

## Criteria | Financial Institutions | Request for Comment: Banks: Rating Methodology

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### Table Of Contents

---

PROPOSAL SUMMARY

THE SCOPE OF THE PROPOSED CRITERIA

SPECIFIC QUESTIONS FOR WHICH WE ARE SEEKING A RESPONSE

A SAMPLE OF PRELIMINARY BICRA SCORES

POTENTIAL IMPACT ON OUTSTANDING RATINGS

RESPONSE DEADLINE

METHODOLOGY: SETTING THE ISSUER CREDIT RATING

METHODOLOGY: STAND-ALONE CREDIT PROFILE

A. Economic Risk

B. Industry Risk

## Table Of Contents (cont.)

---

C. The Anchor SACP: Combining Economic Risk And Industry Risk

D. Bank-Specific Analysis: Building On The Anchor SACP

E. Business Position

F. Capital And Earnings

G. Risk Position

H. Liquidity

### METHODOLOGY: SUPPORT FRAMEWORK

A. Government Support For Banks

B. Group Rating Methodology

C. Rating Banks Above The Sovereign

### RELATED CRITERIA AND RESEARCH

Criteria

Requests For Comment And Related Articles

Research

## Criteria | Financial Institutions | Request for Comment:

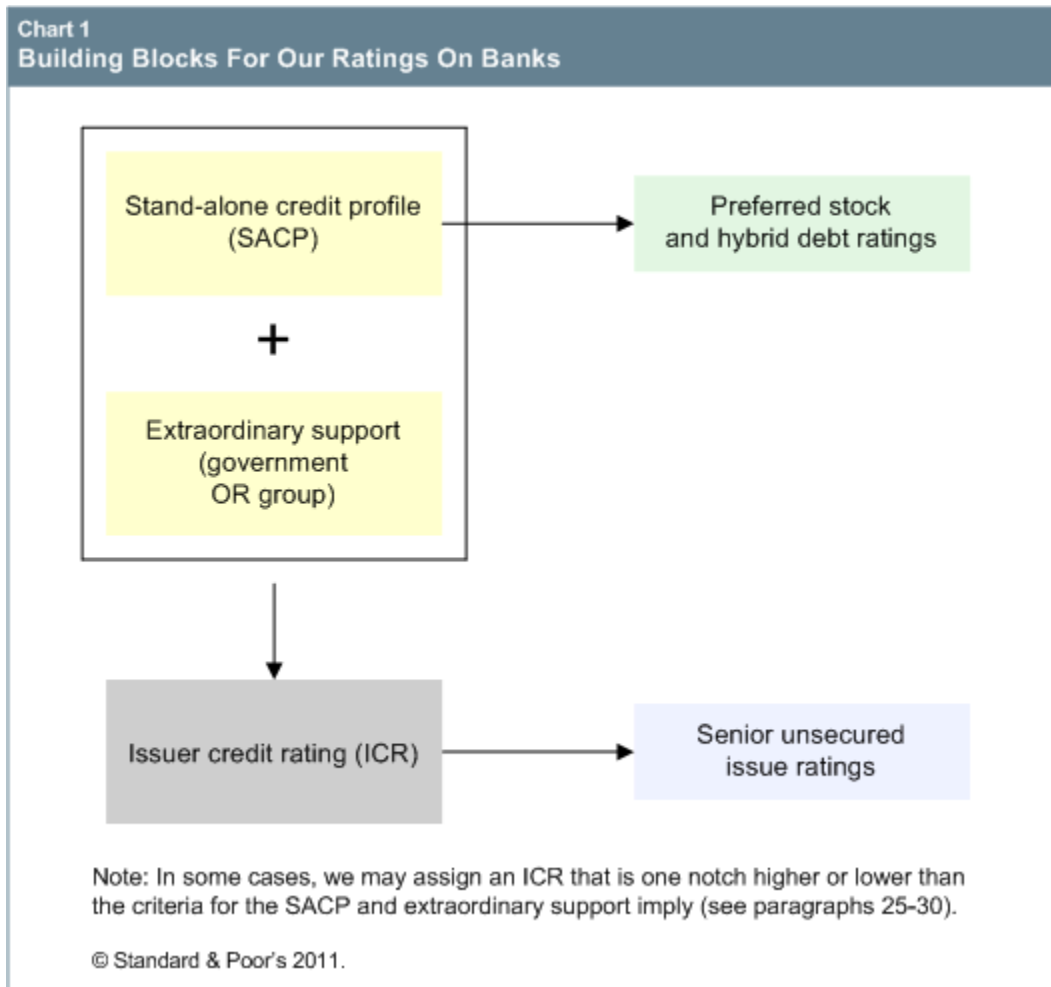
# Banks: Rating Methodology

1. Standard & Poor's Ratings Services is requesting comments on this proposal to revise its criteria for rating banks. It follows the "Advance Notice Of Proposed Criteria Change: Banks, Finance Companies, And Institutional Brokers," published March 11, 2010. In addition, we are reopening our comments period for the "Request For Comment: Methodology For Determining Banking Industry Country Risk Assessments," published May 13, 2010, because of the greater proposed importance of the assessments in the proposed bank criteria.
2. The proposed criteria would represent a significant change and is intended to enhance the comparability of ratings on financial institutions with ratings in other sectors (see "Understanding Standard & Poor's Rating Definitions") and improve transparency about how we assign ratings. The proposed criteria would constitute specific methodologies and assumptions under our "Principles Of Corporate And Government Ratings."
3. The proposed criteria place heightened emphasis on economic risk and industry risk in setting the starting point or "anchor" for a stand-alone credit profile (SACP) of all financial institutions. They then apply analysis of bank-specific factors, such as capitalization, management, risk position, and others, to determine the SACP for each institution. Lastly, the proposed criteria apply analysis of an institution's support framework, including both potential government support and corporate group support, to arrive at an issuer credit rating (ICR). (See "Stand-Alone Credit Profiles: One Component Of A Rating.")
4. In the aftermath of the global financial crisis that started in 2007, we are revising our criteria for rating financial institutions. The crisis brought about the demise of several major institutions including Lehman Brothers, Washington Mutual, and Glitnir Bank. In addition, the crisis caused others, including Fannie Mae, Freddie Mac, Citibank, and Bradford & Bingley to suspend payments on preferred stock or hybrid securities. The crisis also revealed that even more institutions likely would have defaulted if government bailouts or other initiatives had not saved them. In our opinion, extraordinary government actions prevented institutions such as Royal Bank of Scotland, UBS, Goldman Sachs, Morgan Stanley, Landesbank Baden-Wuerttemberg, Bayerische Landesbank, KBC, West LB, Bank of Ireland, Allied Irish Banks, Northern Rock, and Anglo Irish Bank from failing. Finally, several major institutions were forced into mergers with stronger banks, many of which needed subsequent government support to survive the crisis. Such failed institutions include ABN AMRO, HBOS, Fortis, Merrill Lynch, Wachovia, Dresdner Bank, Bear Stearns, and Countrywide Financial.
5. These proposed criteria would place the SACP for the average bank in developed economies in the 'bbb' and 'a' categories, and we use lowercase letters intentionally for these credit profiles to differentiate them from our ratings. As a result, we would assign higher SACPs only to those banks with stronger business positions and capitalization sufficient to withstand a scenario of severe or extreme stress without reliance on governmental or group support. We could possibly assign a higher ICR if we determine there is potential for such support. However, given the recent legislative response in some countries, we believe that some governments will be less likely to offer support in the future.
6. We expect the proposed criteria to limit rating movements on banks as a result of cyclical changes. That's because we are now emphasizing structural changes in the economy, a bank's business position, and its financial strength as key drivers of changes in creditworthiness. Bank ratings of 'AAA' will still be possible but a bank would possess business positions and capitalization that are much stronger than those of most of the banks we rate today.

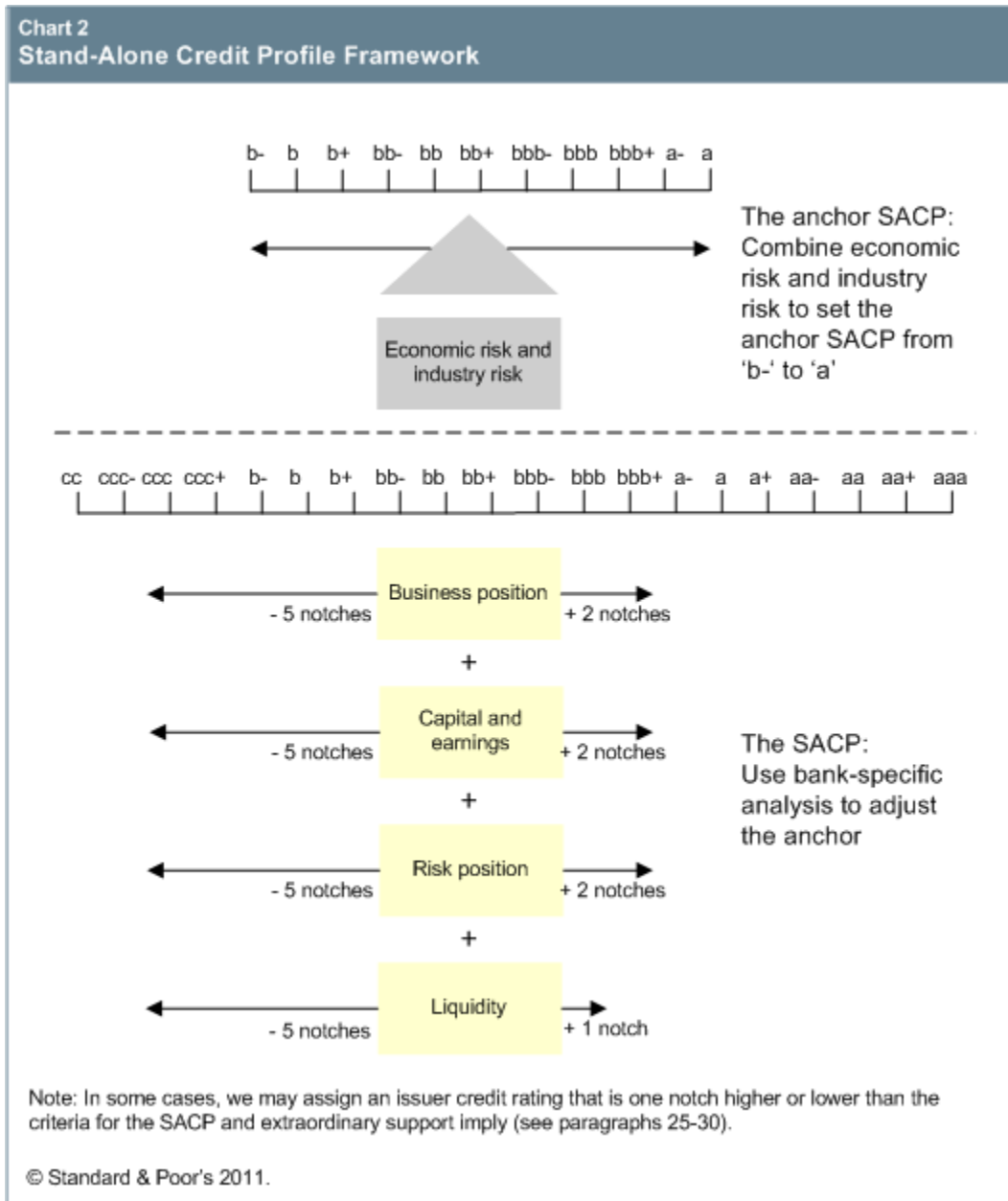
7. These proposed criteria will bring enhanced transparency to our ratings by articulating how we develop both the SACP and ICR for financial institutions and how we integrate the potential for additional direct support from their parent group or sovereign government. We introduce a systematic framework for determining SACP and ratings which will improve the comparability and replicability of our analysis and ratings. The framework integrates recent criteria developments into the methodology with better guidance, for example: our risk-adjusted capital framework, an increased focus on franchise stability and confidence sensitivity, and our credit stress testing methodology. If adopted, the proposed criteria will supersede most of our currently applicable criteria for banks, which we list at the end of this document. (Please note that all references to what we "will" do in this request for comment represent what we will do if we adopt criteria as proposed. References to what we "would" do also indicate what we will do if we adopt these proposed criteria.)

## **PROPOSAL SUMMARY**

8. There are three key steps in our proposed methodology. First, we apply the proposed criteria for the stand-alone credit profile or SACP (see "Stand-Alone Credit Profiles: One Component Of A Rating"). Second we apply the support framework, and third, after combining the SACP and support conclusions to produce a potential ICR, we set the ICR one notch up or down from the potential ICR based on the relative creditworthiness of the bank in its peer group (see chart 1). As the chart illustrates, we would assign issue ratings to hybrid instruments and preferred stock with reference to the SACP (see "Request for Comment: Bank Hybrid Capital Criteria: Methodology And Assumptions") and assign issue ratings to senior unsecured instruments with reference to the ICR.



9. We base our assessment of the SACP on six factors (see chart 2). The first two factors, economic risk and industry risk, draw on our Banking Industry Country Risk Assessment (BICRA) methodology. They represent the strengths and weaknesses of the broader operating environment that situate or anchor the SACP. The other four factors represent bank-specific strengths and weaknesses. Based on our opinions about these factors, we notch the SACP up or down relative to the anchor.
10. The support framework considers the relationship between the bank, and its parent group or government, and how this relationship alters a bank's overall creditworthiness.
11. We would assign a potential ICR that is higher than the bank's SACP if we believe it is likely that the bank would receive additional capital, liquidity, or risk relief from the government or the parent group in a crisis. In practice, a bank normally receives help from either its parent group or government--not both. Consequently, if a bank is a subsidiary, we analyze its creditworthiness using the proposed criteria for both government support and group support, and assign the highest potential ICR resulting from either the first approach or the second. We do not add the result of both approaches.



12. The proposed criteria will supersede most of our current methodology and assumptions for rating banks. Among some of the major changes are:

- We will recognize government support throughout the cycle and not just during a crisis.
- Increased importance to economic risk and industry risk through our proposed BICRA methodology in all SACPs on banks and greater transparency about the direct impact on the ratings of these two types of risk (see table 6).
- Introduction of specific standards about the impact of the risk-adjusted capital (RAC) ratio on the SACP. (We explain how to calculate the RAC ratio in "Bank Capital Methodology And Assumptions.")
- Repositioning of our earnings analysis to focus on risk-adjusted performance and a bank's ability to grow capital through retained earnings and the capacity of earnings to protect capital by absorbing normalized losses.

- Separation of our funding and liquidity analysis, and inclusion of funding in our assessment of business position.
- The integration of our analysis of enterprise risk management into our assessment of risk position so that we can systematically consider management's effectiveness for each driver and type of exposure.
- Specific guidance for assessing each rating factor and for combining them to determine the SACP and ICR.
- Less emphasis on unproven diversification benefits and greater emphasis on risks resulting from the added complexity of off-balance-sheet derivatives and structured finance.

## THE SCOPE OF THE PROPOSED CRITERIA

13. The proposed criteria apply to ratings on retail, commercial, and corporate and investment banks. Our definition of a bank is broad and includes the larger broker-dealers, mortgage lenders, trust banks, credit unions, building societies, and custody banks. This proposal does not apply to ratings on finance companies, asset managers, exchanges, clearing houses, and regional securities brokers. A request for comment on proposed criteria for these sectors will be published separately in the next few months. For these sectors, we expect to use the same overall framework we propose here but with different or additional sector-specific risk factors and metrics.

## SPECIFIC QUESTIONS FOR WHICH WE ARE SEEKING A RESPONSE

14. Specifically, Standard & Poor's is seeking responses to the following questions:
  - How appropriate is the weight that we give to economic risk and industry risk factors in the SACP? Do you think that the industry risk score needs a weighted average by country in the same way that we calculate a weighted average for economic risk?
  - What comments do you have on the BICRA methodology since we have decided to increase its importance in how we rate banks?
  - How well do the proposed criteria handle the risks of concentration and benefits for diversification as part of the assessments of business position and risk position?
  - Do you believe that any of the risks receive too much or too little weight in the SACP or ICR, or that any are unaccounted for or double counted?
  - Investment banking: How well does the adjustment for industry risk and subsequent business position assessment capture the relative risk between investment banking and more traditional commercial banking? Do you think that we could achieve the same or better result without adjusting industry risk and reflecting all the relevant differences in our business position assessment?
  - Sovereign support: What are your thoughts about our approach to sovereign support? Now that we will reflect the potential for future support throughout the economic cycle, do you think it is appropriate to expand the classification of government's tendency to support to more than three categories?
  - Capital and earnings: How appropriate are the benchmarks for the projected RAC ratio? What do you think about the way the proposed criteria position earnings in producing a credit rating?

## A SAMPLE OF PRELIMINARY BICRA SCORES

15. Because our proposed BICRA criteria are an important part of our proposed bank criteria, in this request for comment we are publishing preliminary BICRA scores for 23 countries that represent approximately 80% of

Standard & Poor's credit ratings on financial institutions (see table 1). To determine these scores, we applied the proposed criteria, with a few changes, in "Request For Comment: Methodology For Determining Banking Industry Country Risk Assessments." We based the changes on our review of the proposed criteria in light of the comments we have already received from the market (see paragraph 17).

16. "Preliminary Banking Industry Country Risk Assessments In 23 Countries," published Jan. 6, 2011, provides a brief rationale for each of these preliminary BICRA scores and some of the key metrics the proposed methodology uses.

**Table 1**

	Preliminary			Current
	BICRA group	Economic risk	Industry risk	BICRA group
Canada	1	2	1	1
Sweden	1	1	2	1
Switzerland	1	1	2	1
Hong Kong	1	2	1	2
France	2	2	2	1
Australia	2	2	2	1
Italy	2	3	2	2
Netherlands	2	2	3	1
Japan	2	2	3	2
Germany	3	1	4	2
Korea	3	3	3	4
Taiwan	3	3	4	4
U.S.	3	4	3	3
New Zealand	3	4	3	2
Spain	3	4	3	3
U.K.	3	4	3	3
Mexico	4	4	4	4
Brazil	5	5	5	5
India	5	6	5	6
China	5	6	5	6
Turkey	6	7	5	6
Russia	8	7	8	8
Kazakhstan	9	9	9	9

\*1-10 from lowest risk to highest risk. BICRA--Banking Industry Country Risk Assessment. Source: Standard & Poor's.

17. In response to the comments that we received since May 13, we modified the proposed BICRA methodology as follows:
- We retained the name "economic risk" as one of the two main areas of the methodology instead of a change to "country risk" as proposed in the BICRA request for comment.
  - We changed the formulas for adding the point totals of the three economic risk and three industry risk factors, and the buckets we associate with economic risk and industry risk scores 7, 8, 9, and 10 (see table 2).
  - We changed our approach to determining BICRA groups 1 to 10 from a points total for the six economic risk and



industry risk factors to a fixed combination of economic risk and industry risk scores (see table 3).

- We added guideline metrics to the "economic imbalances" factor that relate the speed and amplitude of a correction in real house prices.
- For the factor "credit risk in the economy," we apply separate and different guidelines for interpreting certain economic and financial systemwide measures for mature and emerging market economies.
- We expect to use more metrics than we initially proposed. Tables 6, 7, and 8 in the commentary, "Preliminary Banking Industry Country Risk Assessments In 23 Countries," show the main ones we propose to add to the BICRA methodology.

**Table 2**

<b>Determining Economic Risk And Industry Risk Scores</b>		
<b>New proposal*</b>	<b>Original proposal (May 13, 2010)*</b>	<b>Economic risk or industry risk score</b>
3-4	3-4	1
5-6	5-6	2
7-8	7-8	3
9-10	9-10	4
11-12	11-12	5
13-14	13-14	6
15-17	15-16	7
18-20	17-18	8
21-23	19-22	9
24-30	23-30	10

\*Point totals of the three economic risk and or industry risk factors (on a scale from 3-30, from lowest to highest risk). Source: Standard & Poor's.

**Table 3**

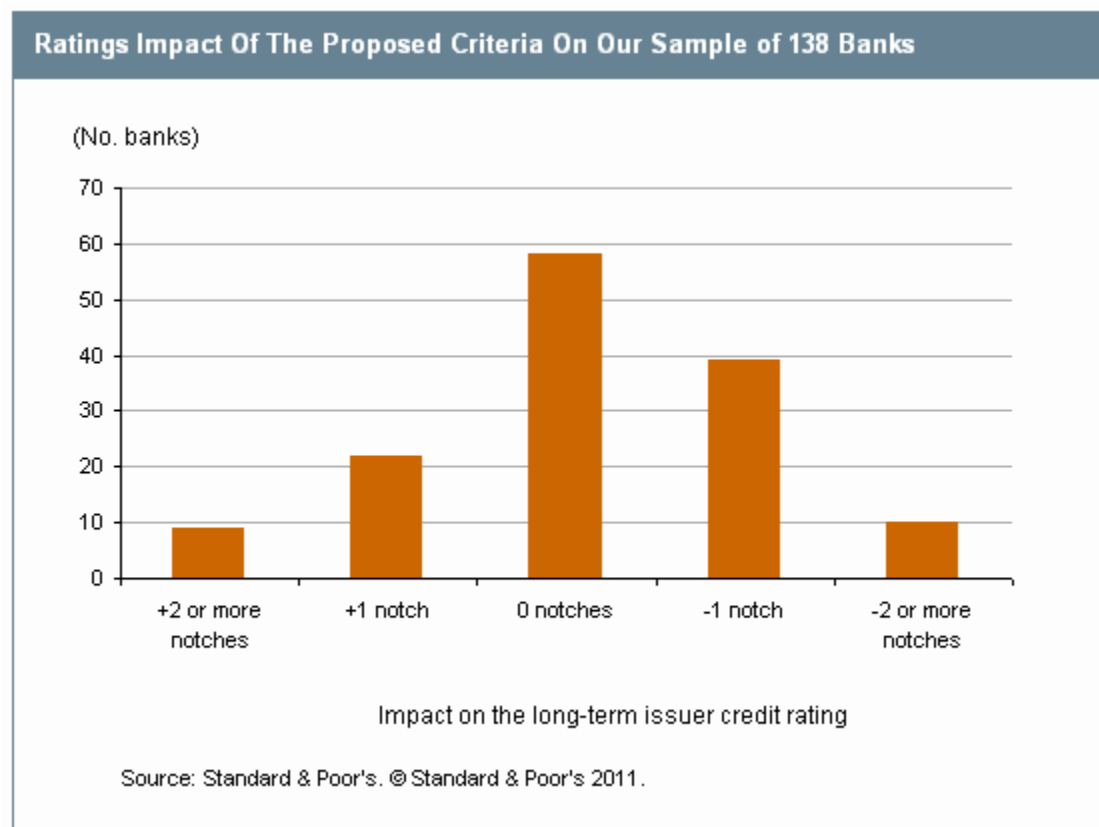
<b>Determining A BICRA Group Using Economic Risk And Industry Risk*</b>										
<b>Economic risk</b>	<b>Industry risk</b>									
	<b>1</b>	<b>2</b>	<b>3</b>	<b>4</b>	<b>5</b>	<b>6</b>	<b>7</b>	<b>8</b>	<b>9</b>	<b>10</b>
<b>1</b>	1	1	2	3	3	4				
<b>2</b>	1	2	2	3	4	4	5			
<b>3</b>	2	2	3	3	4	5	5	6		
<b>4</b>	3	3	3	4	4	5	6	7	7	
<b>5</b>	3	4	4	4	5	5	6	7	8	9
<b>6</b>	4	4	5	5	5	6	7	7	8	9
<b>7</b>		5	5	6	6	7	7	8	8	9
<b>8</b>			6	7	7	7	8	8	9	10
<b>9</b>				7	8	8	8	9	9	10
<b>10</b>					9	9	9	10	10	10

\*On a scale from 1-10, from lowest to highest risk. BICRA--Banking Industry Country Risk Assessment. N.A.—Not applicable. Source: Standard & Poor's.

## POTENTIAL IMPACT ON OUTSTANDING RATINGS

18. We have tested the proposed criteria on 138 banks we rate and our results indicate that the ratings impact would likely be modest. We are providing the results to give perspective to the reader, but it is important to note that the findings are subject to change based on the final criteria we adopt and the subsequent application of those criteria by our rating committees.
19. The sample comprised 47 banks from Western Europe; 38 from Asia-Pacific; 23 from North America; 17 from Latin America; and 13 from Eastern Europe, the Middle East, and Africa. The sample also included 35 of the world's largest banks by assets.
20. The results suggest that 85% of the long-term issuer credit ratings (ICRs) on the banks in the sample would remain the same or move one notch up or down (see chart 3). Of the remaining 15% of the ICRs, we found that about half moved up by more than one notch--especially on smaller institutions or niche players--and about half moved down by more than one notch.

**Chart 3**



21. However, there was a greater effect on our SACPs, as we expected and set out in "Advance Notice Of Proposed Criteria Change: Banks, Finance Companies, And Institutional Brokers," published March 11, 2010. Indeed, over 40% of the SACPs in the test declined by one notch or more. It should be noted that changes to SACPs have a more direct effect on our ratings on hybrid instruments than on ICRs. (See "Request for Comment: Bank Hybrid Capital

Criteria: Methodology And Assumptions," Dec. 6, 2010.)

22. For roughly half of the largest banks, the results show that the proposed criteria would result in downgrades--usually of just one notch for the long-term ratings.
23. Whenever we lower a long-term rating on a bank or its holding company to 'A-' or lower, we lower the short-term rating below 'A-1' (see "Methodology For Mapping Short-Term And Long-Term Issuer Credit Ratings For Banks"). The results show that the proposed criteria would result in downgrades for less than 20% of the banks and bank holding companies in our sample we currently rate 'A-1' or higher.

### Key Factors Affecting The Ratings In Our Test

24. The key factors in our proposed bank criteria that affected the ratings in our test were:
  - The greater importance of economic risk and industry risk factors. The proposed BICRA methodology results in some more negative risk conclusions for some national banking industries (see table 1). Even when BICRA scores did not change, the greater weight given to these two risk factors sometimes lowered SACPs in the 'aa' category.
  - Increased focus on credit stability. The proposed criteria embed into the SACP our view that banking is volatile and prone to crisis. In our testing, recognition of this volatility lead to lower ratings on some of the banks we currently rate the highest. As a result, we found that the highest long-term rating on the banks in our sample was 'AA'.
  - Greater emphasis on capital. Despite banks' efforts to improve capital levels, their leverage continues to be high. Therefore, we generally do not view capital as a rating strength for the banks we rate as a whole.

## RESPONSE DEADLINE

We encourage market participants to submit written comments only on the proposed criteria, including the BICRA request for comment, by March 7, 2011. Please send your comments to [CriteriaComments@StandardandPoors.com](mailto:CriteriaComments@StandardandPoors.com). Once the comment period is over, we will review the comments and publish the criteria.

## METHODOLOGY: SETTING THE ISSUER CREDIT RATING

25. In this part, we explain how application of the proposed criteria would result in the assignment of an ICR. First we establish the stand-alone credit profile for a bank, and then we determine the potential ICR by combining group or government support with the SACP. (We explain both of these steps in full in the next two methodology sections.) Finally we set the ICR at the same level as the potential ICR or one notch higher or lower according to the proposed criteria in paragraphs 27-30.
26. We refine our view of a bank's creditworthiness by considering its relative credit standing among all banks with a similar SACP, that is, the same or one notch higher or lower. For example, if we determine that a bank has an SACP of 'a-', we would compare the bank with other banks with SACPs of 'a', 'a-', and 'bbb+'. For the final peer review, our earnings buffer ratio (table 16 and paragraphs 120-125) and capital sustainability ratio (see table 15 and paragraphs 107-109) are the primary metrics for the comparison. The combination of these earnings measures means that stronger-than-average earnings are only recognized when a bank also maintains or grows capital. However, to highlight specific differences among the peer group, we may use other ratios or softer judgments about a bank's management and track record as well as the economic and industry outlook.

27. We may add a notch to the potential ICR when a bank is:
- In a positive transition that reduces risk or improves creditworthiness that is not already fully captured in the potential ICR; or
  - Subject to political, social, economic, or competitive trends that are strengthening creditworthiness; or
  - A sustained and projected outperformer in its peer group with ratios more reflective of the higher rating unless already captured elsewhere in the methodology.
28. We would not add a notch when a bank's regulatory ratios are "at risk" (see table 13) or if liquidity is "weak" (see table 20).
29. We may deduct a notch from the potential ICR when a bank is:
- In a negative transition that increases risk or reduces creditworthiness that is not already fully captured in the potential ICR; or
  - Subject to political, social, economic, or competitive trends that are weakening creditworthiness; or
  - A poor performer in its peer group with ratios more reflective of the lower rating.
30. Most of the time, there will be no need to adjust the potential ICR up or down. When we do adjust the potential ICR, we expect the aggregate adjustments to the universe of banks that we rate to be roughly even, and if not, no greater than a 2:1 ratio of upward to downward adjustments.

## METHODOLOGY: STAND-ALONE CREDIT PROFILE

31. Standard & Poor's "Principles Of Corporate And Government Ratings," which sets out the company's approach to analyzing credit risk, states that "business risk and financial risk are the main elements of corporate and financial institution analysis." Accordingly, in these proposed criteria, our analysis of economic risk, industry risk, and business position represents our analysis of a bank's business risk. And our assessment of capital and earnings, risk position, and liquidity represents the way we analyze a bank's financial risk.
32. In the past we assessed a bank's business risk and financial risk separately. In the proposed criteria, we instead consider the elements of these risks--but group them differently. That's because we believe that business risk and financial risk in the banking industry or system as a whole are often more important than differentiating features of specific banks within the industry or system. Economic risk and industry risk represent our macro analysis of the creditworthiness of a bank, while business position, capital and earnings, risk position, and liquidity represent our micro analysis.
33. We express the result of this analysis as a stand-alone credit profile (SACP, see "Stand-Alone Credit Profiles: One Component Of A Rating"). This is our starting point for assessing a bank's overall creditworthiness; we then take into account our views about support: the potential for extraordinary support from a parent company or government.
34. We plan to assign an SACP for most of the banks we rate. There are some circumstances when assigning an SACP does not make sense because of a bank's high degree of operational or financial integration with a parent or in a group. In these cases, we view the bank economically as a cost center or division, even though it may legally be a separate company (see paragraph 231).

35. The SACP methodology uses the economic risk and industry risk scores from our proposed BICRA criteria as a cornerstone. We are revising our methodology as we have explained in "Request for Comment: Methodology For Determining Banking Industry Country Risk Assessments." We will continue to express our opinions about economic risk and industry risk as whole numbers on a scale of 1 to 10, from very low to extremely high. The assessments are a relative ranking of credit strengths and weaknesses among national banking systems.
36. These proposed bank criteria emphasize our BICRA analysis more than our existing methodology. We currently use the BICRA as guidance for helping us determine a bank's highest possible rating before taking into consideration support. The proposed bank criteria use the BICRA methodology's economic risk and industry risk scores to determine a bank's anchor SACP (see the section The Anchor SACP: Combining Economic and Industry Risk starting at paragraph 53), our starting point in assigning issuer credit ratings. We then adjust the anchor SACP up or down the ratings scale after we take into account a bank's specific strengths and weaknesses.

## A. Economic Risk

37. Economic risk is the first factor we look at in determining the SACP. A change in an economic risk score might result in a change in the anchor SACP, SACP, or ratings on banks with business in that country.
38. To represent the economic risk of a bank, we use the BICRA economic risk score of the country or countries where it operates. The BICRA scores range from group 1 (very low risk) to group 10 (extremely high risk).
39. Economic risk takes into account our view of the stability and structure of an economy, its economic policy flexibility, actual or potential imbalances, and the credit risk of economic participants--mainly households and enterprises. In other words, we are looking at the potential for adverse economic developments and the country and banking system's capacity to adjust to them, and for problems with banks' borrowers and customers.
40. When the bank is active in more than one country we calculate a weighted average of the economic risk scores--what we call weighted-average economic risk (see table 4). We weight the economic risk scores according to the bank's proportion of business in each country that represents its main economic risks. Indeed, we want the economic risk score to reflect the bank's underlying economic risks. To avoid false precision we account only for countries when business there is more than 10% and round the percentage to the nearest 5%.

**Table 4**

Hypothetical Example Of Weighted-Average Economic Risk For A Bank			
Country	Weighting (% of business)	Economic risk*	Weighted economic risk
France	45	2	0.9
U.S.	20	4	0.8
Switzerland	15	1	0.15
India	10	5	0.5
Japan	10	2	0.2
Weighted-average economic risk	--	--	2.55

\*On a scale from 1-10, lowest to highest risk. Source: Standard & Poor's.

41. For lending institutions, we would weight according to the proportion of loans in each country. When lending activities are minor, we would weight using other measures of underlying economic risks. To do this, we would use a geographic breakdown of a bank's loan book or the adjusted exposure that we use in our capital analysis (see

"Bank Capital Methodology And Assumptions"). We may make adjustments for changes we anticipate in the bank's risk footprint--for example, as a result of acquisitions in new countries. We take a different approach for investment banking because we view it as a global business. Consequently for banks with significant investment banking activities (see definition in paragraph 49), it is the non-trading-related country exposure that is most relevant. For pure investment banks, we would use the economic risk score for the country where the bank has its headquarters.

42. A change in an economic risk score might result in a change in the anchor SACP, SACP, or ratings on banks with business in that country.
43. In addition, we use the economic risk score to scale some of the capital charges in our criteria for assessing a bank's capital--the risk-adjusted capital framework (RACF). We apply higher risk weights to the same assets in countries where we assess higher economic risk. The RAC ratio is one of our most important measures in the proposed bank criteria for our analysis of capital and earnings (see paragraph 102).

## B. Industry Risk

44. Industry risk is the second factor we analyze to determine the SACP, and a change in a BICRA industry risk score might result in a change in the anchor SACP, SACP, or rating on the bank.
45. To represent a bank's industry risk, we use the BICRA industry risk score for the country where it operates. The BICRA scores range from group 1 (very low risk) to group 10 (extremely high risk). The BICRA methodology's approach focuses on the risk of a country's particular banking industry for financial institutions engaged primarily in lending, deposit taking, and managing savings. For banks engaged in investment banking and trading activities, we modify this approach.
46. Industry risk primarily looks at the structural features of a country's banking industry: the quality and effectiveness of bank regulation and the track record of authorities in managing financial sector turmoil, the competitive landscape and performance, financial products and practices, and the role of nonbank financial institutions.
47. We also assess a banking industry's relative degree of risk taking via complex products, including financial derivatives. We associate aggressive use of complex products and derivatives with higher industry risk, and the absence of complex products and derivatives with lower industry risk. In addition, industry risk addresses the range and strength of funding options available to banks in a country, including the role of the central bank and government. We include elements of government support into the SACP via the industry risk score and explain this in more detail starting at paragraph 179 and from paragraphs 185 to 194 in particular.
48. We do not calculate a weighted average for industry risk when a bank operates in more than one country like we do for economic risk. The main reason for this is the importance of the home regulatory framework.
49. We do, however, adjust for investment banking activities, which we define as debt and equity underwriting, mergers and acquisitions (M&A) advisory, sales and trading, principal investing, and proprietary trading. We want the industry risk score to reflect a bank's underlying industry risk.
50. In our view, investment banking has different industry risk characteristics and is generally more volatile than other banking activities. Our proposed BICRA criteria do not include those characteristics, especially volatility from exposure to trends on the global capital markets. Consequently we have set the industry risk for investment banking at least at group 5 and one category riskier than the BICRA industry risk score for the bank's home country. For

example, when the BICRA industry risk is group 1, 2, 3, or 4, the investment banking industry risk score is group 5. When the BICRA industry risk is group 5, 6, 7, 8 or 9, the investment banking industry risk score is group 6, 7, 8, 9 or 10, respectively.

51. We set our investment banking industry risk at no better than group 5 based on our assessment of the industry's institutional framework, competitive dynamics, and funding. The level of business activity is closely tied to the state of the capital markets, and can be quite volatile. Moreover, operational risk is usually high for investment banks because significant operational failures could conceivably have catastrophic consequences. (See "Industry Risk For Investment Banking Is Generally Higher Than For Other Financial Institutions" for further explanation).
52. So, when investment banking activities account for more than 20% of a bank's earnings over the long term, we determine its blended industry risk, combining the domestic BICRA score and an investment banking industry risk score (see table 5). We weight this score according to how much investment banking operations contribute to earnings. To calculate blended industry risk, we combine these two industry risk scores and weight them for our expectations of investment banking's contribution to pretax earnings over the long term, rounded to the nearest 10%.

**Table 5**

Hypothetical Example Of Blended Industry Risk						
	Bank 1			Bank 2		
	Weighting (% earnings)	Industry risk	Weighted industry risk	Weighting (% earnings)	Industry risk (1-10, lowest to highest)	Weighted industry risk
Other banking	100	2	2	80	2	1.6
Investment banking	0	0	0	20	5	1
Blended industry risk	--	--	2	--	--	2.6

### C. The Anchor SACP: Combining Economic Risk And Industry Risk

53. We use the BICRA's economic risk and industry risk scores, adjusted as necessary, to anchor the creditworthiness of a bank in the broader operating environment. To determine the anchor SACP we associate the bank's economic risk and industry risk scores with a particular anchor SACP (see table 6). The anchor SACP is a globally consistent, relative ranking of creditworthiness across national banking markets from 'a', the least risky, down to 'b-', the riskiest.
54. The 'a' level is the strongest anchor SACP, which reflects the volatility of banking even in the strongest markets. Because they are confidence-sensitive and many carry high leverage, banks often respond more severely to otherwise moderate economic shocks. This volatility is inconsistent with high SACPs.
55. Under our criteria for credit stability, we do not assign a long-term ICR of 'AA' where we believe it would likely fall below 'A' within one year under moderate stress conditions or an 'A' rating where we believe it would likely fall below 'BB' within one year under the same stress (see "Credit Stability Criteria"). Significantly, observations of banking crises throughout history show that the SACPs of many important banks in developed markets would have fallen below 'a' under the proposed bank criteria. Therefore, even in countries that offer the most favorable environment, we set the anchor SACP no higher than 'a'.

Table 6

Determining The Anchor SACP From Economic Risk And Industry Risk										
Industry risk	Economic risk									
	1	2	3	4	5	6	7	8	9	10
1	a	a	a-	bbb+	bbb+	bbb				
2	a	a-	a-	bbb+	bbb	bbb	bbb-			
3	a-	a-	bbb+	bbb+	bbb	bbb-	bbb-	bb+		
4	bbb+	bbb+	bbb+	bbb	bbb	bbb-	bb+	bb	bb	
5	bbb+	bbb	bbb	bbb	bbb-	bbb-	bb+	bb	bb-	b+
6	bbb	bbb	bbb-	bbb-	bbb-	bb+	bb	bb	bb-	b+
7		bbb-	bbb-	bb+	bb+	bb	bb	bb-	b+	b+
8			bb+	bb	bb	bb	bb-	bb-	b+	b
9				bb	bb-	bb-	b+	b+	b+	b
10					b+	b+	b+	b	b	b-

SACP--Stand-alone credit profile. Source: Standard & Poor's.

56. Chapter 10 of Reinhart and Rogoff's book, "This Time is Different: Eight Centuries of Financial Folly," focuses on banking crises and serves to underline the nature of banking as volatile. Banks play an important role in national economies through their conversion of shorter-term deposits into longer-term loans. Providing interest to depositors protects the value of their savings from inflation and providing loans to governments and the private sector stimulates investment and growth. By operating with increasingly high leverage--borrowing more from savers and the debt capital markets--banks can lend more, which means greater economic growth. For their high-leverage business position to work, banks rely on the continuing confidence of depositors and investors in their creditworthiness to roll over maturing deposits and refinance maturing debt. And governments aim to boost this confidence through regulation and supervision to protect economic growth. However, serial banking crises throughout history demonstrate that depositors and investors can lose confidence quickly--leading to bank failures, government bailouts, and dampened economic growth. The confidence sensitivity and leverage in the banking system can turn a moderate stress into a more severe and protracted downturn.
57. Reinhart and Rogoff's empirical study of banking crises in 66 countries between 1800 and 2008 shows that they are commonplace in both advanced and emerging economies. For example, since 1800 there have been 13 banking crises in the U.S., 12 in the U.K., and 15 in France. We believe that banking crises will happen again. We expect this pattern of banking sector boom and bust and government support to repeat itself in some fashion, regardless of governments' recent and emerging policy response. New laws put in place following previous crises, such as deposit insurance, have not prevented subsequent downturns. By embedding this knowledge into the anchor SACP, we ensure that the lessons of the recent economic downturn are not forgotten as national economies recover and the next period of favorable conditions gives rise to growth and attractive headline banking profits.
58. Table 7 shows the preliminary BICRA factors as shown earlier but with more detail. The preliminary BICRAs apply the proposed amended criteria (see "Request For Comment: Methodology For Determining Banking Industry Country Risk Assessments," published May 13, 2010, and as amended according to paragraph 17 above). The table shows how the BICRA scores combine for selected countries to produce a starting point for the SACP of a bank in each country, the anchor SACP in the right-hand column. This holds for a bank with less than 20% of its business



in investment banking (paragraph 52) and no foreign business accounting for more than 5% (paragraph 40).

**Table 7**

Preliminary BICRA Scores Under The Proposed Criteria										
Country	Preliminary BICRA group	Preliminary economic risk descriptions				Preliminary industry risk descriptions				Anchor SACP
		Economic stability and resilience	Economic imbalances	Credit risk in the economy	Preliminary economic risk score	Institutional framework	Competitive dynamics	Systemwide funding	Preliminary industry risk score	
Sweden	1	Very low	Low	Very low	1	Low	Low	Low	2	a
Switzerland	1	Very low	Very low	Very low	1	Low	Low	Very low	2	a
Canada	1	Very low	Low	Low	2	Very low	Very low	Low	1	a
Hong Kong	1	Low	Low	Low	2	Very low	Low	Very low	1	a
France	2	Very low	Low	Low	2	Low	Low	Low	2	a-
Australia	2	Very low	Intermediate	Low	2	Very low	Very low	Intermediate	2	a-
Italy	2	Low	Intermediate	Intermediate	3	Low	Low	Very low	2	a-
Netherlands	2	Very low	Low	Low	2	Intermediate	Intermediate	Low	3	a-
Japan	2	Low	Low	Low	2	Intermediate	Intermediate	Very low	3	a-
Germany	3	Very low	Very low	Low	1	Intermediate	High	Very low	4	bbb+
Korea	3	Intermediate	Low	Intermediate	3	Intermediate	Low	Intermediate	3	bbb+
Taiwan	3	Intermediate	Low	Intermediate	3	Intermediate	High	Low	4	bbb+
U.S.	3	Very low	Intermediate	High	4	Intermediate	Intermediate	Very low	3	bbb+
N.Z.	3	Low	High	Intermediate	4	Low	Low	Intermediate	3	bbb+
Spain	3	Low	High	Intermediate	4	Low	Low	Intermediate	3	bbb+
U.K.	3	Very low	Intermediate	High	4	Intermediate	Intermediate	Low	3	bbb+
Mexico	4	Intermediate	Low	High	4	Intermediate	Intermediate	Intermediate	4	bbb
Brazil	5	Intermediate	Intermediate	High	5	Intermediate	High	Intermediate	5	bbb-
India	5	High	Intermediate	High	6	High	High	Low	5	bbb-
China	5	Intermediate	High	High	6	High	High	Low	5	bbb-
Turkey	6	High	High	High	7	Intermediate	Intermediate	High	5	bb+
Russia	8	High	High	Very high	7	Very high	Very high	High	8	bb-
Kazakhstan	9	High	Very high	E. high	9	Very high	Very high	Very high	9	b+

BICRA--Banking Industry Country Risk Assessment. N.Z.--New Zealand. E. high--Extremely high. Source: Standard & Poor's.

## D. Bank-Specific Analysis: Building On The Anchor SACP

59. After we determine the anchor SACP, we then consider a bank's specific features or SACP rating factors in our bank-specific analysis. Based on our analytical conclusions, we add one or more notches to the anchor SACP or subtract from it--or do not change it at all (see table 8). We express these conclusions using specific rankings and qualifiers. We associate these with a number of notches to apply to the anchor SACP to determine the level of the SACP.

**Table 8**

<b>Using Our Bank-Specific Analysis To Determine The SACP</b>	
<b>Rating factor/Ranking</b>	<b>Change in anchor SACP</b>
<b>Business position</b>	
Very strong	+2 notches
Strong	+1 notch
Adequate	No change
Moderate	-1 notch
Weak	-2 to -3 notches
Very weak	-5 notches
<b>Capital* and earnings</b>	
Very strong	+2 notches
Strong	+1 notch
Adequate	No change
Moderate	-1 notch
Weak	-2 to -3 notches
Very weak	-5 notches
<b>Risk position</b>	
Very strong	+2 notches
Strong	+1 notch
Adequate	No change
Moderate	-1 notch
Weak	-2 notches
Very weak	-5 notches
<b>Liquidity</b>	
Strong	+1 notch
Adequate	No change
Less than adequate	-2 notches
Weak¶	-5 notches

\*The cap on the SACP is 'bb+' when regulatory capital is "at risk," at 'ccc+' when it is "subject to regulatory forbearance," and 'cc' when "insolvent." ¶Likewise, when the liquidity assessment is "weak," we cap the SACP at 'ccc+'. SACP--Stand-alone credit profile. Source: Standard & Poor's.

### D.1. Peer analysis

60. We use peer and comparative analysis throughout the proposed criteria to help us develop our opinion for each of the SACP rating factors and the peer analysis takes slightly different forms for each SACP rating factor (see table 9). When setting the ICR (see paragraphs 25-30) we focus the peer analysis on banks with a similar SACP.

Table 9

The Focus Of Peer Analysis For Each SACP Rating Factor		
SACP rating factor	Suggested peers	Guidance and exceptions
Business position	Peers with similar industry risk*	When the bank is better than average, the business position is stronger. When the bank is worse than average, the business position is weaker. For most banks, we compare funding to the domestic industry average to remain consistent with the BICRA funding assessment. We compare business stability, concentration, and management and corporate strategy on a more international basis. We treat banks with more than 50% of business coming from investment banking activities as a global peer group for all categories of the business position to remain consistent with the industry risk assessment for investment banking.
Capital and earnings	All banks	Absolute measures are most important in our capital and earnings assessment, and we use globally consistent metrics to benchmark performance. However, we compare the quality of capital and earnings among all banks.
Risk position	Peers with similar economic risk* offering similar products	The peer analysis supports the more qualitative conclusions about whether the risk assumptions we use in capital and earnings are appropriate for a bank. A bank's loss experience and our loss expectations that are lower than average imply lower risk. Conversely, larger comparative losses imply higher risk.
Liquidity	All banks	We compare a bank's simple liquidity ratios and its dependence on central bank funding with that of national and international peers.

\*The peer group can include international peers and usually when a domestically focused peer group is too small or when many similarities exist among national banking industries. We determine the relative creditworthiness between banking industry and economic risk with the BICRA (Banking Industry Country Risk Assessment) methodology. SACP--Stand-alone credit profile. Source: Standard & Poor's.

## E. Business Position

61. The third of six SACP rating factors, business position, indicates the strength of a bank's business operations. We define business position as the combination of specific features of the bank's business operations that add to or mitigate its industry risk score. These features fall into four categories: funding, business stability, concentration or diversity, and management and corporate strategy. To assess its relative strength, we may look at a number of indicators (see table 10). Although we use quantitative metrics where they are relevant and available, much of our assessment is qualitative.

Table 10

Business Position Characteristics And Indicators		
Characteristics	Explanation	Indicators
Funding (paragraphs 66-73)	Strength of and potential volatility in funding	Loan-to-deposit ratio, reliance on short-term wholesale funding, and overall funding mix
Business stability (paragraphs 74-80)	The stability or fragility of a bank's franchise	Revenue stability, market shares, and the customer base
Concentration or diversity (paragraphs 81-86)	The concentration or diversification of business activities	Contributions of different business lines and geographies to overall revenue
Management and corporate strategy (paragraphs 87-91)	The quality of management, strategy, and corporate governance	Strategic positioning, operational effectiveness, financial management, and governance and financial policies

Source: Standard & Poor's.

62. For each bank we communicate our opinion about the strength of its business position using one of six standard qualifiers (see table 11), based on our observations about its strength relative to peers with a similar industry risk score.
63. Though we assess the four categories independently, it is important to understand that we also look at how categories may reinforce or weaken each other. Our assessment is not a simple addition of metrics for the four categories. For example, funding dependent on the sentiment of investors--such as rolling over short-term finance

like commercial paper--would lead us to take an even more negative view of a weak business stability assessment. In addition, stronger areas do not automatically offset or "average out" weaker areas. Instead, the focus is on identifying risks and determining whether they combine to further increase or reduce overall risk.

Table 11 Business Position Assessment		
Qualifier	What it means	Observations
Very Strong	A bank's business operations mean it is better placed to withstand adverse operating conditions than the industry risk indicates, according to our observations.	A combination of strengths in the four business position categories--funding, business stability, concentration or diversity, management and corporate strategy--outweigh any weakness; and On balance, the business is even stronger than for other strong banks with a similar industry risk score; and The bank did not require direct government support in the latest financial downturn when other banks did.
Strong	A bank's business operations make the bank somewhat less vulnerable to adverse operating conditions than the industry risk indicates, according to our observations.	Strengths clearly outweigh any weakness; and On balance the business is stronger than for other banks with a similar industry risk score; and If the bank received direct government support in the latest financial downturn, new management has executed most substantial elements of the associated restructuring plan successfully.
Adequate	A bank's business operations are representative of the industry risk, according to our observations.	Neither strengths nor weaknesses outweigh each other; A single weakness in one category, which does not dominate the assessment, may be offset by strengths; and On balance the business is representative of the average for other banks with a similar industry risk score.
Moderate	A bank's business operations make it more vulnerable to adverse operating conditions than the industry risk indicates, according to our observations.	Weaknesses clearly outweigh any strengths or, On balance the business is less favorable than for other banks with a similar industry risk score.
Weak*	A bank's business operations make it significantly more vulnerable to adverse operating conditions than industry risk indicates, according to our observations.	A combination of weaknesses among the four categories outweigh any strengths; or A single, dominating weakness in one of the four categories; and On balance the business is weaker than for other banks with a similar industry risk score.
Very weak	The industry risk score is not representative of the bank's vulnerability to adverse operating conditions. (We use this category in more exceptional circumstances.)	The degree of bank-specific weakness overrides any potential benefit from its industry; or The bank's business operations are materially more risky than for other banks with a similar industry risk score.
*The impact on the SACP is a deduction of two or three notches. We deduct three notches only in fragmented industries with a large number of smaller banks that all have weaker than average industry risk. Deducting two or three notches from the SACP for a weak classification helps to differentiate further among such banks. SACP--Stand-alone credit profile. Source: Standard & Poor's.		

64. When we assess a business position as "adequate," we mean that the industry risk score appropriately captures the risk of a bank's business activities. In other words, compared with those of peers with a similar industry risk score, a bank's business activities represent average risk. An assessment of "very strong" or "strong" means that a bank's business activities are less risky than average. An assessment of "moderate," "weak," or "very weak" means that a

bank's business activities are riskier than average.

65. Regarding a bank's comparison to peers with a similar industry risk score, we are referring to blended industry risk (see table 5). For example, when blended industry risk is 2.6 for a bank, we compare it with other banks with industry risk scores between 2 and 3. Depending on the availability of peers, we may use a wider or narrower range of industry risk comparisons. However, for funding comparisons, we prefer to look at the domestic peer group. When available in different markets, we can use additional information to supplement the peer comparisons.

### **E.1. Funding**

66. Funding is the first category we analyze as part of our business position assessment. This category represents a key change to our existing methodology, which combines the analysis of funding and liquidity to assess financial risk. The proposed criteria separate the bank-specific analysis of funding and liquidity, treating funding as a key element of business risk and liquidity as a factor of financial risk. Furthermore, we compare funding to the domestic industry average to remain consistent with the BICRA funding assessment. We can use international peers with a similar industry risk. In contrast, our analysis of liquidity, which starts at paragraph 157, is more absolute.
67. We consider funding as an element of business position because how a bank funds its business and the confidence-sensitive nature of its liabilities directly affect its ability to maintain business volumes in adverse circumstances. Granted, industrywide characteristics influence the availability of stable funding sources, but we look at those as part of our industry risk score.
68. We assess the relative strength and potential volatility of funding by reviewing a bank's liabilities--or mixture of retail and wholesale deposits, interbank loans, and secured and unsecured borrowing in capital markets. In our view, a bank develops a mix of funding resulting from its strategic choices about the products and services it offers, and risk management decisions about what funding options to use, given the availability of stable core deposit or term funding and riskier short-term wholesale funding.
69. When investment banking activities are the largest business segment for a bank, we compare its funding characteristics with those of banks that have similar concentrations in investment banking (see table 5).
70. If a bank does not have access to the central bank's funding mechanism, the business position is moderate at best. In our opinion, central bank borrowing is not a funding option to refinance ordinary business operations on an ongoing basis, but does provide an important source of contingent liquidity. We assess the degree of a bank's dependence on central bank funding in the liquidity analysis. As for the quality of a central bank funding mechanism, we assess that in the BICRA methodology under industry risk.
71. For the peer review, the proposed criteria consider the breakdown of a bank's funding, loan-to-deposit ratio, and long-term funding ratio as the primary quantitative metrics. We rank banks within their industry according to these metrics and compare them against the industry average, weighted by assets. We use these ratios to set the relative position of players within an industry before we apply the more qualitative characteristics below. When confidence-sensitivity is high, a weakness in funding carries more weight in the overall business position assessment.
72. The proposed criteria treat a bank's funding as stronger than the industry norm based on a combination of the following characteristics:
- The bank has less short-term funding in domestic or cross-border capital markets than the industry average.
  - Funding is consistently more diversified across stable sources than it is among peers.

- The bank has an established, stable, and diversified deposit franchise with a high proportion of insured balances; it does not overly rely on potentially more sensitive nonresident deposits or market-leading pricing to attract and retain balances.
  - The bank's refinancing requirements over the next 12 months, both as an absolute amount and as a percentage of total adjusted capital, are lower than for peers and the industry average.
73. The proposed criteria treat a bank's funding as weaker than the industry norm based on a combination of the following characteristics:
- The bank has more short-term or cross-border wholesale funding than the industry average.
  - Funding sources are more concentrated than among peers.
  - The bank's ability to retain deposits and access the interbank and capital markets for funding is more vulnerable to changes in saver, counterparty, or investor sentiment than among peers.
  - The bank's refinancing requirements over the next 12 months, both as an absolute amount and as a percentage of total adjusted capital, are higher than for peers and the industry average.
  - The bank has restricted or no access to central bank funding.

## **E.2. Business stability**

74. Business stability is the second category we look at as part of the business position assessment. We define business stability as the predictability of continuing business volumes in the face of economic and market fluctuations. This is important because the erosion of confidence that a bank may suffer during times of market turbulence exposes it to the possibility of sudden default risk: customers and counterparties could walk away and access to liquidity in the capital market could dry up. A business position that contains this sudden default risk is inconsistent with high SACPs.
75. We associate stronger business stability with banks whose revenues are highly impervious to an economic downturn or a period of market turbulence. We associate weaker business stability with banks whose revenues are susceptible to significant volatility during moderately adverse conditions.
76. A key lesson of the banking crisis that started in 2007 was that differences in franchise stability and confidence sensitivity significantly affect creditworthiness. We found that, for instance, "specialist lenders that depend on short-term wholesale funding and financial institutions with large trading operations--particularly in derivatives--are particularly sensitive to an erosion of confidence" in "Franchise Stability, Confidence Sensitivity, And The Treatment Of Hybrid Securities In A Downturn." The proposed criteria, with their analysis of funding, business stability, and concentration--the drivers of confidence sensitivity--would supersede the 2008 article.
77. The proposed criteria use measures of revenue stability, market shares, and the customer base to rank a bank's business stability with that of peers with a similar industry risk score. We associate stable business lines with recurring fee income and net interest income that have a strong annuity characteristic. In contrast, we view these income sources as less stable: trading income, including interest income from trading activities; net interest income coming from above-average asset-liability mismatches; other market sensitive income; and fee income from off-balance-sheet financing. In our peer comparison, we focus on the underlying contribution of business lines to total revenues and earnings and our estimates for their future contribution.
78. Business stability supports an adequate or stronger business position when we observe the following characteristics:
- The customer base is demonstrably sticky, that is, there are long-standing customer relationships and they

generate a high proportion of revenues. There is strong evidence that customers are likely to stay with the bank during a financial stress.

- Revenues are not sensitive to market perceptions of creditworthiness.
- Credit-related termination events, or triggers, exist in many contracts with customers and counterparties.
- A bank is less reliant on pricing to retain customers than industry peers.

79. Potential instability of business lines exist and could lead to a weaker business position when we observe any combination of the following characteristics:

- Customers can easily switch their business to other providers. There is no evidence that customers are likely to stay with a bank during a financial stress. The relationship between customers and a bank is based on a series of one-off transactions open to market tender.
- There are few or no direct relationships between the end customer and the bank. A bank relies on third parties to supply business volumes.
- Recurring fee or interest income from long-standing customer relationships represent a lower proportion of revenues than average in the industry.
- Revenues are more sensitive to market perceptions of creditworthiness than for peers.
- A bank relies more heavily on pricing to attract and retain customers than peers.
- Financial covenants, credit triggers, and collateral requirements in contracts with trading counterparties are more demanding than for peers with a similar industry risk score carrying out the same types of trades. Many counterparty contracts contain explicit credit triggers for termination or collateral posting.

80. The fragility of the investment banking industry model is already reflected in the industry risk score, so when the peer group is investment banking-oriented, there is no need to view business stability as a further weakness. Instead our judgment focuses on the relative business stability among the investment banks.

### **E.3. Concentration and diversity of business activities**

81. Concentration and diversity is the third category of the business position assessment. We define concentration and diversity of business activities as the contributions of different business lines and geographies to a bank's revenues, compared with those of peers with a similar industry risk. We associate entities with a broader mix of business activity as lower risk and entities with a narrower mix as higher risk. Concentration in business activities can offset all other strengths in our business position assessment.

82. Here the focus is on the concentration or diversity of business volumes or revenues. We believe that concentration can lead to less stable and predictable revenues, which weakens the business position. On the other hand, successful diversification can lead to more stable and predictable revenues. The proof is in the results. Successful diversification means that a bank's earnings were stronger than industry peers during the last domestic downturn and since then management has not increased the bank's exposure or risk appetite materially.

83. We also look at concentration in other areas of the proposed methodology, but in different ways. For example, we look at the risk correlations among risk exposures in our assessment of risk position (see table 18 and paragraphs 127-137), and we assess concentration in funding sources in the previous section (see paragraphs 72 and 73).

84. The proposed criteria would treat a bank as more concentrated than average for the industry when it has a more limited product range or geographic breadth, particularly for a bank with a regional, product, or customer focus. Even if concentration is in an attractive region, product, or customer, it is a weakness because it is not reflected in

the industry risk score. Region must be considered in the context of the size of the local or regional economy. For example a focus on the U.S. state of Texas is very different from, and far less concentrated than, a focus on a Swiss canton.

85. In our opinion, business diversification can be either a strength or a weakness in a bank's business position. Successful and continuing diversification supports a stronger business position. Such business diversification is often international and is supported with evidence that the bank is overall less susceptible to volatility in domestic business and economic conditions than is average for peers in the home industry. Poor diversification weakens the overall business position, as seen when a bank enters new products and countries where management has limited expertise and the bank has limited critical mass to be a real competitor with the incumbent market leaders. The weakness is greater when the new products or markets are riskier than the traditional core business.
86. Acquisitions can increase concentration risk if the acquired assets are similar to those in the bank's existing book and particularly when the bank does not increase risk-adjusted capital in line with assets and risks.

#### **E.4. Management and strategy**

87. This final category in the business position assessment, management and strategy, considers management's ability to execute operational plans in a consistent manner, a bank's strategic direction, management's risk appetite, and a bank's ownership and governance. Management's strategic competence, operational effectiveness, and risk tolerance shape a bank's competitiveness in the marketplace and its financial condition.
88. This assessment is qualitative, but past performance and forward-looking targets provide some objective standards. It is also relative. We assess a bank's business position to that of peers with similar industry risk. If we conclude that management plays a positive role in determining a bank's operational success, we can be more confident of its ability to manage important strategic and operating risks in the future. Alternatively, a weak management with a flawed operating strategy or inability to execute its business plan effectively in our view increases risk.
89. Management and strategy would support an adequate or stronger business position when we observe the following:
- The bank is more prudent and conservative than average in the industry. Management has proven execution capabilities, and is a stable team. There is a track record of avoiding strategic mistakes experienced by peers.
  - Returns have been and are likely to be less volatile than average in the industry. Both compensation and financial targets are focused on long-term value for all stakeholders (including bondholders).
  - There is a strong influence from independent directors, and a robust system of checks and balances in decision-making.
90. Our assessment of management and strategy could lead to a weaker business position if we observe any of the following:
- Management's risk appetite, strategies, financial targets--such as return on equity (ROE) and growth in earnings per share (EPS)--and acquisition strategies are more aggressive than average for the industry.
  - The bank consistently outperforms the sector or country average ROEs particularly during a period of expansion.
  - Governance standards compare negatively to the industry average.
  - The entity depends on continuing service from key individuals or small teams.
  - The organization operates with more complex corporate, legal, or tax structures.
  - Compensation schemes encourage short-term profit-taking.
  - There is unplanned management turnover in critical senior positions.



- The bank has made acquisitions at prices that reflect premiums to tangible book value, projected earnings, or acquired core deposits, compared with prices paid for recent transactions of comparable size and nature.

91. Although this assessment is largely qualitative, we do look at historical data on past performance and forward-looking indicators of the attitude of management and owners toward risk, including financial targets like target ROEs and EPS growth, as well as compensation schemes, management incentive schemes, and statements of risk appetite. A study of reported ROE relative to average ROE for the sector or country can be a crude indicator of risk appetite. Consistent outperformance of sector or country average ROEs, particularly during a period of expansion, could indicate higher management and strategy risk.

## F. Capital And Earnings

92. Capital and earnings is the fourth SACP rating factor and measures a bank's ability to absorb losses, providing protection to senior creditors on a going concern basis. We assess capital and earnings by looking at regulatory requirements, the level of capital, and the quality of capital and earnings. These proposed criteria treat earnings differently than our current methodology, making it a component of our capital analysis rather than a separate rating factor. We incorporate earnings into capital by assessing their capacity to absorb losses and build capital. We look at several measures of capital; however, our projected risk-adjusted capital ratio is the most important. This section concludes with an example of how we apply these risk assumptions to a bank.
93. The RAC ratio compares a bank's capital to its risk-weighted assets, according to our globally consistent measures of capital, total adjusted capital (TAC), and Standard & Poor's risk-weighted assets (Standard & Poor's RWAs or our RWAs). To arrive at our RWAs for a bank, we apply our own risk weights to a bank's exposures (see "Bank Capital Methodology And Assumptions" for a full explanation). Even with the plans to adopt the Basel III framework, we expect regulatory ratios to remain inconsistent among different countries.
94. In theory, a bank's product pricing includes a margin to cover the expected losses on its assets, which leaves capital to provide protection against unexpected losses. The proposed criteria for this factor measure the degree to which a bank's capital and earnings would cover our estimate for losses that would arise following a substantial economic stress for developed countries.
95. First, we establish how a bank performs against its regulatory requirements because meeting these requirements is a prerequisite for operating as a going concern. Any weakness here would be an overriding factor limiting the SACP.
96. Second, if performance against regulatory measures is adequate or better, we use our projected RAC ratio to form our opinion of a bank's future capital. These proposed criteria introduce standards for how to interpret our projected RAC ratio. Because earnings retention is the primary way that a bank builds or maintains capital, we make sure that the projected RAC ratio is consistent with the capital sustainability ratio (see paragraphs 107-109 and table 15). That ratio looks at the balance that a bank is striking between growth, which weakens capital, and the buildup of capital through retained earnings.
97. Third, we assess the quality of capital and earnings by looking at the composition of and trend in TAC, and the stability and predictability of earnings. When the RAC ratio is at the upper end of a scoring range, high-quality capital could push the capital and earnings assessment into a stronger category. Conversely, when the RAC ratio is at the lower end of a range, weaker quality of capital or earnings could push our assessment into a weaker category.

98. Finally, the proposed criteria assess earnings capacity, the first line of defense against losses and the primary way that a bank builds or maintains capital. To do that we are introducing the earnings buffer (see paragraphs 120-125 and table 16), a metric that measures the capacity of earnings to absorb normalized losses through the credit cycle. We determine whether a bank's earnings buffer is positive or negative. When the bank's earnings buffer is negative, earnings are not sufficient to cover normalized losses. We also use the earnings buffer to identify consistent out- and underperformers when setting the final ICR (see paragraphs 26-29).
99. We place a bank's capital and earnings into one of six categories indicating strength according to a set of guidelines for interpreting the metrics (see table 12).

Table 12 Capital And Earnings Assessment		
Qualifier	What it means	Observations
Very Strong	Capital and earnings are able to withstand an extreme stress as defined by our risk assumptions (see table 17).	The projected RAC ratio is and will remain above 15% and the earnings buffer is positive.* Low-quality capital or earnings can push a borderline very strong assessment down to strong.¶
Strong	Capital and earnings are able to withstand a severe stress as defined by our risk assumptions (see table 17).	The projected RAC ratio is and will remain more than 10% and less than 15%.* High-quality capital could push a borderline strong assessment up to very strong and low-quality capital or earnings could pull it down to adequate.¶
Adequate	Capital and earnings are able to withstand a substantial stress as defined by our risk assumptions (see table 17).	The projected RAC ratio is and will remain more than 7% and less than 10%.* High-quality capital could push a borderline adequate assessment up to strong and low-quality capital or earnings could pull it down to moderate.¶
Moderate	Capital and earnings are able to withstand a moderate stress as defined by our risk assumptions (see table 17).	The projected RAC ratio is and will remain more than 5% and less than 7%.* High-quality capital could push a borderline moderate assessment up to adequate and low-quality capital or earnings could pull it down to weak.¶
Weak§	Capital and earnings are able to withstand a modest stress as defined by our risk assumptions (see table 17).	The projected RAC ratio is and will remain more than 3% and less than 5%.* High-quality capital could push a borderline weak assessment up to moderate. Low-quality capital or earnings could pull the assessment down to very weak.¶
Very weak	Capital and earnings are not able to withstand a modest stress as defined by our risk assumptions (see table 17).	The projected RAC ratio is and will remain less than 3%. High-quality capital or earnings capacity could push a borderline very weak assessment up to weak, unless the earnings buffer is negative.¶
*If the earnings buffer (see table 16) is negative, the RAC ratio needs to be stronger by a corresponding amount to compensate for the normalized losses not covered by earnings. ¶We interpret borderline as within 25 basis points of the scoring range limit as indicated in table 14. §The impact on the SACP is a deduction of two or three notches. If the projected RAC ratio is between 4% and 5%, it is two notches; and between 3% and 4%, three notches.		

## F.1. Regulatory requirements

100. Our proposed BICRA methodology calls for a description for each country about how much capital that regulators require banks to hold and whether it is a legal minimum or a regulatory policy for banks in a country to hold more than the minimum amount. Each regulator may use slightly different ratios and calculations for minimum capital requirements and is likely to intervene at different levels. The most common ratios are variations on Bank for International Settlements (BIS) capital ratios--a total capital ratio comprising a tier 1 capital ratio and sometimes an additional tier 2 ratio. In addition, regulators in some countries have established balance-sheet leverage ratios in an attempt to limit aggressive risk-taking behavior.
101. In general, a bank with an SACP of 'bbb-' or higher in our view operates at margins above capital requirements deemed acceptable by its local regulator. (However, banks that operate above these capital requirements may have a lower SACP because of other weaknesses.) For banks operating at margins close to or in breach of regulatory minimum requirements, we qualify them as "at risk," "subject to regulatory forbearance," or "insolvent," and cap their SACPs at 'bb+', 'ccc+', or 'cc', respectively, according to table 13.

**Table 13**

Regulatory Requirement Assessment	
Qualifier	Definition
At risk	We cap the SACP at 'bb+' when we expect a bank to meet regulatory capital requirements--but by a narrow margin, usually less than 100 basis points. At this level, we regard a bank as "at risk" of breaching its regulatory requirements in case of plausible adverse developments. To be clear, this means that a bank's capital ratios are above the legal minimum but close to breaching the levels regulators deem acceptable. Furthermore, we set our assessment of capital and earnings at "weak" at best.
Subject to regulatory forbearance	We cap an SACP at 'ccc+' when the regulator allows the bank to continue operating even though it is in breach of regulatory capital requirements. This might occur if regulators give a bank a temporary waiver or a ruling that calculates regulatory capital requirements more generously than usual. The category also includes banks that would be in breach of regulatory minimum requirements if they had reported losses in accordance with accepted accounting principles but did not. We assess capital and earnings at "very weak" in these situations.
Insolvent	We assess the SACP at 'cc' when a bank is in breach of legal regulatory minimum requirements and there are no prospects for it to reach them or for regulatory forbearance. The proposed criteria do not rule out that regulators could eventually intervene before actual insolvency or to foster a recapitalization. We set our assessment of capital and earnings at "very weak."

Source: Standard & Poor's.

## F.2. Capital

102. Assessing capital using the RAC ratio is the cornerstone of our capital and earnings criteria ("Bank Capital Methodology And Assumptions"). We rank a bank's level of capital according our projected RAC ratio before adjustments for concentration or diversification (see table 14).

**Table 14**

Capital Assessment	
Qualifier	Projected RAC ratio before concentration or diversification adjustments (%)
Very strong	More than 15%
Strong	More than 10% and up to 15%
Adequate	More than 7% and up to 10%
Moderate	More than 5% and up to 7%
Weak	3% up to 5%
Very weak	Less than 3%

RAC--Risk-adjusted capital. Source: Standard & Poor's

103. The proposed criteria consider capital prospectively by focusing on a bank's projected RAC ratio. This might be

much lower than at the last reporting date during a period of growth, or higher than at the last reporting date during a recovery or risk reduction, or period of restructuring. Because a bank's major source of capital, either internal or external, is its earnings, we make sure that our projected RAC ratios are consistent with our opinion of the bank's ability to grow or rebuild capital through internally generated retained earnings. We can include capital raising that is underwritten in capital projections as well.

104. The risk-adjusted capital framework applies our own risk weights to a bank's on- and off-balance-sheet exposures to produce Standard & Poor's RWAs. The risk weights that we apply to each risk type and asset class reflect their relative degree of risk. To calculate the RAC ratio, we divide a bank's TAC (total adjusted capital, our consistent definition of capital) by our RWAs. In addition, we have calibrated the risk weights according to our standard stress scenarios that in turn are linked to our ratings to maximize their consistency across sectors and over time. Specifically, we calibrate our RWAs to our 'A' or substantial stress scenario (see appendix IV of "Understanding Standard & Poor's Rating Definitions"). An 8% RAC ratio, for example, implies that a bank in a developed country has sufficient capital to withstand the 'A' or substantial stress scenario. By comparison, a 12% RAC ratio implies that a bank has sufficient capital to withstand our 'AA' or severe stress in a developed country. We base these calibrations on our observations that banking losses following an 'AA' or severe stress are typically about 1.5 times more than following a substantial stress and about two times more than after an 'AAA' or extreme stress.
105. Note that our stress scenarios generally hold for issuers or obligations in developed countries such as the U.S., Japan, Western Europe, and Australia, and we use the scenarios to derive risk assumptions for banking losses in those economies. However, we adjust the risk assumptions for structural differences using our BICRA methodology. Structural differences could be differences in credit culture, banking and bankruptcy laws, and observed lower loss experience for some asset classes. In addition for developing countries, we adjust the risk assumptions for the higher-risk characteristics of these economies and specific kinds of exposures of banks operating in these countries. We assess these factors with our BICRA methodology, whose 1-10 scale for the BICRA group and economic risk score serves as a proxy for these structural differences.
106. Although the RAC ratio provides a globally consistent measure of capital, because of the limitations of all models, we continually test the RACF's risk assumptions as part of our assessment of the risk position. The thrust of the risk position analysis is to determine the degree to which the capital and earnings analysis understates or overstates bank-specific risk. We make qualitative judgments about the quality of TAC and the quality of earnings later in the capital and earnings analysis.
107. Our next step is to ensure that the projected RAC ratio is consistent with our capital sustainability ratio. This represents our forward-looking estimate of a bank's ability to grow or rebuild capital through retained earnings, and is basically the difference between the buildup of capital and capital requirements (see table 15 for details on how we calculate this ratio). The ratio is most relevant when a bank is growing and reporting profits. We base the ratio on our estimates about growth and earnings retention. There is usually a relationship between our capital sustainability ratio and our projected RAC ratio, and one is a check for the other:
  - When capital sustainability is between -30 basis points (bps) and +30 bps, the projected RAC ratio is likely to show flat growth, unless a bank has announced plans to raise external capital or to achieve some other means of capital relief and we believe it will be successful.
  - When capital sustainability is lower than -30 bps, the projected RAC ratios should show a decline unless the bank has announced plans to raise external capital or to achieve some other means of capital relief and we believe it

will be successful.

- When capital sustainability is greater than 30 bps, the projected RAC ratios should show an increase based on internal capital generation.
- When the bank is loss-making these rules do not apply.

**Table 15**

<b>How We Compute Capital Sustainability For A Hypothetical Bank</b>			
<b>(Mil. €)</b>	<b>Next year</b>	<b>This year</b>	<b>Last year</b>
Preprovision operating income	2,094	1,672	1,553
Credit losses (actual/projected)	(295)	(450)	(700)
Other losses (actual/projected)	0	(56)	(125)
Tax	(452)	(343)	(231)
Distributions	(156)	(128)	(105)
Share buybacks	(650)	(350)	0
Capital buildup (CB)	541	345	392
S&P risk-weighted assets (RWAs)	42,000	36,500	28,500
CB/S&P RWAs (bps)	129	95	138
3-year average CB/S&P RWAs	--	120	--
S&P RWAs	42,000	36,500	28,500
Growth (actual/projected) (%)	15.07	28.07	3.00
Risk-adjusted capital (last reported) (%)	8.49	8.49	8.49
Total adjusted capital (actual/projected)	3,566	3,099	2,420
Additional capital requirement (ACR)	467	679	226
ACR/S&P RWAs	111	186	79
3-year average ACR/S&P RWAs	--	126	--
CB less ACR (bps)	18	(92)	58
Capital sustainability (bps)	--	(5)	--

bps--basis points. Source: Standard & Poor's.

108. During periods of expansion, we determine how much a bank is using retained earnings to fund growth and maintain capital ratios. To illustrate, if we expect risk-weighted assets to grow by 10%, capital needs to grow by close to 10% to maintain capital ratios. Failure to grow capital via retained earnings at the same pace as growth in the business indicates to us that capital will deteriorate--unless a bank has access to external sources to make up for the deficiency. When a bank is taking on more risk and reporting greater returns, our calculation for capital sustainability adjusts for this by increasing Standard & Poor's RWAs accordingly. This allows us to question headline earnings growth and take into account the pace of the bank's expansion. Growth beyond the capacity of management, infrastructure, and capital is a leading indicator of increasing risk.
109. The credit loss estimates and projections in the second row of table 15 are our most likely scenario, mirroring Standard & Poor's economic forecasts. They are point in time and country-specific, and we adjust them for the economic and credit cycle. We can adjust these country-level loss estimates for a specific bank, if we have more severe or favorable loss expectations based on bank-specific risks. We do not treat credit loss estimates as criteria. In contrast, the earnings buffer calculation (paragraphs 120-125 and table 16) uses normalized losses to risk-adjust earnings on a more constant basis using a set of credit risk assumptions that do not move during the economic or credit cycle. We propose to treat the credit risk assumptions driving normalized losses as criteria assumptions.

110. If due to peer comparisons or otherwise we believe that a bank's loan loss coverage or its credit impairment recognition on securities holdings may be materially deficient, we adjust our forecast for earnings accordingly to take account of the need to strengthen loss reserves or increase impairments.

### **F.3. Quality of capital and earnings**

111. The quality of capital and earnings assessment is the third step in our capital and earnings analysis. This helps us determine whether our projected TAC has failed to capture additional strengths or weaknesses in earnings or the capital base. We look at several characteristics to conclude whether the quality of capital is "high" or "low." The contribution of the quality of earnings has a negative bias in this section as the strengths are already incorporated into projected TAC.
112. We consider the bank's relative quality of capital and earnings by comparing it with other banks of a similar economic risk score and determine whether it commands additional financial flexibility or demonstrates weaker earnings. When the projected RAC ratio is borderline (within 25 bps of the upper or lower end of the ranges in table 14 above), high quality of capital can push our assessment of capital and earnings into the next strongest category, and low-quality capital or earnings can push our assessment into the next weakest category (see table 12).
113. We associate high-quality capital with a combination of the following characteristics:
- Adjusted common equity (ACE) divided by ACE plus all hybrid instruments and preferred stock is more than 85%.
  - The investor base is more supportive of strong capital relative to other banks; investors have lower expectations for dividend yields and there have been no share buybacks.
  - We think the bank is able and willing to sell attractive assets, equivalent in value to about at least 10% of TAC, to raise funds that would not require restructuring or damage its competitive position. Several buyers are interested in such assets--even in a period of economic and market turbulence.
  - The bank has substantial economic capital included in reserves of at least 10% of TAC that we haven't recognized elsewhere in the analysis. These typically arise from tax optimization.
  - The bank has issued hybrid instruments or preferred stock (which its regulator treats as capital) of at least 10% of TAC in the markets or with the government, which are ineligible for inclusion in TAC.
114. The proposed criteria associate low-quality capital or earnings with any combination of the following:
- ACE divided by ACE plus all hybrid instruments and preferred stock is less than 70%.
  - Significant legal, tax, or regulatory constraints or characteristics of the group structure (for example, minority interests) constrain the flow of capital among group members to absorb losses.
  - We expect dividend payouts or planned share buybacks to prevent the maintenance of strong capital.
  - An aggressive, financial shareholder may be increasing its ownership and could pressure management to maintain weaker capital through time.
  - The government may have contributed to TAC but expects repayment when possible.
  - The absolute size of the capital base is less than \$100 million, bringing into question the bank's ability to withstand significant shocks or events that other, larger players could more readily absorb.
  - A bank holding company has high double leverage (paragraph 115).
  - Revenues rely on one-off items such as realized capital gains on securities holdings or fixed assets, producing a lower level of risk-adjusted core earnings or more volatility in the earnings performance.
  - Over 75% of revenues come from a relatively narrow business line especially when net interest income and fees

and commissions account for less than 60% of revenues.

- We perceive that credit provisions (loan loss reserves) are materially deficient.
- Unconsolidated subsidiaries are in our view materially undercapitalized.
- The bank has other substantial economic losses that the financial statements have not yet recognized.

115. We propose no changes to the existing treatment of double leverage (see "Analytical Approach To Assessing Nonoperating Holding Companies"). Double leverage (DL) is only relevant when we do not calculate TAC on fully consolidated accounting data that combine holding company financials with operating banks. We define DL as holding company investments in subsidiaries divided by holding company (unconsolidated) shareholders' equity. DL in our view renders the nonoperating holding company (NOHC) dependent in part on dividends to meet interest payments on external debt. We consider high DL--of 120% or more--as a sign of aggressive liquidity and capital management and we believe it may increase the possibility of liquidity stress, unless offset by liquidity at the parent. Similarly, if the absolute amount of DL of a financial group with a NOHC exceeds two years' net income of the consolidated group, we would look for offsetting liquidity at the NOHC parent.
116. In addition, when traditional earnings ratios are weaker than for other direct competitor banks, we view earnings quality as low. A bank that demonstrates strong or very strong earnings on an absolute basis but is underperforming direct competitors on a risk-adjusted basis in our view is more vulnerable to any deterioration in the operating environment. We believe that lower earnings based on lower risk are generally positive for creditworthiness, and that higher returns based on higher risk are generally negative for creditworthiness.
117. Generally speaking, our objective in carrying out the earnings peer analysis is to identify outliers under a variety of different measures. It is the bank's overall relative positioning that influences our opinion about earnings quality. However, under some circumstances, we may come to a conclusion about earnings quality based on a single feature. The earnings peer analysis will draw on these ratios to help determine our opinion about a bank's relative quality of earnings.
118. If these ratios are higher in our opinion they indicate higher quality:
- Net interest income/total revenue,
  - Fees and commissions/total revenues,
  - Core earnings/Standard & Poor's RWAs,
  - Core earnings/assets, and
  - Net operating income before loan loss provisions/assets.
119. If these ratios are lower in our opinion they indicate higher quality:
- Trading gains/total revenues,
  - Other market-sensitive income/total revenues,
  - Other revenues/ total revenues, and
  - Cost-income ratio.

#### **F.4. Earnings capacity**

120. We assess earnings capacity as the final step in our capital and earnings analysis. When earnings fail to cover our estimates of a bank's normalized loss (paragraphs 124-125) we add the deficit to the risk requirements to be covered by capital. Our new metric, the earnings buffer, measures the capacity for earnings to cover normalized losses (see table 16). When this ratio is negative, the proposed criteria looks for the RAC ratio to be stronger by a

corresponding amount to compensate for the deficiency (see footnote to table 12).

**Table 16**

<b>How We Compute Earnings Buffer For A Hypothetical Bank</b>			
<b>(Mil. €)</b>	<b>Next year</b>	<b>This year</b>	<b>Last year</b>
Preprovision operating income	1,180	1,105	905
One-off items	0	0	320
Normalized credit losses	(579)	(540)	(521)
Normalized operating income	601	565	704
Standard & Poor's RWAs	30,000	28,000	27,500
Earnings buffer (%)	2.00	2.02	2.56
3-year average earnings buffer (%)	--	2.19	--

RWAs--Risk-weighted assets. Source: Standard & Poor's.

121. The normalized loss estimates focus on credit-related losses. We treat other market or operational losses as unexpected and therefore intended to be covered by capital. Consequently when earnings are most sensitive to market and operational risks, we interpret a strong earnings buffer with caution. For banks with significant market risk, the earnings buffer may look relatively strong, but the measure does not taken into account the volatility associated with market risk. This volatility is assessed more qualitatively in quality of earnings (paragraph 114).
122. First, we estimate normalized credit losses to assess earnings through the cycle or normalized operating income (see paragraphs 124-125 in this document and appendix C of "Bank Capital Methodology And Assumptions").
123. We adjust earnings to a level that reflects underlying, through-the-cycle profitability. Starting with preprovision operating income, we subsequently remove the impact of one-off items, including significant mark-to-market write-downs of securities, and deduct normalized losses. We then compare the residual earnings to Standard & Poor's RWAs. This ratio is then averaged over three years (last year, current year, and next year).
124. We estimate normalized loss rates for each asset class by country. We use an approach based on the average "through the cycle" annual loss rate that we expect to occur for a given exposure class. This average includes both the low and the peak loss rates of the credit cycle. Where data is available, we look over a 12-year credit cycle, including three years of recession, to estimate idealized, through-the-cycle, normalized losses. We believe our notion of normalized loss is more conservative than a pure expected loss calculation over a shorter time horizon, which might exclude periods of recession.
125. To calculate normalized loss for an asset class:
  - We look back at the available data on historical loss experience in each market.
  - We then adjust the normalized loss rate upward or downward to factor in any changes or potential changes in underwriting standards or risks in the economy.
  - We extrapolate the loss rates using our proposed BICRA economic risk score. First we use the same loss rates for assets in economies with the same economic risk score. Then we scale the loss rates across the 10 economic risk groups with reduced loss rates in lower-risk countries and increased loss rates in higher-risk countries. This scaling is in line with the RACF's risk weights.



## F.5. Example of standard risk assumptions

126. The risk assumptions we use in capital and earnings are the combination of the RACF's capital charges and the normalized loss rates that we use in the earnings buffer. For an illustration of these risk assumptions for a hypothetical bank based in a country with in BICRA group 3 and with an economic risk score of 3, see table 17.

**Table 17**

<b>Risk Assumptions For A Hypothetical Bank*</b>					
(%)	<b>Annual normalized loss rate</b>	<b>3-year cumulative normalized loss rate</b>	<b>RACF capital charge</b>	<b>Aggregate risk assumptions</b>	
<b>Government</b>					
Sovereign	0	0	0.25	0.25	
Local or regional	0	0	0.29	0.29	
<b>Financial institutions</b>					
Credit institutions	0.06	0.18	1.86	2.04	
Covered bonds	0.04	0.12	1.24	1.36	
<b>Corporate</b>					
Corporate	0.50	1.60	6.00	7.60	
Commercial real estate	1.60	4.80	18.00	22.80	
<b>Retail and personal loans</b>					
Prime residential mortgages	0.20	0.60	2.40	3.00	
Self-certified mortgages	0.80	2.40	9.60	12.00	
Credit cards¶	3.50	--	8.40	11.90	
Auto loans	0.50	1.50	4.50	6.00	
Other unsecured	1.00	3.00	6.00	9.00	

\*In a BICRA group 3 country with an economic risk score of 3. ¶We calibrate credit card losses to a single-year loss instead of a three-year cumulative loss. RACF--Risk-adjusted capital framework. Source: Standard & Poor's.

## G. Risk Position

127. Risk position is the fifth of six SACP rating factors and serves to develop a more refined view of a bank's actual or specific risks compared to the standard assumptions that we use in our capital and earnings analysis. The risk assumptions and data that we use to calculate the RAC ratio and normalized losses do not always reflect or adequately capture the specific risk characteristics of a particular bank.
128. There are five steps that help us to differentiate a bank's unique risk position relative to the quantification of risk in capital and earnings:
- First, we look for how the bank manages growth and changes in its risk positions.
  - Second, we assess the impact of risk concentrations or risk diversification.
  - Third, we determine how increased complexity adds additional risk.
  - Fourth, we consider whether material risks are not captured by RACF, and
  - Fifth, we look for evidence of an adequate or relatively stronger risk position by comparing how past and expected losses on the current mix compare with peers' losses, and how a bank's loss experience during past economic downturns compares with our standard risk assumptions. Greater-than-average losses can be a factor

reflecting a weaker risk position.

129. We believe that the combination of the first four steps properly captures the degree to which our standard risk assumptions under- or overstate the bank's specific risks and the fifth step serves as a cross-check to the first four. For guidance on how we combine these five steps to form a single opinion on risk position, see table 18.

Table 18 Risk Position Assessment: Very Strong, Strong, Adequate		
Qualifier	What it means	Observations
Very Strong*	Bank-specific risks mean the bank is better able to withstand economic stress than indicated by our conclusion in capital and earnings.	Management has the capacity to manage risks arising from growth or changes in exposure, and Risk diversification has and is expected to dampen the negative impact of economic downturns on bank performance compared to peers. This is the factor that most supports a very strong risk position, and Management has the capacity to manage risks arising from complexity, and The RACF does not miss any material risk exposures, or we believe that the diversification benefit outweighs any risk that the capital framework misses. A very strong risk position is supported by evidence that the bank's recent loss experience and the expected loss trend are much stronger relative to peers, and the bank's loss experience during past economic downturns was better than average.
Strong	Bank-specific risks mean the bank is somewhat more able to withstand economic stress than indicated by our conclusion in capital and earnings.	Management has the capacity to manage risks arising from growth or changes in exposure, and Either there are no risk concentrations, or if they exist, all risk concentrations are more than compensated by other lower-risk characteristics, and Management has the capacity to manage risks arising from complexity, and The RACF does not miss material risk exposures or we believe that the diversification benefit outweighs any risk that the capital framework misses. A strong risk position is supported by evidence that the bank's recent loss experience and the expected loss trend are stronger relative to peers, and the bank's loss experience during past economic downturns was better than average.
Adequate	Bank-specific risks mean the bank is able to withstand economic stress as indicated by our conclusion in capital and earnings.	Management has the capacity to manage risks arising from growth and changes in exposure, and Either there are no material risk concentrations, or any potential diversification benefit is offset by other higher-risk characteristics, and Either the RACF does not miss material risk exposures or if it does, we believe other lower-risk characteristics more than offset them, and Management has the capacity to manage risks arising from complexity, and An adequate risk position is supported by evidence that the bank's recent loss experience and the expected loss trend are at least average relative to peers, and the bank's loss experience during past economic downturns was close to average.

Table 18 Risk Position Assessment: Moderate, Weak, Very Weak		
Qualifier	What it means	Observations
Moderate†	Bank-specific risks mean the bank is somewhat less able to withstand economic stress as indicated by our conclusion in capital and earnings.	Management may not have the capacity to manage risks arising from growth or changes in exposure, or Either there are material risk concentrations, or any risk diversification is more than offset by other higher-risk characteristics, or Management may not have the capacity to manage risks arising from complexity, or The RACF misses material risk exposures, or The bank's recent or expected losses or are greater than peers, or the bank's loss experience during past economic downturns was worse than average and we have not observed any improvement in risk appetite, controls, and management.
Weak§	Bank-specific risks mean the bank is far less able to withstand economic stress as indicated by our conclusion in capital and earnings.	Management does not have the capacity to manage risks arising from growth or changes in exposure, or There are material risk concentrations, or Management does not have the capacity to manage risks arising from complexity, or The RACF misses material risk exposures, or The bank's recent or expected losses are much greater than peers, or the bank's loss experience during past economic downturns was greater than implied by our risk assumptions and we have not observed any improvement in risk appetite, controls, and management.
Very weak**	Bank-specific risks are so high relative to the risk assumptions we use in our capital and earnings analysis that the conclusions from capital and earnings are misleading.	The RACF misses additional material risk exposures that override any positives from risk management or diversification. or The bank's loss experience and the expected loss trends look unrelated to the loss rate assumptions in our capital and earnings assessment.
*It is unlikely that more than 10% of banks will demonstrate a very strong risk position. †Risk position is moderate at best when trading activities are material or a bank employs specific strategies driven by regulatory arbitrage (see paragraph 139). §We do not necessarily expect a balance between banks that have a weak risk position and very strong risk position. **We expect to use this category only in exceptional circumstances.		

130. It is useful to consider how the capital and earnings assessment and the risk position assessment can combine to impact the SACP. Take, for example, Bank A and Bank B, which have two different assessments. Both have a healthy earnings buffer and the same adequate quality of capital. Both maintain regulatory capital ratios comfortably above the regulatory requirement. However, we expect Bank A to maintain an 11% RAC ratio and Bank B a 6% RAC ratio, according to our calculations for their projected RAC ratios. The proposed capital and earnings criteria view Bank A as "strong" and Bank B as "moderate." Following our fundamental risk analysis, we observe that bank A's loss experience is more volatile than for peers. While risk management looks good, many products are complex. There are large derivative exposures, a large and risky private equity portfolio, and a narrow focus on advisory services, structured credit, and proprietary trading. We conclude that Bank A has a "moderate" risk position. Alternatively, Bank B has a global retail and commercial franchise with market-leading positions in all of its business units. The products are simple. Off-balance-sheet activity is low and all derivatives hedge

customer-driven business. The bank has grown steadily through time, and often at a slower pace than aggressive competitors. Volatility is lower and losses are consistently less than average. Notably, Bank B continued reporting profits during the previous two downturns. Bank B has a "very strong" risk position. According to the proposed criteria then, these conclusions modify our "strong" and "moderate" capital and earnings assessments of Bank A and Bank B. All other things being equal, the effect of these two factors on Bank A is no change to the anchor SACP and the addition of one notch to the anchor SACP for Bank B. This combined impact is summarized in table 19.

**Table 19**

<b>Impact On The SACP Of Combining Capital And Earnings And Risk Position Assessments</b>				
	<b>Bank A</b>		<b>Bank B</b>	
	<b>Assessment</b>	<b>Impact on SACP</b>	<b>Assessment</b>	<b>Impact on SACP</b>
<b>Capital and earnings</b>	Strong	+1 notch	Moderate	-1 notch
<b>Risk position</b>	Moderate	-1 notch	Very strong	+2 notches
<b>Combined impact</b>	<b>No change</b>		<b>+1 notch</b>	

SACP--Stand-alone credit profile. Source: Standard & Poor's.

### G.1. Growth and changes in exposure

131. We consider a bank's portfolio of risks and its movement and direction on the risk spectrum. This is important because rapid expansion tends to presage outsized losses in both the banking and trading book. A change in the bank's risk means that the traditional expertise that has helped it to survive previous economic downturns may be less relevant.
132. Management may not have the capacity to manage additional risk presented by growth or other changes in exposure when a bank is displaying one or more of the following trends:
  - Showing more aggressive recent organic or acquisitive growth and better prospects for future growth than in the past and compared with those of peers with a similar economic risk score;
  - Moving into new product, customer, or market activities in a material way outside of its traditional area of expertise; or
  - Displaying weakening underwriting standards relative to peers with a similar economic risk score. For example, a prime mortgage lender materially weakens its standards on affordability, borrower credit standing, or loan-to-value (LTV); a senior secured commercial real estate lender increasingly underwrites mezzanine or corporate development loans; or a commercial bank increasingly underwrites larger or riskier transactions.
133. Management has the capacity to manage risks associated with growth and changes in exposure when a bank is displaying one or more of the trends below. This strength could compound other strengths to offset a weakness in the bank's risk position.
  - Showing lower recent organic or acquisitive growth and weaker prospects for future growth than in the past and compared with peers with a similar economic risk score, when the lower growth is based on avoiding risk and declining riskier growth opportunities that other banks are willing to take;
  - Maintaining underwriting standards despite competitive pressures;
  - Reducing its risk exposure, for example by exiting risky activities or tightening underwriting standards;
  - Continuing to remain focused on servicing its core customer base with traditional expertise and limiting opportunistic proprietary activities; or

- Keeping a similar portfolio of risks that limited losses experienced in previous economic downturns.

## G.2. Risk concentrations and risk diversification

134. Risk concentrations of any type in our view are a primary reason for bank failures. On the other hand, some banks can demonstrate that diversity of uncorrelated risks has led to lower aggregate losses than for less diverse peers. We consider the impact of risk concentration or diversification here because it is not included in our capital and earnings analysis. The RACF produces an adjustment for concentration or diversification that we use as an input to the risk position analysis. Remember that the business position rating factor captures concentrations or diversification in revenue contribution by business line (paragraphs 81-86) and uses concentrated earnings sources as an indicator of low-quality earnings (paragraph 114). The risk position factor focuses on the concentration of exposures to individual debtors, counterparties, and industries or sectors, or aggregations of risk across asset classes and risk types.
135. There are material risk concentrations when a bank has one or more of the following:
- Risk exposures by sector, country, or single name in the loan portfolio, investment portfolio, and the trading book that are more concentrated than for peers with a similar economic risk score. We use the RACF adjustment for diversification and concentration to support this comparison (see appendix B of "Bank Capital Methodology And Assumptions").
  - Underlying risk that affects several risk types as in the commercial real estate example below (paragraph 137). This aggregation of risk is not captured by the RACF adjustment.
  - A limited number of counterparties for derivatives and other trades when these counterparty exposures are material as a share of our total RWAs for the bank.
  - A capital base of less than \$100 million, which makes a bank more sensitive to concentration and event risk than larger peers.
136. There is a risk diversification benefit when a bank has one or more of the following:
- The RACF adjustment for concentration and diversification indicates a reduction in Standard & Poor's RWAs;
  - Geographic diversification arises from exposures that are clearly connected with a client franchise abroad and not from opportunistic product, tax, regulatory, or currency arbitrage; and
  - Sector or risk-type diversification arises from operations in similar or less risky activities than the bank's traditional core business.
137. The RACF's adjustment for concentration or diversification is a useful input to our conclusion. It is a quantitative measure, based on standard correlation matrices (see appendix B in "Bank Capital Methodology And Assumptions"). This adjustment may not capture all concentration issues relevant for a specific bank. Take the example of a bank that provides a loan to a corporate customer so it can purchase premises or develop commercial property and that at the same time holds commercial mortgage-backed securities (CMBS) on its balance sheet. The RACF risk weights for the corporate loan exposure and the CMBS portfolio are not fine enough to recognize the resulting concentration risk to commercial real estate. Similarly, the bank's reported segmentation of exposure by industry, which is the data input for the RACF, may not capture certain concentrations within a sector. For example, a bank's exposures to the broader transportation sector may hide a concentration in shipping finance.

### G.3. Complexity

138. Something that significantly adds risk is the ever-increasing level of complexity in products, business lines, regions, and organizational structure, which has often outstripped the capacity of a bank's management to manage risk. In recent years, much of the increased complexity has been fueled by the increasing use of derivatives, off-balance-sheet activities, securitizations, and other exotic products. Greater scale may bring diversification benefits to a bank but in our view also increase complexity. There is a danger in giving too much credit for diversification to those highly complex institutions that are most difficult to manage. Conversely, there is a danger in overpenalizing smaller, less complex institutions for concentration risk.
139. It is unlikely that we would view risk position as better than moderate when the bank has material trading activities or makes more-than-modest use of strategies with regulatory arbitrage as their main purpose. We would view trading activities as material when we expect investment banking activities to contribute more than 60% to pretax earnings over the long term. A particularly high multiple of total managed assets to ACE (see paragraph 141) can indicate that a bank is a material user of regulatory arbitrage strategies. In light of such complexity, we consider whether senior management has the expertise and tools to fully understand and manage the risks that the bank faces and we also question the degree of clarity about how and where the bank makes its profits.
140. Management may not have the capacity to manage the additional risks associated with complexity when a bank has one or more of the following:
- Business lines with complex products such as derivatives, securitizations, and structured credit like CDOs that are important to the overall group.
  - Limited transparency into underlying risk positions, risk management, or earnings generation.
  - A siloed approach to risk management, which may hinder a consistent measurement and management of risk exposure.
  - Material dependence on mathematical models and their underlying, often complex assumptions to measure and manage risk and value assets and liabilities.
  - A portfolio that contains risks with a low probability of occurrence but high loss severity, otherwise known as tail risk.
  - Balance sheet strategies that are driven by regulatory arbitrage.
  - Operations in many jurisdictions or with an organizational structure with many legal entities that adds complexity which may grow beyond management's capacity to control.
141. In this context, the opposite of complexity is the presentation of transparent and straightforward risks that are well understood and managed compared with those of peers with a similar economic risk score and product mix. However, we believe that the absence of complexity in and of itself is rarely sufficient to improve a bank's overall risk position.
142. A high and increasing ratio of total managed assets to ACE that is not mirrored in a low and declining RAC ratio can indicate additional risk from complexity. The ratio of total managed assets to ACE is a crude capital measure, insensitive to risk, and susceptible to definitional accounting inconsistencies. Nevertheless, trends in the ratio or high multiples may uncover risk exposures that are not captured in other metrics. In such cases, the risks are likely resulting from off-balance-sheet activities or large derivative positions, implying complexity and opaque risks, which we view negatively.
143. When we expect investment banking activities to contribute more than 60% to pretax earnings over the long term,

the proposed criteria treat the risk position as moderate at best because of the limitations in the way we quantify market risk from trading in the capital and earnings analysis. In the RACF, the standard charge for trading activities is a multiple of the bank's value at risk (VAR), as used by regulators. Although VAR has many known limitations (summarized in "Chasing Their Tails: Banks Look Beyond Value-At-Risk"), it has the value of being widely available for financial institutions.

144. Based on further analysis of market risk for banks with significant trading operations, we may assign a weak score for risk position. When trading is a significant activity we do not rely solely on VAR. We treat these banks as a peer group and we may score the relatively more risky banks as weak in this risk position assessment. This deeper analysis would include reviews of the results from the banks' stress and scenario testing; policies, risk limits, practices, and organizational structure in trading risk management; and policies, practices, and supplemental VAR data. "Lifting The Lid On Traded Market Risk" explains how we make comparisons using the supplemental VAR data.

#### **G.4. Risks not covered by the RACF**

145. The most common risks that the RACF does not cover are interest rate and currency risk in the banking book and the volatility of pension funding, but there may be other less common bank-specific risks relevant to an individual bank or segment of the market that the capital framework does not capture. We view such a risk as material when it is more significant for a bank than for peers with a similar economic risk score.

##### **G.4.a. Interest rate and currency risk in the banking book**

146. To assess interest rate risk, we look at structural interest rate risk, which arises naturally from business lines such as mortgage lending, and strategic interest rate risk, which the ALM (asset-liability management) function strategically maintains and manages.
147. There is no single measure for sizing interest rate risk. We form a qualitative judgment based on a review of some or all of the following:
- The sensitivity of a bank's projected earnings to changes in interest rates or the shape of the yield curve based on its own stress testing;
  - Senior management's engagement and awareness for setting and managing the amount of interest rate risk;
  - The degree of maturity gap between repricing assets and liabilities; and
  - The adequacy of a bank's risk management based on a review of its scenario and stress testing, optionality characteristics of assets or liabilities with prepayment or extension options, or other behavioral characteristics that differ from contractual ones.
148. For further guidance on how we conduct these reviews and what we view as weaker interest rate risk management, see "Assessing Enterprise Risk Management Practices Of Financial Institutions" and "A Roadmap For Evaluating Financial Institutions' ERM Practices."
149. Similarly, to assess currency risk, we look at the sensitivity of projected earnings to changes in currency exchange rates based on a bank's own stress testing. Currency risk arises when assets in the loan portfolio and the bank's funding are held in different currencies that are not hedged. The risk position of a bank is weaker when currency risk is relatively larger than for peers with a similar economic risk score.

#### **G.4.b. Volatility of pension funding**

150. Standard & Poor's deducts staff unfunded benefit scheme liabilities, including pension deficits, from TAC where a bank's financial statements have not fully recognized them. However, the bank faces additional risk from potential movements in the values of the scheme's assets and liabilities, particularly for defined benefit pensions, and the RACF does not otherwise include this risk.
151. How much risk depends on the size of the scheme's liabilities, and key actuarial assumptions, including the discount factor, life expectancy, or future salary increases and other variables like the investment policy, and the amount of reinsurance used. When the size of the scheme's liabilities is large, a minor change in one of these variables can have a material impact on a bank's financial strength. The pension scheme's valuation report identifies the impact on scheme liabilities from changes in some of the assumptions and variables. An example of such a sensitivity test is the impact on liabilities by increasing participant life expectancy by one year.
152. We look at the ratio of the sensitivity tests to TAC. We may view the risk position as relatively weaker when the impact on scheme liabilities from any of the sensitivity tests identified in the valuation report relative to TAC is relatively larger than for peers with a similar economic risk score.

#### **G.5. Evidence of stronger or weaker loss experience**

153. We expect to see evidence of a stronger risk position reflected in relatively lower recent and expected losses than for peers and a better-than-average track record of losses during recent periods of economic stress (as according to table 18). Conversely, we associate weaker risk positions with losses that are greater than average for peers with a similar economic risk score and similar product mix.
154. We seek to explain any deviation from the average peer performance by highlighting the root causes as any combination of growth, concentration, and complexity, or by considering how bank-specific risk is materially different from the standard risk assumptions in the RACF or our calculation of normalized losses.
155. Examples of the differences may be any of the following:
  - Credit provisioning and loss recognition that may be more or less aggressive than for peers,
  - Volatility in the bank's equity portfolio that may be lower or higher than the RACF charges for equity in the banking book,
  - Legal or regulatory costs or fines that could be higher or lower than for peers in the same lines of business, or
  - Material insurance business (more than 10% of earnings) that could be undercapitalized compared with that for the rest of the group.
156. The RACF equity charges are broadly based on the observed volatility in equity indices in each country. The bank's equity portfolio may be more or less risky than these indices.

## **H. Liquidity**

157. Liquidity is the sixth and final SACP rating factor and the proposed criteria assess the degree to which a bank appears able and prepared to manage its liquidity in adverse market and economic conditions and whether the bank is able to survive over an extended period of time in such conditions. We determine whether liquidity is "strong," "adequate," "less than adequate," or "weak."
158. The main differentiators for liquidity are relative dependence on central bank funding and relative ability to access



other liquidity sources (see table 20 for how we distinguish liquidity among banks). We explain uses and sources of liquidity below (see paragraphs 166-171). We view liquidity as becoming progressively weaker when an institution is relying on funding support from the monetary authorities because funding from other sources is unavailable or prohibitively expensive, particularly when other banks are not using the facilities to the same extent.



Table 20 Liquidity Assessment		
Qualifier	What it means	Observations
Strong*	We have a very high degree of confidence that the bank is able and prepared to successfully manage its liquidity in both benign and adverse economic and market conditions, and can survive in such stressful conditions for 12 months.	Liquidity ratios and market indicators are stronger than for other speculative-grade banks. Short-term sources of liquidity appear to cover short-term uses by at least 1.2 times, even if adverse market and economic conditions arise. In particular, the bank can survive with no access to market funding in the next 12 months. We see no unusual or large liquidity needs in the 12-24 month window. The bank applies comprehensive stress scenarios to identify the full range and size of contingent liabilities. Contingent liabilities are not material and easily identified. The bank's contingency plan does not rely on central bank facilities.
Adequate	We believe that the bank is able and prepared to successfully manage its liquidity in both benign and adverse economic and market conditions, and can survive in such conditions for more than six months.	Liquidity ratios and market indicators do not identify the bank as an outlier relative to other banks with a similar industry risk score. Short-term sources of liquidity appear to cover short-term uses, even if adverse market and economic conditions arise. Contingency plans for adverse conditions include pledging collateral with the central bank to raise liquidity if market access remains constrained for more than six months, but not as a dominant source of liquidity. We see no unusual or large liquidity needs in the 12-24 month window. The bank applies comprehensive stress scenarios to identify the full range and size of contingent liabilities.
Less than adequate	Relative to peers, we believe that the bank is less able and prepared to manage its liquidity in either benign or adverse economic and market conditions. We are less confident that the bank can survive adverse conditions without heavy dependence on the central bank.	Liquidity ratios or market indicators may suggest that the bank has noticeably weaker liquidity than other banks with a similar industry risk score. A bank temporarily relies on government or central bank liquidity facilities more than similar industry risk peers but we expect the bank to reduce its reliance in the next few months. There are signs that the bank has restricted access to nonsecured funding from counterparties other than the central bank and less access than other industry risk peers. Short-term sources of liquidity may not cover short-term uses if adverse market and economic conditions arise. There are large or unusual liquidity needs in the 12-24 month window, but short-term sources of liquidity appear to cover short-term uses, even if adverse market and economic conditions arise. Liquidity management appears aggressive and contingency planning inadequate. Risk management is slow in responding to growth in more sensitive funding sources. The bank's contingency plans are too general or lack detail or do not extend to the appropriate levels across the group, for example, by subsidiary or country.
Weak†	We believe that the bank may be unable or unprepared to manage its liquidity in either benign or adverse economic and market conditions without extraordinary central bank support.	Liquidity ratios for the bank are noticeably weaker than for industry risk peers. The bank cannot access nonsecured funding from counterparties other than the central bank. For refinancing, the bank relies on government or central bank liquidity facilities and it is not clear that the bank can fund independently in the market in the next six months. The reliance on central bank funding is greater than for industry risk peers. The bank is underprepared for a liquidity crunch or has inadequate or questionable emergency liquidity sources.
*We only use this category for speculative-grade banks—not investment-grade banks. †When liquidity is weak, we limit the SACP to 'ccc+' at best.		

159. When comparing uses and sources of liquidity, we consider different survivability periods--for example 30 days, three to six months, and 12 months--since there is no telling how long a market disruption or economic downturn could persist. Where relevant, our analysis includes the potential for local or foreign currency mismatches. In addition, we look at noncontractual or reputational contingencies arising from management's perceived need to preserve franchise value. This may include the repurchase of commercial paper in advance of maturities; calling long-term debt at the first call date, despite having no contractual obligation to do so; the provision of support to money market funds, tender option bonds, and auction rate securities; support of secondary markets in assets as a market maker; or protecting investors from losses on asset-backed securitizations that a bank originates.
160. Even when liquidity is well managed, the proposed criteria would not treat liquidity for a bank as "strong" because a key source of contingent liquidity is based on support from the central bank or monetary authorities. In other words, banks are not entirely self-supporting. High leverage and an asset-liability maturity mismatch--due to the fundamental role of maturity transformation that most banks play--make them confidence-sensitive. This means a bank relies heavily on depositor confidence to avoid having to repay all deposit liabilities on contractual maturity, otherwise known as a run on the bank. As a central part of a bank's contingency plan for such an event, many rely on support from third parties, notably the central bank or monetary authorities. We consider this reliance on third parties to cover the contingent liquidity requirement acceptable for an "adequate" assessment at best for investment-grade banks.
161. Strong liquidity, however, can make a real difference to default risk for a weaker bank. If it is very liquid, a bank could avoid default for a longer period of time than could speculative-grade banks with liquidity that is "adequate" or "weaker." For this reason, the proposed criteria do allow a "strong" liquidity assessment for a bank with an ICR that is 'BB+' or lower. A "strong" liquidity assessment should not raise the final ICR to 'BBB-' from 'BB+'. In such a case, we propose to score liquidity as "adequate."
162. Nonbank financial institutions that do not have access to central bank liquidity may have stronger liquidity than regulated banks and can command a "strong" liquidity assessment. Typically financial institutions without formal access to central bank funding restrict their exposure to short-term calls on their liquidity or rely on excess asset liquidity and committed bank facilities to cover liquidity requirements.
163. We calculate standard liquidity ratios according to table 20. Some ratios will not be available for some banks because of the big differences in public disclosure. We can confidently produce the following universal liquidity ratios:
- Liquid assets to short-term liabilities, and
  - Liquid assets to total deposits.
164. When more detailed data is available, we also look at:
- Liquid assets to short-term wholesale funding,
  - Net liquid assets to core deposits, and
  - Liquidity buffers to short-term liabilities.
165. We interpret liquidity ratios when comparing peers because of definitional differences in financial reporting standards. In addition, we also acknowledge that ratios and adequacy may vary according to a bank's business model. For example, a savings bank will have very different liquidity ratios than a bank focused on corporate and investment banking.

## H.1. Comparing the uses and sources of liquidity

166. Our analysis seeks to find the balance between the bank's expected and contingent uses for liquidity and its sources of reliable liquidity during adverse market and economic conditions. The following two sections explain how we assess the uses of liquidity and the sources of liquidity.
167. Given the contingent nature of a bank's liquidity requirements, our liquidity analysis focuses on understanding how a bank sizes and manages the options embedded in its liabilities under different stresses, and less on specific accounting-based measures and ratios. Sizing the uses of liquidity is complicated by the choices or options that banks normally grant customers and counterparties. For example, depositors are often able to withdraw their funds on demand or at relatively short notice, wholesale investors are free to decide whether to roll over their funding or not, customers may draw down from committed loan facilities at any time, and under derivative contracts changes in market prices or credit perception can increase margin calls and collateral requirements.
168. Regarding the sources of liquidity, we propose to assess the reliability of sources, determine how much unencumbered asset liquidity is on a bank's balance sheet, and assess the strength of liquidity commitments made to it from other counterparties, even during adverse conditions. As an implicit part of this assessment, we consider the strength of a bank's liquidity risk management framework and controls, taking into account the type of business it undertakes and the markets where it operates.

### H.1.a. Uses for liquidity

169. Our analysis assesses the following potential uses of cash to determine a bank's contractual and contingent short-term obligations:
- Deposit runoff and withdrawal. We assess deposit stability by taking account of deposit composition: insured versus uninsured, international versus domestic, corporate versus retail, relationship-based versus rate-based. In each case, the first is more stable than the second.
  - Runoff of other customer funds, for example, prime broker free credit balances.
  - Drawdown of credit commitments. We assess the ability of the bank to reduce limits and the extent of undrawn commitments to customers.
  - Inability to roll over short-term unsecured borrowings, for example, commercial paper, certificates of deposit, promissory notes, or to refinance maturing long-term unsecured debt. We review the maturity profile of wholesale liabilities.
  - Market-driven inability to roll over maturing short-term secured debt or repurchase agreements. That is the market could dry up altogether for lower-quality securities or short of that seek increased margins, collateral requirements, or credit spreads.
  - Company-specific, credit-driven increases in margin and collateral requirements, for example resulting from a breach of rating triggers.
  - Settlement frictions as counterparties increasingly dispute marked-to-market valuations and delay payments.
  - Inability to refinance maturing securitizations backed by revolving assets.
  - Calls under guarantees to unrelated third parties such as standby letters of credit, performance guarantees, securities lending indemnifications, and custody guarantees.
  - Support payments to affiliates, including those that regulations require, guarantees, and keepwell or support agreements.
  - Capital commitments under joint ventures.
  - Penalties resulting from regulatory sanctions.

- Judgments or settlements relating to litigation.

### **H.1.b. Sources of liquidity**

170. The focus of our review of a bank's sources of liquidity is reliability, ranked here according to dependability:
- Drawdown of unrestricted cash and short-term deposits.
  - Systemwide liquidity facilities at central banks or from other government sources, both routine and extraordinary. To determine size, we look at unencumbered assets that the central bank would qualify as collateral and liquidity available in exchange for these assets after central bank haircuts.
  - Drawdown of committed credit facilities, subject to financial covenants and headline considerations.
  - The sale or repo of unencumbered high-quality liquid securities in the open market. Banks make different assumptions about what qualifies as liquid and we seek to understand them and compare them to our market value criteria for rating transactions backed by securities. (See for example, our proposed liquidity criteria in our "Request For Comment: Methodology and Assumptions for Market Value Securities," specifically the section on Asset Liquidity Rankings and table 6.)
  - Within corporate groups, the ability to access funds from affiliates in the form of advances or capital, subject to regulatory and covenant restrictions.
  - Liquidation of short-term advances to other financial institutions sold and reverse repos.
  - Cash available from maturing advances to customers.
  - Accessing the debt and stock markets to the extent still possible.
  - Accessing securitization or covered bond markets through established facilities or asset sales programs.
  - Whole loan sales.
171. Where regulatory or accounting data exist, we can aim to quantify the balance between the uses and sources of liquidity. For an example, see "Liquidity Risk Analysis: Canadian Banks." Following the recent financial crisis, we expect banks to make more data publicly available.

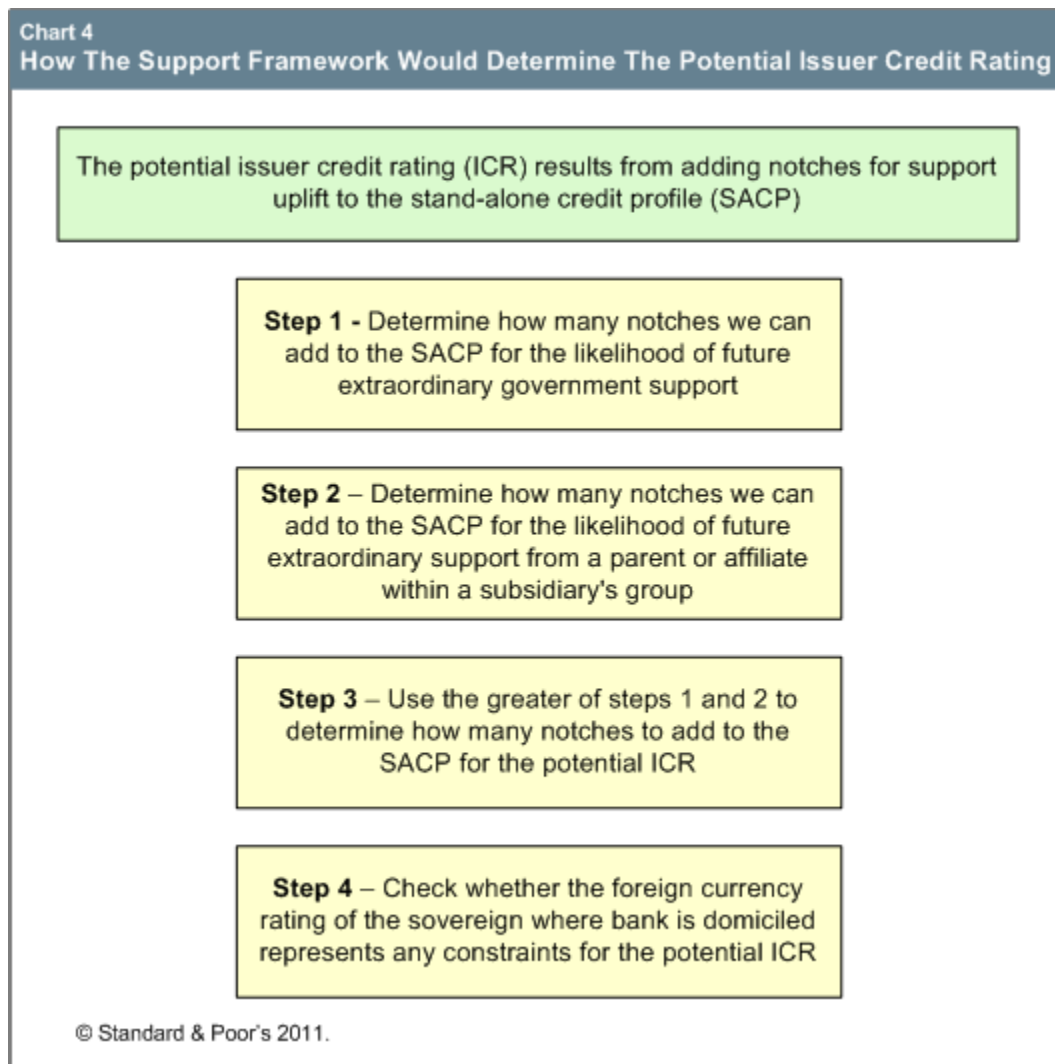
### **H.2. Liquidity-related issues that are handled in other rating factors**

172. Other factors can lead to liquidity problems and we address them elsewhere in the proposed criteria. Liquidity problems can be caused by concerns regarding capital, asset-liability management, or asset quality and we assess those factors in our capital and earnings analysis or risk position analysis.
173. We also exclude elements of funding from our liquidity assessment because the proposed criteria assess systemwide funding as part of the industry risk factor and bank-specific funding as part of the business position factor. Consequently, to avoid double counting, our liquidity assessment does not take into account government actions that strengthen systemwide liquidity or backstop a decline in the interbank or debt markets.
174. It is rare for governments or their agents to commit to bilateral liquidity facilities with a specific bank, but when such formal arrangements are committed, we include them in the liquidity assessment.
175. More commonly, banks use central bank funding facilities as part of the systemwide support that the government provides. We expect banks to use these facilities on a regular basis for balancing their books overnight or opportunistically taking advantage of rates that the central bank offers. While we determine the extent of dependence on the central bank facility in this part of the proposed criteria, the proposed BICRA methodology assesses the quality of the facility. And we look at a bank's ability to access these facilities in the business position assessment.

## METHODOLOGY: SUPPORT FRAMEWORK

176. The support framework considers the relationship between a bank, and its parent group or government, and how this relationship alters the bank's overall creditworthiness. We may assign a potential ICR that is higher than a bank's SACP if we believe it is likely that the bank would receive future extraordinary support in a crisis. In many cases, however, the support framework leads us to conclude that there may be no additional support available, and consequently, the ICR would be at the same level as the SACP. There are three main parts to the proposed support framework that we apply according to chart 4:

- First, we determine the likelihood for future extraordinary government support.
- Second, we assess the likelihood for future extraordinary group support.
- Then, we consider the constraints that the sovereign credit rating may imply for the rating of a bank in the subject's jurisdiction.



177. In practice, a bank normally receives help from either its parent group or government--not both. Consequently, if a

bank is a subsidiary, we would analyze its creditworthiness using our proposed criteria for both government support and group support, and assign the strongest potential ICR resulting from either the first approach or the second. We do not add the result of both approaches.

178. The potential ICR can be higher than the foreign currency rating on the sovereign where the bank is domiciled, only if the bank can meet the conditions listed in paragraph 249. It is possible that the SACP could be stronger or the potential ICR based on group support could be stronger than the foreign currency rating of the sovereign where the bank is domiciled.

## A. Government Support For Banks

179. We are proposing a comprehensive methodology to show how we incorporate the influence of governments into our ICRs on banks. In the next section, we explain how government interactions feed into either the SACP directly or into the support framework. Then the proposed criteria lay out a five-step process for assessing the potential for extraordinary government support and its impact on the rating. Our assessment of the likelihood that the government will provide future extraordinary support builds upon our methodology for assessing support for government-related entities (GREs), "Rating Government-Related Entities: Methodology And Assumptions."
180. Faced with a financial crisis, a government will often, but not always, provide additional support to protect confidence in its economy, in the expectation that the cost of this additional support is less damaging to the overall economy than allowing banks to fail. We recognize that financial institutions, banks in particular, fulfill the crucial functions of safeguarding national savings, allocating savings and deposits to companies and individuals in the form of loans and investments, and serving as intermediaries and agents in financial transactions. Governments implement monetary policy via the banking industry. They also maintain lending arrangements for banks to balance their books on a daily basis and meet short-term liquidity needs. Many governments closely regulate banks and most other financial institutions to ensure that the industry as a whole can perform these crucial roles in a manner that maintains the confidence on which the modern financial system depends.
181. Government influence on banks is usually positive, but on occasion is negative. We also observe that a government may elect to support its banks even if that support results in deterioration in the government's creditworthiness. See our article about the recent case in Ireland: "Republic of Ireland Long-Term Rating Lowered To 'AA-' On Higher Banking Sector Fiscal Costs."

### A.1. Interactions between banks and government: impact on credit ratings

182. We identify the types of government interaction we include in our assessment of the SACP and those we may use to raise the SACP to produce the potential ICR, what we call support uplift.
183. The SACP includes the positive effect of government support for the financial system, negative government interference, and direct support that has already been received or that the government has already "committed" to the bank (see "Stand-Alone Credit Profiles: One Component Of A Rating").
184. We are mindful that the extraordinary government support we expect a bank to receive is by no means certain. This uncertainty means that the support uplift will never result in equal ratings on a non-GRE bank with those on the sovereign. This is because we recognize other variables. For example, the government may:
- Be less able to support a range of banks in a countrywide financial crisis because of its own balance sheet



constraints or because individual banks may be large relative to the domestic economy,

- Be less willing to provide financial support if the specific crisis affects a particular bank rather than all the banks in the national financial system and would have limited knock-on implications for the whole system,
- Change its attitude toward supporting the banking sector over time, or
- Not provide support in time to prevent a default or may provide support that does not fully cover all senior creditors.

185. Government support that is available to the national financial system is included in the SACP. We call this system support and assess it as part of economic and industry risk. Targeted or more direct support that the government provides to a specific bank in crisis is called direct support. The proposed criteria also identify types of government intervention that we consider negative for a bank's SACP, which we capture in the industry risk, business position, and risk position rating factors.

#### **A.1.a. System support**

186. The proposed criteria include system support in the SACP. Governments provide system support to financial institutions through the legal infrastructure, banking regulatory frameworks, and their role in funding banks and maintaining confidence in the financial system. Typically, the impact of system support on a specific institution is difficult to quantify. This reflects the intention of the government support to improve confidence in the country's financial system rather than to directly influence the creditworthiness of a specific bank.
187. We believe that governments support their financial systems to limit the long-term damage of a banking crisis on the economy. Under these proposed criteria, we view any support that is available to the wider system as system support, whether it is ongoing or extraordinary. We have observed many cases of system support in recent years that is extraordinary in nature but not ongoing in our view. Examples are increased depositor insurance, extremely low interest rates, quantitative easing, asset-protection schemes, government-guaranteed liquidity and debt programs, and the eligibility of lower-quality assets as central bank collateral.
188. We assess system support in our proposed BICRA methodology, which feeds directly into the SACP via economic risk (paragraphs 37-43) and industry risk (paragraphs 44-52) rating factors. We therefore reflect changes in a sovereign's support for the country's financial system by reviewing our BICRA, which may result in SACP changes for banks with exposure to that country.

#### **A.1.b. Direct support**

189. The proposed criteria include direct support in the SACP. Governments may provide direct support to individual banks by making liquidity or capital injections or by buying or insuring risky assets. Direct support can be easier to quantify and usually influences the rating factors related to financial risk (capital and earnings, risk position, and liquidity).
190. Once the government has made a commitment to providing direct support, we include it in the SACP. The proposed criteria treat government support as committed when a government's support plans have received the appropriate political approvals, such as from congress or parliament. In some countries, laws exist to give the administration the authority to act without further approvals. It is impractical to separate the capital and liquidity that the government provides from the bank's own resources, especially in subsequent reporting periods.
191. However, we regard it as unlikely that the direct support would raise the bank's SACP to the level it was before the difficulties began. We believe the bank's business position will be weaker than before the stress. The franchise will

have been damaged and there will remain continuing execution risk for the bank in managing through the crisis and back to independence.

#### Chart 5 Example Of System And Direct Support

The boundaries between system support and direct support can be difficult to determine, especially for countrywide programs. When regulators or central banks put these into place and make them available to a range of banks, they can have effects both on the national financial system and directly on individual banks. First, they bring stability to the industry risk score in the SACP assessment and may offset some other weakness, such as funding or the institutional framework. Second, we may raise our assessment of the SACP of those banks that benefit directly from government support programs to reflect the additional support. This is because not all banks will participate in the programs.

The Asset Protection Scheme in the U.K. is an example of a systemwide program. The British government has offered capital relief to all U.K.-based banks by offering to insure them against losses on specific pools of assets. Banks have to apply to the scheme. So far, the only applicant has been the Royal Bank of Scotland Group PLC (RBS), which received £282 billion in risk relief.

If we had applied these proposed criteria at the time, we would have positively factored in the system support delivered to the U.K. banking industry in the BICRA and that would have fed into the SACP for RBS and all U.K. banks. In addition, the direct support for RBS would have offset our view of its weak risk position and consequently would have enhanced its SACP. Finally, we would have still expected RBS to qualify for extraordinary support in the future, which would have resulted in our maintaining the support uplift above the SACP.

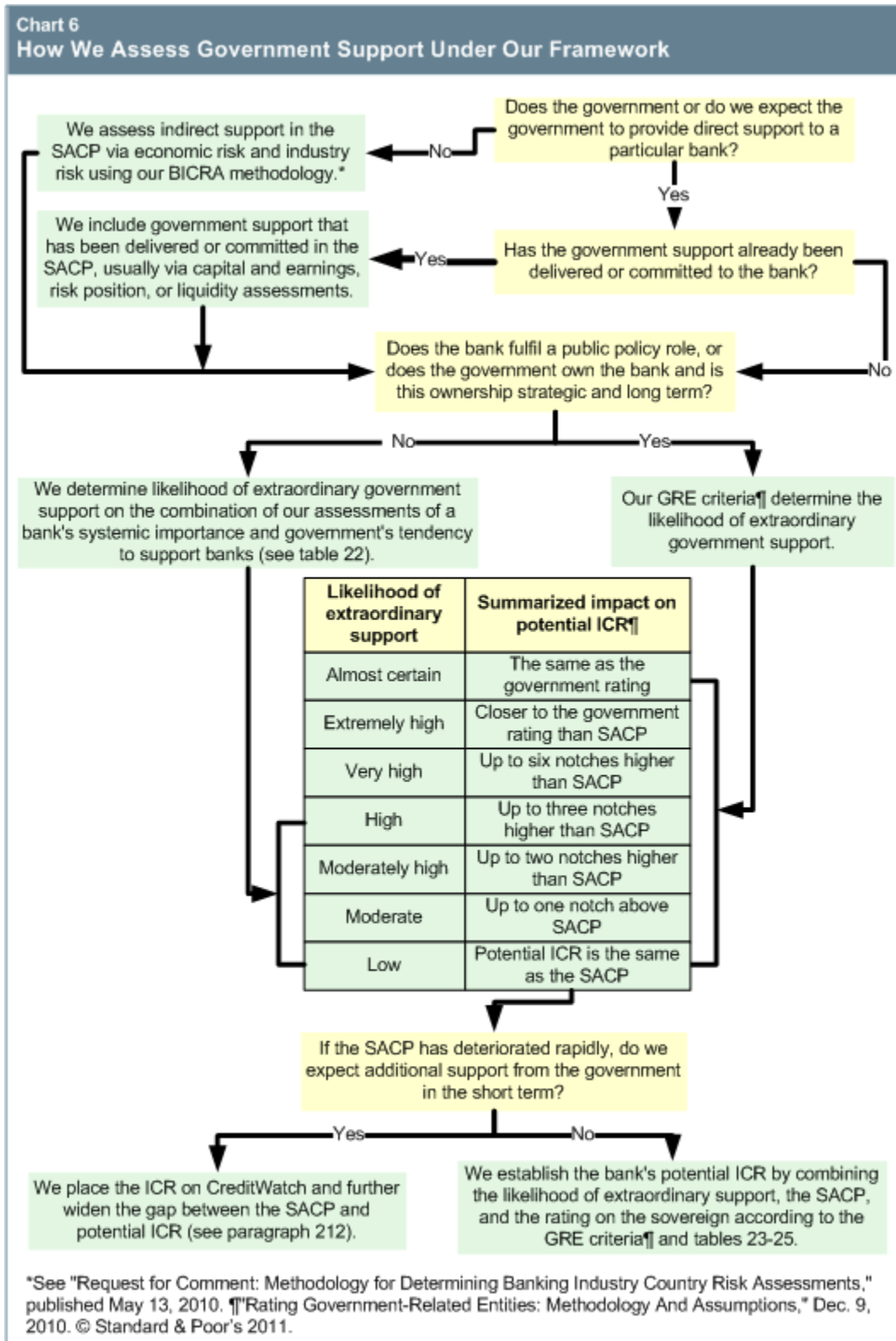
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#### A.1.c. Government interventions that weaken the SACP

192. Various government actions can weaken a bank's creditworthiness by creating distortions or inefficiencies. These can take various forms, including government actions that influence a bank's business decisions. Two specific examples are directed lending and the creation of market distortions.
193. **Directed lending.** Governments can intervene via ownership or regulation and direct banks to lend to particular borrowers or sectors for political purposes. We consider this type of intervention, directed lending, a negative rating factor for the SACP and we take account of this under the business position rating factor (see paragraph 90). We expect lending based on the bank's assessment of the borrowers' ability to repay will lead to fewer credit losses than lending based on government directions. Consequently, we expect that credit losses on directed lending will be greater than the industry average for specific asset classes, which we assess in the risk position rating factor (see paragraph 153).
194. **Market distortions.** A government can also influence the nature of competition in a banking market. Government-owned or -controlled banks can compete on uneconomic terms, forcing a structurally low-margin environment across the sector. We address market distortions in the BICRA methodology as part of our consideration of competitive dynamics. Therefore, it is reflected in a bank's industry risk and anchor SACP.

## A.2. Recognizing support uplift

195. We reflect the potential for future direct or extraordinary government support by raising the credit rating on a bank above its SACP. We factor in this additional support at all times, that is, even under favorable economic conditions when the need for any support appears remote. The support uplift reflects the likelihood that direct support will be made available if the bank experiences financial stress in the future. This recognizes the reduced risk of default for banks that, in our view, are likely to be supported, compared with those of banks that we believe are unlikely to receive additional support.
196. We break the proposed criteria for support uplift from governments into five key steps:
- First, we determine the degree of a bank's systemic importance.
  - Second, we determine a government's tendency to support banks.
  - Third, we establish the likelihood that the government will provide support to a particular bank.
  - Fourth, we determine whether additional short-term support is available, and
  - Fifth, we coordinate the approach to government support in both sovereign and bank ratings.



197. For government-related financial institutions that fulfill a public policy role or where we regard government ownership as strategic and long-term, we assess the likelihood of support using our methodology for rating GREs

(see "Rating Government-Related Entities: Methodology And Assumptions"). We determine the likelihood of government support by assessing the importance of the bank to the government and the strength of the link between the government and the bank.

198. For private-sector commercial banks, we regard the likelihood of government support as a function of our assessment of both the bank's importance in maintaining overall confidence in the financial system (or what we call systemic importance) and the government's tendency to support private-sector commercial banks. The motivation for governments to support private-sector commercial banks is not as clear as that for GREs. Governments act to support their national economies and financial systems and this support often results in added protection for senior creditors of systemically important commercial banks, but the link is by no means certain.
199. We regard private-sector commercial banks as having "high," "moderate," or "low" systemic importance, which we define below. We also explain how we determine a government's tendency to support financial institutions, classifying it into three categories: "interventionist," "supportive," and "uncertain." We then show how we combine these two factors to derive the likelihood of direct government support in the future for private-sector commercial banks.

#### A.2.a. Systemic importance

200. We define systemic importance as the degree to which confidence in the financial strength of a particular bank influences overall confidence in the financial system of the country where it operates. We classify banks as having high, moderate, or low systemic importance. Given the uncertainty of sovereign support, it is possible that banks that we classify as having systemic importance might not receive support in a time of stress.
201. ***Banks with high systemic importance.*** A bank has high systemic importance if the country's financial system is likely to be weakened if the bank defaults on its senior unsecured obligations. In addition, a default is likely to limit the availability of credit for the private sector and trigger a significant financial stress at several other financial institutions. A loss of confidence in such a bank is likely to lead to a loss of confidence in the entire national banking system. However, we do not automatically classify a bank as having high systemic importance if the government or local market participants refer to it that way. Our classification depends on our own assessment of government support.
202. Although size is not the only determining factor, banks that we classify as having high systemic importance usually would be those that maintain a substantial market share (typically more than 10%, particularly in retail banking), with a leading position and brand recognition in the country. They may also be a significant counterparty within the country and international financial system or play a critical role in the national payments system, such that their failure would lead to a loss of confidence in the financial system and significant losses among other counterparties in the market. In addition to these factors, some banks may have high systemic importance because we see that no other institution can step into the key role they play in the economy if they fail.
203. ***Banks with moderate systemic importance.*** A bank has moderate systemic importance if a default on its senior unsecured obligations could weaken the financial system and limit the supply of credit for the private sector. A loss of confidence in such a bank may lead to a loss of confidence in the entire banking system.
204. In our view, a bank with moderate systemic importance is likely to maintain a significant market share in retail banking at the national level, or is a leading provider of banking services to a particular region or sector that plays a significant role in the economy. We believe the systemic implications of a default of such a bank would be more manageable at a national level than would a default of a bank with high systemic importance, but the effect in

specific parts of the economy could be considerable. Banks with moderate systemic importance may also be leading providers of politically sensitive products, such as residential mortgages. A classification of moderate systemic importance for a bank means that if it fails, we expect other counterparties to take on the failed bank's market role.

205. ***Banks with low systemic importance.*** In our opinion, a bank has low systemic importance when it does not fit the definitions for "high" or "moderate" systemic importance. We expect the majority of banks in a banking industry to be in this category, unless the market is particularly concentrated, in which case there could be fewer banks with low systemic importance.
206. Predicting sovereign support for these institutions is very difficult. There is no obvious incentive for sovereigns to prevent the failure of these types of banks. In the event of a crisis, the sovereign may decide to support a bank even though we assign it low systemic importance.

#### **A.2.b. Government tendency to support private-sector banks**

207. We observe that the tendency of governments to support financial institutions varies among countries and can change over time, particularly as legislators respond to the effects of a banking crisis. We consider the capacity and willingness of sovereigns to support failing banks during a crisis and classify sovereigns into three groups, "interventionist," "supportive," and "uncertain" (see table 21).

Table 21 Tendency Of A Sovereign To Bail Out Financial Institutions	
Qualifier	Observations
Interventionist	<p>The government tends to be explicit about its willingness to continually support financial institutions with high and moderate systemic importance, even in the case of bank-specific crises.</p> <p>We can observe a track record of frequent interventions that protect senior creditors from loss.</p> <p>We expect the interventionist policy to continue.</p> <p>The sovereign has sufficient financial resources to support banks and a reasonable framework in place for monitoring its risk to the financial system.</p> <p>Interventions are typically direct capital or liquidity injections, guarantees, or risk-protection schemes.</p> <p>Government interventions are typically not subject to authorization or restrictions by supranational agencies (such as the EU or IMF).</p>
Supportive	<p>The government has no explicit policy of support for the financial sector.</p> <p>We can observe a track record of sovereign actions to support financial institutions with high and moderate systemic importance, particularly during a systemic crisis, which protect senior creditors from loss.</p> <p>Rather than providing support directly, the sovereign tends to encourage or organize a market-led solution where possible.</p> <p>We expect future actions to provide similar support.</p> <p>The government is authorized to provide support, but has to comply with particular conditions or is subject to authorization from parliament/legislatures or supranationals.</p> <p>The sovereign has sufficient financial resources to support banks.</p> <p>The government will typically have a range of policy alternatives for reacting to banking sector stress, which may include legislation that requires creditors to share the burden of providing support to a distressed bank (such as by discounting creditors' obligations).</p> <p>The form of support is typically governed by the type of crisis.</p>
Uncertain	<p>The government has no explicit policy of support, or there is an unambiguous policy or legislation preventing direct support for financial institutions.</p> <p>Senior creditors are expected to share in the losses resulting from the failure of the financial institution.</p> <p>We see no reliable track record of sovereign support actions during past financial crises or evidence that support is not extended to unsecured senior creditors of the bank.</p> <p>We have doubts about the sovereign's capacity to support systemically important financial institutions.</p>

### A.3. Determining the likelihood of government support

208. We determine the likelihood of government support: "high," "moderately high," "moderate," or "low" by combining our assessments of a bank's systemic importance and a government's tendency to support banks according to table 22.

**Table 22**

Systemic importance	Government's tendency to support private-sector commercial banks		
	Interventionist	Supportive	Uncertain
<b>High systemic importance</b>	High	Moderately high	Low
<b>Moderate systemic importance</b>	Moderately high	Moderate	Low
<b>Low systemic importance</b>	Low	Low	Low

Source: Standard & Poor's.

209. Once we have determined the likelihood of extraordinary government support, the proposed criteria establish the bank's potential issuer credit rating by combining the likelihood of extraordinary support, the SACP, and the rating on the sovereign. The combination of these factors and their effect on the potential ICR is outlined in tables 23-25 below. These tables yield the bank's potential ICR based on its SACP (listed down the left-hand side of the table), the government's local currency rating (listed across the top of the table), based on our assessment of the likelihood of extraordinary government support. A low likelihood of support means that the potential ICR is the same as the SACP. But the ICR may be different from the potential ICR after we apply the proposed criteria for group support (see paragraphs 221-246) or when we set the ICR (see paragraphs 25-30)
210. Although we may assess a bank's SACP at 'aa+', even if the likelihood of government support is "high" and the sovereign is rated 'AAA', we would not raise the ICR to 'AAA'. This is line with our view of the general uncertainty of government support for non-GRE banks. The potential ICRs for banks indicated in tables 23-25 would generally be capped at the level of the sovereign foreign currency rating, unless the bank's SACP exceeds the sovereign foreign currency rating, after considering the factors listed in paragraph 249.

**Table 23**

High Likelihood Of Extraordinary Government Support																
Government's local currency rating																
SACP	AAA	AA+	AA	AA-	A+	A	A-	BBB+	BBB	BBB-	BB+	BB	BB-	B+	B	B-
aaa	AAA															
aa+	AA+	AA+														
aa	AA+	AA	AA													
aa-	AA	AA	AA-	AA-												
a+	AA-	AA-	AA-	A+	A+											
a	AA-	A+	A+	A+	A	A										
a-	AA-	A+	A+	A	A	A-	A-									
bbb+	A+	A+	A	A	A	A-	BBB+	BBB+								
bbb	A	A	A	A-	A-	A-	BBB+	BBB	BBB							
bbb-	A-	A-	A-	A-	BBB+	BBB+	BBB+	BBB	BBB-	BBB-						
bb+	BBB+	BBB+	BBB+	BBB+	BBB+	BBB	BBB	BBB	BBB-	BB+	BB+					
bb	BBB	BBB	BBB	BBB	BBB	BBB	BBB-	BBB-	BBB-	BB+	BB	BB				
bb-	BBB-	BBB-	BBB-	BBB-	BBB-	BBB-	BBB-	BB+	BB+	BB+	BB	BB-	BB-			
b+	BB+	BB+	BB+	BB+	BB+	BB+	BB+	BB+	BB	BB	BB-	BB-	B+	B+		
b	BB	BB	BB	BB	BB	BB	BB	BB	BB	BB-	BB-	BB-	B+	B	B	
b-	BB-	BB-	BB-	BB-	BB-	BB-	BB-	BB-	BB-	BB-	B+	B+	B	B-	B-	B-
ccc+	B+	B+	B+	B+	B+	B+	B+	B+	B+	B+	B	B	B-	B-	B-	CCC+
ccc	B	B	B	B	B	B	B	B	B	B-	B-	B-	CCC+	CCC+	CCC+	
ccc-	B-	B-	B-	B-	B-	B-	B-	B-	B-	B-	CCC+	CCC+	CCC+	CCC	CCC	CCC
cc	B-	B-	B-	B-	CCC+	CCC+	CCC+	CCC+	CCC+	CCC+	CCC	CCC	CCC	CCC-	CCC-	CC

SACP--Stand-alone credit profile.



Table 24

Moderately High Likelihood Of Extraordinary Government Support																
Government's local currency rating																
SACP	AAA	AA+	AA	AA-	A+	A	A-	BBB+	BBB	BBB-	BB+	BB	BB-	B+	B	B-
aaa	AAA															
aa+	AA+	AA+														
aa	AA	AA	AA													
aa-	AA	AA-	AA-	AA-												
a+	AA-	AA-	A+	A+	A+											
a	A+	A+	A+	A	A	A										
a-	A+	A	A	A	A-	A-	A-									
bbb+	A	A	A-	A-	A-	BBB+	BBB+	BBB+								
bbb	A-	A-	A-	BBB+	BBB+	BBB+	BBB	BBB	BBB							
bbb-	BBB+	BBB+	BBB+	BBB+	BBB	BBB	BBB	BBB	BBB-	BBB-	BBB-					
bb+	BBB	BBB	BBB	BBB	BBB	BBB-	BBB-	BBB-	BBB-	BB+	BB+	BB+				
bb	BBB-	BBB-	BBB-	BBB-	BBB-	BBB-	BBB-	BB+	BB+	BB+	BB	BB	BB			
bb-	BB+	BB+	BB+	BB+	BB+	BB+	BB+	BB	BB	BB	BB-	BB-	BB-			
b+	BB	BB	BB	BB	BB	BB	BB	BB	BB-	BB-	BB-	B+	B+	B+		
b	BB-	BB-	BB-	BB-	BB-	BB-	BB-	BB-	BB-	B+	B+	B+	B	B	B	
b-	B+	B+	B+	B+	B+	B+	B+	B+	B+	B+	B	B	B	B-	B-	B-
ccc+	B	B	B	B	B	B	B	B	B	B-	B-	B-	CCC+	CCC+	CCC+	
ccc	B-	B-	B-	B-	B-	B-	B-	B-	B-	B-	CCC+	CCC+	CCC+	CCC	CCC	CCC
ccc-	CCC+	CCC+	CCC+	CCC+	CCC+	CCC+	CCC+	CCC+	CCC+	CCC	CCC	CCC	CCC-	CCC-	CCC-	
cc	CCC	CCC	CCC	CCC	CCC	CCC	CCC	CCC	CCC	CCC	CCC-	CCC-	CCC-	CC	CC	CC

SACP--Stand-alone credit profile.

Table 25

Moderate Likelihood Of Extraordinary Government Support																
Government's local currency rating																
SACP	AAA	AA+	AA	AA-	A+	A	A-	BBB+	BBB	BBB-	BB+	BB	BB-	B+	B	B-
aaa	AAA															
aa+	AA+	AA+														
aa	AA	AA	AA													
aa-	AA-	AA-	AA-	AA-												
a+	AA-	A+	A+	A+	A+											
a	A+	A+	A	A	A	A										
a-	A	A	A	A-	A-	A-	A-									
bbb+	A-	A-	A-	A-	BBB+	BBB+	BBB+	BBB+								
bbb	BBB+	BBB+	BBB+	BBB+	BBB+	BBB	BBB	BBB	BBB							
bbb-	BBB	BBB	BBB	BBB	BBB	BBB	BBB-	BBB-	BBB-	BBB-						
bb+	BBB-	BBB-	BBB-	BBB-	BBB-	BBB-	BBB-	BBB-	BB+	BB+	BB+	BB+				
bb	BB+	BB+	BB+	BB+	BB+	BB+	BB+	BB+	BB+	BB	BB	BB	BB			
bb-	BB	BB	BB	BB	BB	BB	BB	BB	BB	BB-	BB-	BB-	BB-			
b+	BB-	BB-	BB-	BB-	BB-	BB-	BB-	BB-	BB-	BB-	B+	B+	B+	B+		
b	B+	B+	B+	B+	B+	B+	B+	B+	B+	B+	B+	B	B	B	B	
b-	B	B	B	B	B	B	B	B	B	B	B	B	B-	B-	B-	B-
ccc+	B-	B-	B-	B-	B-	B-	B-	B-	B-	B-	B-	B-	B-	CCC+	CCC+	CCC+
ccc	CCC+	CCC+	CCC+	CCC+	CCC+	CCC+	CCC+	CCC+	CCC+	CCC+	CCC+	CCC+	CCC+	CCC	CCC	CCC
ccc-	CCC	CCC	CCC	CCC	CCC	CCC	CCC	CCC	CCC	CCC	CCC	CCC	CCC	CCC-	CCC-	CCC-
cc	CCC-	CCC-	CCC-	CCC-	CCC-	CCC-	CCC-	CCC-	CCC-	CCC-	CC	CC	CC	CC	CC	CC

SACP--Stand-alone credit profile.

#### A.4. Additional short-term support for systemically important banks

211. If the SACP of a bank with high or moderate systemic importance deteriorates rapidly--by more than two notches at a single review--we consider whether the government is likely to provide additional short-term support. If so, we would apply temporary uplift based upon our expectation that the government will provide such support. In practice, it can take some time for the government to make a specific commitment to providing additional short-term support after a financial problem at a highly systemically important bank surfaces. In such cases, we can occasionally anticipate the form and quantity of support, based on our view of a government's intentions before it commits the support. For that reason, we would assign greater support uplift above the SACP than implied by tables 23-25.
212. In all instances, if we observe that a bank's SACP is deteriorating rapidly, we would lower our assessment of the SACP, lower the ICR by at least one notch, and place the ICR on CreditWatch with negative implications. The proposed criteria expect an expression of the following in the rationale for the CreditWatch:
  - That we expect the government to confirm the importance of the bank by providing a public statement of support that we believe covers the bank's obligations to its senior creditors;

- Our estimate of the amount or range of support required to restore the bank's capital or liquidity to the minimum levels set by the regulator; and
  - Our opinion about whether the sovereign has sufficient capacity to provide this level of support.
213. If there is no public statement of support from the government in the ensuing days, we would change our assessment of systemic importance to "low" and thereby remove the uplift for government support and lower the ICR to the level of the SACP. If there are doubts about the sovereign's ability to support the institution, we would lower the ICR to the same level as the bank's SACP and, in addition, review the uplift available for all other banks with high or moderate systemic importance in that country.
214. If the government makes a clear statement of intent to support the bank, we can resolve the CreditWatch by estimating the monetary amount of support that will be made available. We can base this estimate on details provided by the government, or by calculating the amount of fresh capital or liquidity required to restore capital or liquidity to the regulatory minimum, that is, the amount that would keep the bank a going concern from a regulatory perspective. We calculate the amounts to meet the minimum regulatory requirement, unless there is guidance that the regulator expects the bank in question to comply with a different requirement.
215. Using this estimate, we can assess notches of uplift once the support is committed by including it in our evaluation of capital, risk, or liquidity. Therefore, in the short term, uplift will reflect the anticipated near-term government support, as well as the potential to receive additional support in the future (according to table 22). After the anticipated near-term support is committed, we include the support in the SACP and refer to the relevant support table (table 23, 24, or 25) to determine the potential ICR.
216. The government support that Citigroup received in 2008 and 2009 are examples of what we consider to be additional short-term support. In line with these proposed criteria, we could have estimated in late 2008 that Citigroup needed \$45 billion to restore capital so that tangible common equity would have been 4% of regulatory RWAs. At the time, tangible common equity divided by RWAs was the regulator's favored capital measure. If we had believed that the likelihood of government support would have been moderately high for Citigroup, we could have justified a wider gap between the SACP and the potential ICR, as indicated in table 24. Subsequently, when Citigroup received the funds, we would have included this in our assessment of capital and earnings and raised the SACP.

#### **A.5. Linking government-supported bank ratings to sovereign ratings**

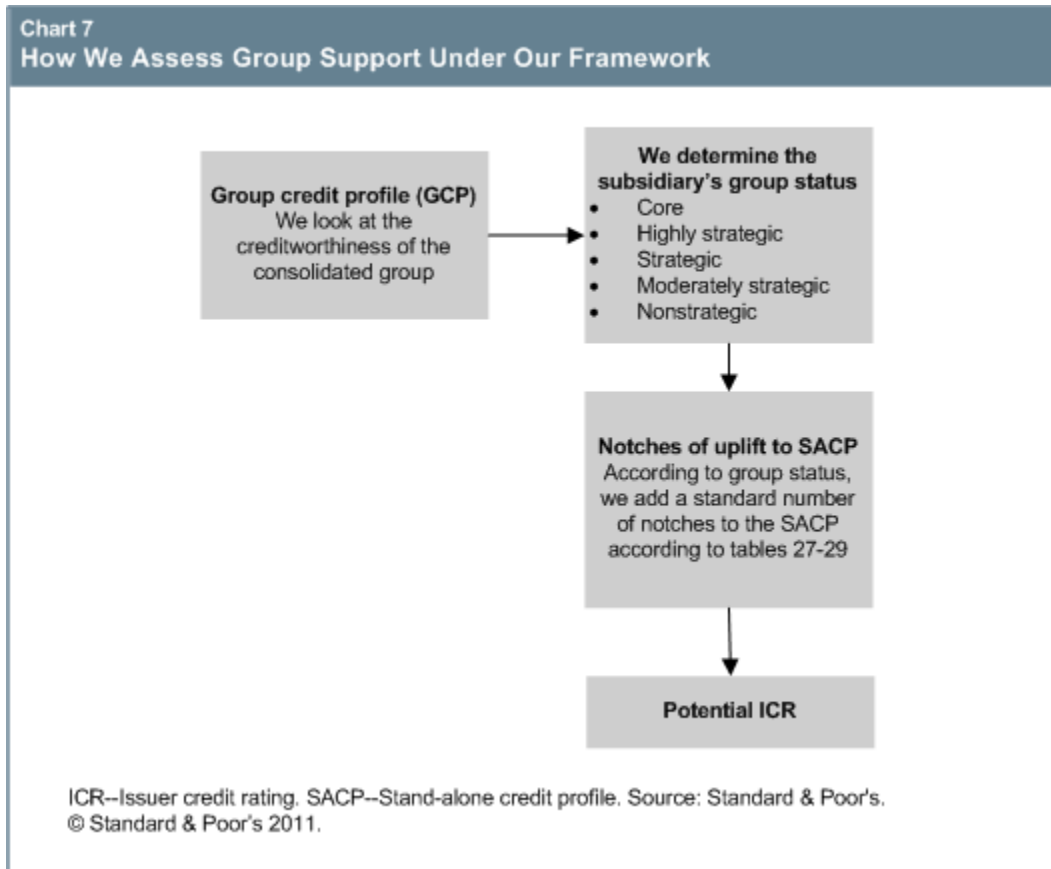
217. The proposed criteria for rating banks ensure a direct link with the criteria for rating sovereign governments to cross-check that the government support available to banks does not exceed the contingent liability we factor into our sovereign ratings for supporting the financial system. We use a three-step process to do this. First, we estimate the sovereign's contingent liability toward its financial sector (see "Request for Comment: Sovereign Government Rating Methodology And Assumptions," paragraph 93). Second, we estimate the aggregate capital shortfall for the financial sector, as defined by the systemically important banks and other financial institutions that are GREs. Finally, we compare the two estimates. When the aggregate shortfall for the financial sector exceeds the contingent liability, we either limit the number of systemically important banks, or we increase the contingent liability for the sovereign.
218. We would limit the number of banks with high and moderate systemic importance by rank ordering the banks in terms of importance according to the factors detailed in paragraphs 201-205 and excluding the least important banks until the aggregate estimated shortfall is less than the contingent liability. Alternatively, an increase in

contingent liability for the sovereign could lead to a lower sovereign rating, and a lower sovereign rating would in turn lead to lower ratings on banks according to tables 23-25.

219. A significant input to the estimate for the sovereign's contingent liability is our proposed estimate for stressed systemwide credit losses. We calculate the aggregate credit loss for the country's banking industry following the same economic stress as measured in the RACF, by applying the RACF's capital charges to aggregate loans in the country. (For how we apply different charges in different countries according to the BICRA economic risk score see paragraph 105).
220. We estimate the capital shortfall for GREs and banks with high or moderate systemic importance by calculating the aggregate capital needed to increase the banks' capital ratios to the minimum levels acceptable to the regulators (see paragraph 100).

## B. Group Rating Methodology

221. Ownership ties and group affiliations among different legal entities are a key rating consideration. The proposed criteria reflect the potential for a bank subsidiary to receive future extraordinary support from a group affiliate or parent by raising the credit rating on a bank subsidiary above its SACP. Just as for government support, we factor in this additional support at all times, even under favorable economic conditions when the need for any support appears remote.
222. To determine the degree of group support and its impact on the potential ICR, the proposed criteria follow these three steps:
  - First, we determine an SACP on the subsidiary and a group credit profile (GCP).
  - Second, we assess the strategic importance of the subsidiary to the group.
  - Third, we determine the potential ICR by combining the GCP, the SACP on the subsidiary, and the strategic importance classification.



223. This section concludes by addressing the impact of intragroup support agreements, how to apply the group methodology to start-up subsidiaries, and finally how the proposed criteria treat stronger subsidiaries owned by a weaker group or parent. "Analytical Approach To Assessing Nonoperating Holding Companies" explains how we rate holding companies.

### B.1. Group credit profile

224. When we rate a member of a financial services group, we start by assessing the credit profile of the overall group, that is, the group credit profile. We use the relevant methodology for rating banks or insurers and assess the entire consolidated group as though it were a single entity. Our GCP assessment serves as the reference point for rating individual legal entities that are part of the group. When insurance business represents more than 50% of the group, we apply the insurance group methodology to any group subsidiary. When banking represents more than 50% of the group, we plan to apply the methodology described in this section to any group subsidiary.
225. When using the GCP in tables 27-29 below, it is important to consider the impact of any future extraordinary government support. If we believe that government support for the group would not be available to a subsidiary, we apply the tables using the GCP excluding the uplift for extraordinary government support. If we believe that the government would approve the use of its support to help a group subsidiary, we apply the tables using the GCP including the uplift for extraordinary government support.

## B.2. Strategic importance

226. Historical data show that financial services groups typically support their subsidiaries. We are mindful, however, that a subsidiary's importance to a group will influence the amount of support it receives. According to a framework that we discuss in detail below, we classify a subsidiary's group status into one of five categories:

- Core,
- Highly strategic,
- Strategically important,
- Moderately strategic, and
- Nonstrategic.

227. We then associate a level of group status with differing degrees of uplift, if any, above or below the SACP to arrive at the potential ICR (see table 26). We can rate any subsidiary the same as the GCP if we consider its SACP to be equal to or stronger than the GCP.

**Table 26**

Associating A Subsidiary's Group Status With A Potential ICR		
Group status	Definition	Potential ICR*
Core	Integral to the group's current identity and future strategy. We believe the rest of the group would support core subsidiaries under any foreseeable circumstances.	Same as the group credit profile
Highly strategic	Almost integral to the group's current identity and future strategy. We believe the rest of the group would support highly strategic subsidiaries under most foreseeable circumstances.	See table 27
Strategically important	Less integral to the group than highly strategic subsidiaries. We anticipate that the group would provide additional liquidity, capital, or risk transfer in some circumstances. However, some factors raise doubts about the extent of group support.	See table 28
Moderately strategic	Not important enough to warrant additional liquidity, capital, or risk-transfer support in several foreseeable scenarios. Nevertheless, there is potential for some minimal support from the group.	See table 29
Nonstrategic	No strategic importance to the group. We believe these subsidiaries could be sold opportunistically in the near or medium term.	Same as the stand-alone credit profile

\*Subject to sovereign rating constraints (see paragraphs 247-252), and application of the government support criteria (see paragraphs 195-220). Source: Standard & Poor's.

228. We often regard highly strategic or strategically important subsidiaries as dynamic entities that are either potentially moving toward full core status or gradually losing strategic significance. The failure of a group to support any strategic subsidiary in financial difficulty would prompt us to review the strategic status of all of its subsidiaries that we rate. Similarly, we would review the rating of a subsidiary where we have factored in group support if the parent sells or intends to sell it. In such cases, we remove the support element from the rating.

### B.2.a. Core subsidiaries

229. Core subsidiaries meet all of these characteristics:

- Operate in lines of business integral to the overall group strategy. The activities they undertake or the products they sell are very closely aligned with the group's mainstream business, and they often operate in the same target market. Nevertheless, the subsidiary's business risk should not be substantially higher than the group's;
- Have a strong commitment of support from senior group management in good times and in bad. We could view a decision to integrate the operations of a subsidiary or affiliate fully into those of the group as an indication of such a commitment;
- Constitute a significant proportion of the consolidated group, that is, at least 5%-10% of consolidated group capital, or show the ability to reach this level within three to five years. The subsidiary should also consistently

- contribute a sizable proportion of the group's consolidated turnover and earnings;
- Are closely linked to the group's reputation among customers and counterparties in the group's home country, when operating in foreign markets;
- Are unlikely to be sold, for instance, if administrative, operational, and infrastructure interdependence makes it virtually impossible to sever the entity from the rest of the group; and
- Are majority owned, that is, the parent group controls at least 51% of the voting rights.

230. Core subsidiaries must also have one of the following characteristics:

- Share the same name or brand with the main group, unless there is a strong business development incentive to use a different name;
- Are incorporated separately for legal, regulatory, or tax purposes, but operate more as divisions or profit centers within the group. Their business, customer, and regional orientations are usually similar to those of other principal operations of the group. Core subsidiaries often use the group's distribution networks and share administrative functions with other major operating units;
- Demonstrate capitalization commensurate with the rating on the group; or
- Are successful at what they do, or have what we see as realistic medium-term prospects for achieving group management's specific expectations and earnings norms within the group. We would not view as core any subsidiaries that have ongoing performance problems or that in our view will underperform against group expectations and earnings norms over the medium to long term.

231. If a group fully integrates a subsidiary's operations, it may be difficult to determine a SACP on the subsidiary. We would therefore regard the subsidiary as a cost center or division rather than a separate legal entity. In such cases, we define such subsidiaries as "core" and rely on our analysis of the group.

### **B.2.b. Highly strategic subsidiaries**

232. We define highly strategic subsidiaries as those that we may decide not to rate at the same level as the group, despite their very close integration with the group. We consider that highly strategic subsidiaries are very close to "core," but do not display one or two of the mandatory characteristics.
233. Typically, we would not classify a newly acquired subsidiary as "core" during the first year or two after the acquisition because of integration risks and the potential for new unanticipated risks to emerge. The sooner the group assimilates a major acquisition, the faster we would consider regarding it as a core subsidiary. However, significant and sustained operating deterioration or earnings underperformance could cause us to reclassify the subsidiary's group status.

Table 27

The Potential ICR For Highly Strategic Subsidiaries																
Group credit profile																
SACP	AAA	AA+	AA	AA-	A+	A	A-	BBB+	BBB	BBB-	BB+	BB	BB-	B+	B	B-
aaa	AAA															
aa+	AAA	AA+														
aa	AAA	AA+	AA													
aa-	AAA	AA+	AA	AA-												
a+	AA+	AA	AA	AA-	A+											
a	AA+	AA	AA-	AA-	A+	A										
a-	AA+	AA	AA-	A+	A	A	A-									
bbb+	AA+	AA	AA-	A+	A	A-	A-	BBB+								
bbb	AA+	AA	AA-	A+	A	A-	BBB+	BBB+	BBB							
bbb-	AA+	AA	AA-	A+	A	A-	BBB+	BBB	BBB	BBB-						
bb+	AA+	AA	AA-	A+	A	A-	BBB+	BBB	BBB-	BBB-	BB+					
bb	AA	AA-	A+	A+	A	A-	BBB+	BBB	BBB-	BB+	BB	BB				
bb-	AA	AA-	A+	A+	A	A-	BBB+	BBB	BBB-	BB+	BB	BB-	BB-			
b+	AA	AA-	A	A	BBB+	BBB+	BBB	BBB-	BB+	BB	BB	BB-	B+	B+		
b	AA-	A+	A	A	BBB+	BBB+	BBB	BBB-	BB+	BB	BB	BB-	B+	B	B	
b-	AA-	A	A	A	BBB	BBB	BBB	BBB-	BB+	BB	BB	BB-	B+	B	B-	B-
ccc+	BBB-	BBB-	BBB-	BBB-	BBB-	BBB-	BBB-	BB+	BB	BB-	B+	B+	B	B-	B-	CCC+
ccc	BB+	BB+	BB+	BB+	BB+	BB+	BB+	BB	BB	BB-	B+	B+	B	B-	B-	CCC+
ccc-	BB+	BB+	BB+	BB+	BB+	BB+	BB+	BB	BB	BB-	B+	B+	B	B-	B-	CCC+
cc	BB-	BB-	BB-	BB-	BB-	BB-	BB-	B+	B+	B+	B	B	B-	CCC+	CCC+	CCC

ICR--issuer credit rating. SACP--Stand-alone credit profile. Source: Standard & Poor's.

### B.2.c. Strategically important subsidiaries

234. A strategically important subsidiary satisfies at least one of the following conditions:

- Does not exhibit the size that we regard as necessary for core status;
- Is important to the group's long-term strategy, but operates independently from the group;
- Does not share the group's name or uses a different name that does not appear to have high brand value. In such instances, we could regard the difference in name as a way to distance the parent company from the subsidiary;
- Appears to have the commitment of group management, and the group is unlikely to sell it within two years;
- Shares the same customer or distribution base and many other characteristics with the core group, but the nature of the business poses a distinctly higher risk than is normal for the group. Such subsidiaries could constitute a potentially significant threat to the earnings or financial strength of the consolidated group;
- Is reasonably successful at what it does or has realistic medium-term prospects of success relative to group management's specific expectations and group earnings norms; or
- Is unlikely to be sold, even though the product line or market is not strategic to the group's continuing operations. An example might be a major subsidiary facing significant problems and challenges, but where we



expect the group to keep the subsidiary within the group.

235. Infrequently, we may regard subsidiaries as strategically important, even though they clearly operate outside a group's mainstream business areas. The group may not closely integrate the management of these operations. Nevertheless, we may consider them important to the group's ongoing strategy if we perceive a strong commitment to the subsidiary and if we believe it unlikely that the group will sell the subsidiary.

**Table 28**

The Potential ICR For Strategically Important Subsidiaries																
Group credit profile																
SACP	AAA	AA+	AA	AA-	A+	A	A-	BBB+	BBB	BBB-	BB+	BB	BB-	B+	B	B-
<b>aaa</b>	AAA															
<b>aa+</b>	AA+	AA+														
<b>aa</b>	AA+	AA	AA													
<b>aa-</b>	AA	AA	AA-	AA-												
<b>a+</b>	AA-	AA-	AA-	A+	A+											
<b>a</b>	AA-	A+	A+	A+	A	A										
<b>a-</b>	AA-	A+	A+	A	A	A-	A-									
<b>bbb+</b>	A+	A+	A	A	A	A-	BBB+	BBB+								
<b>bbb</b>	A	A	A	A-	A-	A-	BBB+	BBB	BBB							
<b>bbb-</b>	A-	A-	A-	A-	BBB+	BBB+	BBB+	BBB	BBB-	BBB-						
<b>bb+</b>	BBB+	BBB+	BBB+	BBB+	BBB+	BBB	BBB	BBB	BBB-	BB+	BB+					
<b>bb</b>	BBB	BBB	BBB	BBB	BBB	BBB	BBB-	BBB-	BBB-	BB+	BB	BB				
<b>bb-</b>	BBB-	BBB-	BBB-	BBB-	BBB-	BBB-	BBB-	BB+	BB+	BB+	BB	BB-	BB-			
<b>b+</b>	BB+	BB+	BB+	BB+	BB+	BB+	BB+	BB+	BB	BB	BB-	BB-	B+	B+		
<b>b</b>	BB	BB	BB	BB	BB	BB	BB	BB	BB	BB-	BB-	BB-	B+	B	B	
<b>b-</b>	BB-	BB-	BB-	BB-	BB-	BB-	BB-	BB-	BB-	BB-	B+	B+	B	B-	B-	B-
<b>ccc+</b>	B+	B+	B+	B+	B+	B+	B+	B+	B+	B+	B	B	B-	B-	B-	CCC+
<b>ccc</b>	B	B	B	B	B	B	B	B	B	B	B-	B-	B-	CCC+	CCC+	CCC+
<b>ccc-</b>	B-	B-	B-	B-	B-	B-	B-	B-	B-	B-	CCC+	CCC+	CCC+	CCC	CCC	CCC
<b>cc</b>	B-	B-	B-	B-	CCC+	CCC+	CCC+	CCC+	CCC+	CCC+	CCC	CCC	CCC	CCC-	CCC-	CC

ICR--issuer credit rating. SACP--Stand-alone credit profile. Source: Standard & Poor's.

### B.2.d. Moderately strategic subsidiaries

236. A moderately strategic subsidiary meets at least one of these conditions:
- Shows some characteristics of strategically important entities but appears less well capitalized than the rest of the group, or is unlikely to meet the group management's expectations and group's earnings norms over the medium to long term;
  - Is unlikely to be sold in the short term. We believe such subsidiaries are likely to receive support from the parent if they fall into financial difficulty and support would be small relative to the group's resources; or
  - Is for sale, but relies on support from the parent to maintain its value. In such cases, we believe that for the

subsidiary to remain a going concern, the new owner would need to be stronger than the subsidiary and be willing and able to provide the same level of support to the subsidiary.

**Table 29**

The Potential ICR For Moderately Important Subsidiaries																
SACP	Group credit profile															
	AAA	AA+	AA	AA-	A+	A	A-	BBB+	BBB	BBB-	BB+	BB	BB-	B+	B	B-
<b>aaa</b>	AAA															
<b>aa+</b>	AA+	AA+														
<b>aa</b>	AA	AA	AA													
<b>aa-</b>	AA-	AA-	AA-	AA-												
<b>a+</b>	AA-	A+	A+	A+	A+											
<b>a</b>	A+	A+	A	A	A	A										
<b>a-</b>	A	A	A	A-	A-	A-	A-									
<b>bbb+</b>	A-	A-	A-	A-	BBB+	BBB+	BBB+	BBB+								
<b>bbb</b>	BBB+	BBB+	BBB+	BBB+	BBB+	BBB	BBB	BBB	BBB							
<b>bbb-</b>	BBB	BBB	BBB	BBB	BBB	BBB	BBB-	BBB-	BBB-	BBB-						
<b>bb+</b>	BBB-	BBB-	BBB-	BBB-	BBB-	BBB-	BBB-	BB+	BB+	BB+	BB+					
<b>bb</b>	BB+	BB+	BB+	BB+	BB+	BB+	BB+	BB+	BB	BB	BB	BB				
<b>bb-</b>	BB	BB	BB	BB	BB	BB	BB	BB	BB	BB-	BB-	BB-	BB-			
<b>b+</b>	BB-	BB-	BB-	BB-	BB-	BB-	BB-	BB-	BB-	BB-	B+	B+	B+	B+		
<b>b</b>	B+	B+	B+	B+	B+	B+	B+	B+	B+	B+	B+	B	B	B	B	
<b>b-</b>	B	B	B	B	B	B	B	B	B	B	B	B	B-	B-	B-	B-
<b>ccc+</b>	B-	B-	B-	B-	B-	B-	B-	B-	B-	B-	B-	B-	B-	CCC+	CCC+	CCC+
<b>ccc</b>	CCC+	CCC+	CCC+	CCC+	CCC+	CCC+	CCC+	CCC+	CCC+	CCC+	CCC+	CCC+	CCC+	CCC	CCC	CCC
<b>ccc-</b>	CCC	CCC	CCC	CCC	CCC	CCC	CCC	CCC	CCC	CCC	CCC	CCC	CCC	CCC-	CCC-	CCC-
<b>cc</b>	CCC-	CCC-	CCC-	CCC-	CCC-	CCC-	CCC-	CCC-	CCC-	CCC-	CC	CC	CC	CC	CC	CC

ICR--issuer credit rating. SACP--Stand-alone credit profile. Source: Standard & Poor's.

### B.2.e. Nonstrategic subsidiaries

237. A nonstrategic subsidiary meets at least one of these conditions:

- It does not qualify under the proposed criteria for the other strategic categories;
- It is not prudently capitalized, in our view;
- We believe that it might be sold in the relatively near or intermediate term or, in the case of insurance subsidiaries, be placed in runoff;
- It is highly unprofitable or marginally profitable, and we believe there is little likelihood of a turnaround or of additional support from the group; or
- It operates in an ancillary, nonstrategic business for the group.

### B.3. Support agreements

238. The strategic incentive for a group to support its subsidiary is more important than a nonbinding agreement. For that reason, our group methodology takes precedence over support agreements for the determination of the degree of group support uplift. Group members may support affiliates through written agreements. Such support agreements are less formal than guarantees and can take the form of maintenance agreements, keepwell agreements, or letters of comfort. We generally consider support agreements less reliable than guarantees because:
- They are negotiated among affiliates rather than directly with debtholders. We therefore see a possibility that these agreements can be modified or terminated, to the detriment of the debtholder;
  - Debtholders are unable to legally enforce such agreements in many jurisdictions; and
  - The agreements do not provide directly for debt service. Consequently, if a company suffers a sudden liquidity crisis, it may not receive sufficient relief in time to prevent a default.
239. Although not binding like a guarantee, some support agreements in our view are significant in that they formally state the group's intentions to support a subsidiary. We examine the terms and conditions of support agreements to assess their credit value. If we conclude that a support agreement is strong, we move the subsidiary into the next strongest strategic category--for example from strategically important to highly strategic or from moderately strategic to strategically important. We don't consider a support agreement a sufficient basis for equalizing the ICR of the subsidiary with the GCP, so we do not move the category from highly strategic to core.
240. When we analyze the support provider, we take account of the contingent liabilities that support agreements create.

### B.4. Start-ups

241. We also assign a group status to start-up subsidiaries. Generally, we do not view entities in business for five years or less as core because they lack an operating history. This means the potential for volatile earnings will be higher than for long-standing operations. However, we may consider start-ups core to the group despite their newness, such as subsidiaries set up in tax havens to serve important existing customers or that are a separate legal entities due to regulatory requirements.
242. When we view a start-up as strategically important or moderately strategic, we apply table 28 or table 29, respectively.

#### B.5.a. Strong subsidiary owned by a weak group or parent

243. Excluding the conditions in paragraphs 245 and 246, we don't rate a strong subsidiary of a weak parent higher than the parent. This applies even if the credit quality of a subsidiary appears better than that of the parent. This is mainly because:
- The weak parent could take assets from the subsidiary or burden it with liabilities during financial stress;
  - Financial stress at the parent level will likely affect the subsidiary's SACP, particularly if there are close business or funding ties between the two; and
  - In some jurisdictions, a bankruptcy petition by the parent would include the subsidiary or cause the subsidiary to go into administration.
244. Regulatory protection may insulate a subsidiary from risks otherwise borne by the entire group, shielding creditors and counterparties to a certain extent. For example, bank regulators typically impose minimum capital standards and may limit transactions--notably dividends and funding advances--between the subsidiary and other group affiliates. However, this also means that the parent and other group members may be at a disadvantage because the

subsidiary would be prevented from supporting them.

245. Although we generally rate regulated core subsidiaries at the same level as the GCP, we could rate the subsidiary higher by one notch if the following conditions are met:
- We consider the subsidiary's SACP superior to the GCP;
  - The subsidiary's business prospects and funding are, in our view, relatively independent from those of the group and we believe that even if other core entities encounter severe setbacks, the relative strength of the subsidiary would remain intact;
  - We believe that regulatory restrictions would prevent the subsidiary from supporting the group to an extent that would impair the subsidiary's stand-alone creditworthiness;
  - We are of the opinion that the subsidiary would not be drawn into the group's bankruptcy or reorganization proceedings; and
  - Such a rating decision would also stem from a clear understanding of the parent's strategy with respect to the subsidiary and, in particular, our view that it has a compelling economic incentive to preserve the subsidiary's credit strength.
246. We could rate an unregulated core subsidiary higher than the group if we regard the subsidiary's SACP as stronger than the group's creditworthiness and we believe the subsidiary's prospects don't depend on those of the group. In the absence of regulatory protection, significant minority ownership could reinforce the subsidiary's independence, particularly if the minority owner has enough power, such as board representation, to minimize the influence of the parent company. Other factors, such as financial covenants, can help safeguard the subsidiary's independence by restricting dividends or asset transfers. However, we do not base our assessment on covenants alone because most of them can be evaded, are usually legally unenforceable, and in certain jurisdictions don't prevent the parent from placing the subsidiary into bankruptcy.

## C. Rating Banks Above The Sovereign

247. We believe that it is unlikely that either the SACP or ICR on a bank will exceed the foreign currency credit ratings of the sovereign where a bank is domiciled because banks tend to be highly leveraged and depend on the sovereign for liquidity and other forms of system support. In addition, banks are affected by economic factors similar to those that cause sovereign stress, and the sovereign's regulatory and supervisory powers may link the financial system's flexibility to domestic developments.
248. Sovereign stress can affect banks in various ways. It can cause, among other things, a sharp deterioration in banks' asset values, much more expensive foreign currency liquidity, shortages in local currency liquidity, a harsher regulatory environment, mandated changes in credit terms, higher taxes, and declining public services, which could adversely affect the economic environment and increase bad debts for banks.
249. A bank would need to demonstrate all of the following conditions to have ratings higher than the foreign currency ratings on the country of domicile:
- The institution has sufficient capital and liquidity to cover the stress we would associate with a sovereign default scenario.
  - Institutional characteristics, sovereign policy flexibility, or historical precedence suggest that there is a high likelihood that the sovereign will not interfere or acquire resources from banks and that they are unlikely to

require additional support from the sovereign.

- The financial sector, or at least the specific bank, is in a net external asset position and in our view will remain so.
- The bank has little loan or other asset exposure to the sovereign or the wider public sector and in our view this will not change.
- The bank's earnings, capital, and other ratios are stronger than those of similarly rated banks in countries with stronger economies according to our proposed BICRA methodology.

250. These same conditions apply if the potential ICR is higher than the sovereign's foreign currency rating based on group support from a foreign parent or affiliate. We expect the group support to withstand the stress associated with a sovereign default; otherwise the ICR we assign is limited by the foreign currency rating on the sovereign where the subsidiary is domiciled.
251. In the rare instance that all of these conditions are met, we could rate the bank higher than the sovereign. Still, our transfer and convertibility (T&C) risk assessment on the sovereign would cap the foreign currency credit rating on the bank. Our T&C assessments reflect our view of the likelihood of a sovereign restricting a nonsovereign access to foreign exchange needed to satisfy debt service obligations (see "Criteria For Determining Transfer And Convertibility Assessments").
252. Bank branches are subject to the same tests as separate legal entities. We rate bank branches, as part of the same legal entity, at the same level as the bank itself, unless the branch is located in another country. If a branch is in another legal jurisdiction, we consider whether actions of the "host" sovereign could affect the ability of the branch to service its obligations. We do not assign ratings to a branch that are higher than those on the host sovereign unless the conditions listed above are met or the branch's creditors can--without impediment--access all of their funds in a timely manner via any other branch located in another jurisdiction. In most cases, the host sovereign foreign currency credit rating will cap the ratings we assign on a branch. If we rate the host sovereign higher than the bank, we then equalize the ratings on the branch with those on the bank.

## RELATED CRITERIA AND RESEARCH

### Criteria

We propose to supersede or partially supersede the articles below upon publication of the criteria resulting from this request for comment.

#### To be superseded

- Applying Group Methodology To Independent U.S. Investment Banks, June 2, 2008
- Assessing Trading Risk Management Practices Of Financial Institutions, Oct. 17, 2005
- Assumptions For Base-Case Credit Losses For Italian Banks, April 23, 2010
- Assumptions For Credit Stress Testing Financial Institutions In Spain, Sept. 15, 2009
- Assumptions For Credit Stress Testing German Banks, Aug. 21, 2009
- Assumptions For Credit Stress Testing Irish Banks, Jan. 26, 2010
- Assumptions For Credit Stress Testing U.K. Banks, July 27, 2009
- Assumptions For Stress Testing U.S. Financial Institutions, Feb. 1, 2010
- Assumptions: Credit Stress Testing Banks In Kazakhstan, Dec. 10, 2009

- Bank Survivability Criteria, March 24, 2004
- Credit FAQ: External Support In Bank Ratings, March 9, 2007
- Credit Stress Testing For Financial Institutions, April 29, 2009
- External Support Key In Rating Private Sector Banks Worldwide, Feb. 27, 2007
- FI Criteria: Bank Rating Analysis Methodology Profile, March 18, 2004
- Financial Institutions Bank Fundamental Strength Ratings, July 10, 2005
- Franchise Stability, Confidence Sensitivity, And The Treatment Of Hybrid Securities In A Downturn, Dec. 1, 2008
- How Systemic Importance Plays A Significant Role In Bank Ratings, July 3, 2007
- Likelihood Of Bank Of Japan Supporting Distressed Entities, Oct. 29, 2006
- Rating Securities Companies, June 9, 2004
- Securities Company Ratings Analysis Methodology Profile, April 29, 2004
- Sovereign Risk for Financial Institutions, Feb. 16, 2004
- Stress Testing U.S. Financial Institutions, April 29, 2009
- The Ratings Approach To Australian Government-Guaranteed Debt, April 20, 2009
- The Ratings Approach To U.S. Financial Institutions' FDIC-Guaranteed Commercial Paper, April 6, 2009
- U.S. Mortgage Bank Rating Analysis Methodology Profile, April 12, 2004
- Updated Assumptions For Problem Assets And Credit Costs For Banks In Russia, May 18, 2010

#### **To be partially superseded**

- A Roadmap For Evaluating Financial Institutions' ERM Practices, May 3, 2007
- Assessing Enterprise Risk Management Practices Of Financial Institutions, Sept. 22, 2006
- Group Methodology, April 22, 2009; this article partially supersedes the criteria for banks but will not affect the criteria for insurance companies

#### **Continuing criteria**

We propose that publication of criteria resulting from this request for comment will not affect the following criteria articles. They will therefore stand alongside that article to represent the body of our criteria governing financial institutions.

##### ***General.***

- Credit Stability Criteria, May 3, 2010
- Criteria For Determining Transfer And Convertibility Assessments, May 18, 2009
- Principles Of Corporate And Government Ratings, June 26, 2007
- Rating Government-Related Entities: Methodology And Assumptions, Dec. 9, 2010
- Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010
- Understanding Standard & Poor's Rating Definitions, June 3, 2009

##### ***Banks.***

- Bank Capital Methodology And Assumptions, Dec. 6, 2010
- Analytical Approach To Assessing Nonoperating Holding Companies, March 17, 2009
- Assumptions: Analytical Adjustments For Captive Finance Operations, June 27, 2008
- Bank Spreadsheet Data Definitions, May 2, 2005
- Commercial Paper I: Banks, March 23, 2004

- Commercial Paper II: Finance Companies, March 22, 2004
- Counterparty And Debt Rating Methodology For Alternative Investment Organizations: Hedge Funds, Sept. 12, 2006
- Equity Credit for Hybrid Securities Issued by Asset Managers, Nov. 13, 2006
- Finance Company Ratios, March 18, 2004
- Issues Of Subordination for Hedge Fund Debt, Sept. 13, 2007
- Liquidity Risk Analysis: Canadian Banks, June 27, 2007
- Methodology For Analyzing Funding And Liquidity Positions Of Bank-Licensed Investment Companies, July 2, 2010
- Methodology For Mapping Short- And Long-Term Issuer Credit Ratings For Banks, May 4, 2010
- Methodology: Hybrid Capital Issue Features: Update On Dividend Stoppers, Look-Backs, And Pushers, Feb. 10, 2010
- Microfinance Institutions: Methodology And Assumptions: Key Credit Factors, Aug. 5, 2009
- Rating Asset Management Companies, March 18, 2004
- Rating Network Payment Providers, June 1, 2005
- Rating Private Equity Companies' Debt And Counterparty Obligations, March 11, 2008
- Rating Sovereign-Guaranteed Debt, April 6, 2009
- Recovery Ratings For U.S. Finance Companies, June 19, 2008
- Standard & Poor's Updated Methodology For Rating Exchanges And Clearinghouses, July 10, 2006

## Requests For Comment And Related Articles

- Request for Comment: Bank Hybrid Capital Criteria: Methodology And Assumptions, Dec. 6, 2010
- Request for Comment: Methodology And Assumptions For Market Value Securities, Aug. 31, 2010
- Request for Comment: Methodology For Determining Banking Industry Country Risk Assessments, May 13, 2010
- Request for Comment: Sovereign Government Rating Methodology And Assumptions, Nov. 26, 2010

## Research

- Industry Risk For Investment Banking Is Generally Higher Than For Other Financial Institutions, Jan. 6, 2011
- Preliminary Banking Industry Country Risk Assessments In 23 Countries, Jan. 6, 2011
- Banking Industry Country Risk Assessments (published monthly)
- Chasing Their Tails: Banks Look Beyond Value-At-Risk, July 12, 2005
- Lifting The Lid On Traded Market Risk, Oct. 31, 2006
- Republic of Ireland Long-Term Rating Lowered To 'AA-' On Higher Banking Sector Fiscal Costs, Aug. 24, 2010
- S&P's Banking Industry Country Risk Assessments: Global Annual Roundup, Aug. 9, 2007
- "This Time Is Different: Eight Centuries Of Financial Folly," Carmen M. Reinhart and Kenneth S. Rogoff, Princeton University Press, 2009.

These criteria represent the specific application of fundamental principles that define credit risk and ratings opinions. Their use is determined by issuer- or issue-specific attributes as well as Standard & Poor's Ratings Services' assessment of the credit and, if applicable, structural risks for a given issuer or issue rating. Methodology

and assumptions may change from time to time as a result of market and economic conditions, issuer- or issue-specific factors, or new empirical evidence that would affect our credit judgment.



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