the capital and earnings analysis. As such, we assess factors other than those reflected in capital and earnings, such as asset quality and risks related to other exposures.

Funding and liquidity are separately assessed and then combined as the final factor. How an FI funds its business, and the confidence-sensitive nature of its liabilities, directly affects its ability to maintain business volumes and to meet obligations in adverse circumstances. The analysis of funding considers the stability of an entity's funding sources and the likelihood they will be available to fund existing and new assets over an extended period to fund existing and new assets, including during times of market or idiosyncratic stress. Our liquidity assessment focuses on an FI's ability to withstand liquidity outflows that could occur typically under stress over the coming 12 months.

The SACP includes ongoing external support or interference from a government or a group.

Moving From The SACP To The ICR: Combining The SACP And Support Framework

We derive the ICR by combining the SACP and the support framework, which determines the extent of uplift, if any, for potential extraordinary external support, or the risk of extraordinary negative intervention or sovereign-related risks.

The support framework considers both the relationship between an entity and its external parties-- such as the parent group, government, or the loss-absorbing characteristics represented by ALAC (additional loss-absorbing capacity) securities--and how this affects overall creditworthiness. The potential ICR is the same as the SACP unless the FI is likely to receive additional capital, funding, liquidity, or risk relief from external parties in a crisis. Such support can arise from a parent group or government but can also come from a guarantor or from investors in ALAC-eligible instruments.

We may apply an adjustment of one notch in either direction for government support-related factors when we consider that the potential outcome understates or overstates the potential for extraordinary government support.

The potential ICR on an FI is the highest outcome resulting from the criteria assessment of these forms of potential support. We then apply any relevant sovereign constraints to the potential ICR in determining the ICR.

Related Criteria

- [Financial Institutions Rating Methodology](#), Dec. 9, 2021
- [Banking Industry Country Risk Assessment Methodology And Assumptions](#), Dec. 9, 2021

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