



Financial Institutions Rating Methodology

Financial Institutions

7 February 2023

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1. Introduction

This document provides the latest update of Scope Ratings' (Scope) Financial Institutions Rating Methodology.

This rating methodology explains our approach to assigning credit ratings to financial institutions globally, including banks and a broad range of non-banking financial institutions. These include listed and unlisted credit institutions such as savings banks or cooperative groups; government-owned banks, retail and commercial banks, investment banks, specialised lenders, diversified credit institutions; other providers of financial services like mortgage institutions; non-bank lending institutions such as building societies, microfinance companies, leasing and factoring companies; and lending captives of car or other manufacturing companies. It is not intended to assign credit ratings to insurance companies.

The methodology is based on a transparent step-by-step approach. The first step, combining credit views on a financial institution's operating environment, business model and long-term sustainability, leads to the determination of an adjusted rating anchor. We then refine this anchor with a compare-and-contrast analysis of financial performance, specifically earnings capacity and risk exposures, financial viability management, and additional factors when applicable. The third and final step of the analysis addresses external support, whenever applicable.

Besides editorial changes, with this update we:

- i) Expand on our approach to rating bank capital instruments, incorporating key methodological elements from the Bank Capital Instruments Rating Methodology, which will be withdrawn.
- ii) Introduce a refined five-grade scale under our long-term sustainability assessment (previously a four-grade scale), with a wider notching approach to reflect additional downside risks.
- iii) Revise the number of notches under our financial viability management assessment to avoid any cliff-effect in case of a deteriorating credit profile.
- iv) Specify in more detail how we may assign deposit ratings as well as local and foreign currency ratings.
- v) Specify how we assign credit ratings to branches.
- vi) Clarify the sources of information we use to derive credit ratings.
- vii) Clarify the typical description of the operating environment, business model and earnings capacity and risk exposures qualifiers.
- viii) Clarify how we factor in external support.
- ix) Clarify how we derive short-term ratings for financial institutions from the short-term/long-term Credit Rating correspondence presented in Scope's Credit Rating Definitions.
- x) Relabel additional risk factors as additional credit factors to remove the reference to support and avoid confusion with external support.

The updates are not expected to impact existing financial institutions ratings.

1. Rating framework

1.1. Issuer rating, long-term debt ratings and short-term debt ratings

1.1.1. The issuer rating

Issuer ratings assigned on our long-term credit rating scale (see [Credit Rating Definitions](#)) are forward-looking opinions on the relative creditworthiness of an issuer's ability and willingness to repay its financial obligations when due and with an original maturity of one year or more.

1.1.2. The likelihood of regulatory action leading to the non-payment of debt is a sector-specific consideration for regulated financial institutions

Because banks and some other financial institutions are regulated entities, investors may face the risk that they are either unable to meet their financial commitments or are prevented from doing so due to regulatory intervention.

Regulatory action ranges from preventing a bank from making payments on specific categories of liabilities, like capital instruments, to placing a bank into insolvency or another form of closure. Many jurisdictions have implemented resolution regimes to deal with banks that are failing or are likely to fail. These apply when: i) private-sector solutions or further supervisory actions are deemed unlikely to prevent failure; and ii) provided it is in the public interest for a failing bank not to be placed into insolvency. Beyond the European Economic Area, resolution regimes exist in several other jurisdictions, including the UK, Switzerland and the United States.

Unlike for other private sector credits, regulatory action may result in the non-payment of debt for banks and other regulated financial institutions. This action can be in the form of: i) early supervisory intervention, e.g. to prevent payments on capital securities; ii) resolution-related debt bail-ins that affect liabilities eligible for bail-in; or iii) insolvency proceedings. Credit ratings must therefore assess the extent to which credit fundamentals and other factors evaluated in the rating process influence the likelihood of such an event, along with events that are common to other sectors.

Neither supervisory intervention-induced non-payment on capital securities, nor a resolution-induced bail-in of eligible liabilities, could be considered *de jure* defaults, although the impact for investors in these securities may result in the absence of a timely payment.

1.1.3. Issuers benefiting from a guarantee, a government-related entity (GRE) status

Our Financial Institutions Rating Methodology describes how we assign ratings based on the analysis of standalone credit factors and the review of external support factors. In general, we do not intend to perform a standalone analysis for financial institutions that benefit either from an effective guarantee provided by a public sponsor or a government-related entity status with a strong level of integration with the public sponsor. In such cases, we opt for a top-down approach as defined under our [Government-Related Rating Entities methodology](#).

1.1.4. Rated business perimeters and accounting perimeters – group membership

Financial institutions can have complex corporate structures. We consider the operational and legal/structural features of the underlying corporate structure on a case-by-case basis to determine the appropriate analytical approach. This is the starting point to determine whether a financial institution is analysed under a consolidated group approach, or alternatively on a standalone basis.

The identification of a group is not limited to a specific legal entity owning or controlling others but can also include a mutual or cooperative structure. For instance, there may be legal, contractual, regulatory, or governance considerations that show that the entities collectively form the equivalent of a group. Furthermore, the notion of a consolidated group for the purpose of this analysis does not necessarily coincide with accounting-specific consolidation.

For issuers that benefit from full support or high likelihood of support under exceptional circumstances due to their group membership, we may also use a top-down approach, taking into consideration the creditworthiness of the group to which they belong (see section 2.9).

1.1.5. Long-term debt ratings and correlation with issuer rating

We rate each class of long-term debt securities based on: i) the issuer's credit strength as typically reflected by the issuer rating; and ii) the specific terms and conditions of the debt instrument itself. Consequently, long-term debt ratings could be assigned as follows (see section 3):

- Higher than the issuer rating: certain classes of liabilities benefit from additional protection because they are secured by collateral and/or because of our expectation that they would otherwise be shielded from losses, even in a gone concern scenario. This would typically be the case for covered bonds (see our [Covered Bonds Rating Methodology](#)).
- Same as the issuer rating: for categories of senior unsecured debt, depending on their seniority, as well as the regulatory and legal framework. For example, in the case of banks subject to resolution, preferred senior unsecured debt (or equivalents) would be rated at the same level as the issuer rating.
- Lower than the issuer rating: for capital instruments, subordinated debt and for categories of senior unsecured debt, depending on the ranking in the capital structure, debt-specific features as well as the regulatory and legal framework. For example, in the case of banks subject to resolution regimes, non-preferred senior unsecured debt, or structurally subordinated senior debt, would be rated at least one notch below the issuer rating.

1.1.6. Short-term debt ratings and correlation with issuer rating

Short-term debt ratings reflect an issuer's capacity to repay debt with maturities typically up to 12 months – such as commercial papers, certificates of deposit or other short-term financial commitments.

Our analysis of short-term debt ratings is a subset of our analysis of long-term debt ratings. For short-term debt ratings, the assessment is informed by a review of an issuer's funding and liquidity characteristics – including the role played by changes in market sentiment and access to central bank funding in case of market disruptions. For this reason, which is also a differentiating factor compared to non-financial corporations, we typically assign the highest possible short-term rating equivalent to the long-term given range.

The correlation between short-term and long-term ratings is detailed in our Credit Rating Definitions.

1.2. Sources of data and information

We perform our credit analysis using qualitative and quantitative information, mostly from the public domain. In advanced economies, regulatory initiatives contribute to a significant improvement in the quality, depth, and degree of standardisation of public disclosures on financial and non-financial information. Assessing the adequacy and completeness of the information available for the rating process is a prerequisite. We will consider any limitation observed in available information, such as partial or delayed publication or limited access to audited accounts.

We primarily use audited annual statements, which we may supplement with other public or non-public information (when available).

2. Rating methodology

2.1. Outline of methodology and analytical framework

To begin our analysis, we examine the range of data and information available, on both the macro and micro levels.

As indicated in sections 1.1.3 and 1.1.4, steps 1 and 2 might not always be needed when we rate an issuer using a top-down approach (for eligible government-related entities or subsidiaries).

2.1.1 Step 1: Initial mapping and anchor assessment

We arrive at an initial mapping based on a combined assessment of an issuer's operating environment and business model. The initial mapping is not notch-specific, but rather indicates the higher or lower end of a certain rating category.

We further hone the initial mapping by analysing the long-term sustainability of the issuer's business in the context of a changing operating environment. This analysis is based on environmental, social and governance (ESG) considerations and given the anticipated transformational impacts of technology on the financial sector, how an issuer copes with digitalisation.

The adjusted anchor is the end point of step 1 and is a notch-specific anchor assessment.

2.1.2 Step 2: Determination of a standalone credit assessment

We refine our anchor assessment by reviewing the issuer's financial performance:

- Earnings capacity and risk exposures: we assess the risk profile of the issuer, in particular asset quality, and the level of risk protection provided by its ability to generate adequate risk-adjusted returns that build buffers, from provisions to capital.
- Financial viability management, which assesses to what extent an issuer operates at a sufficient distance from regulatory minimum requirements, or industry benchmarks, which are also de facto binding constraints for non- or less regulated entities, and therefore manage the risk of regulatory failure, or the equivalent market perception.
- Additional factors that are not necessarily already captured in the above steps. Temporary considerations that weigh positively or negatively on the issuer's creditworthiness could also be captured in this step.

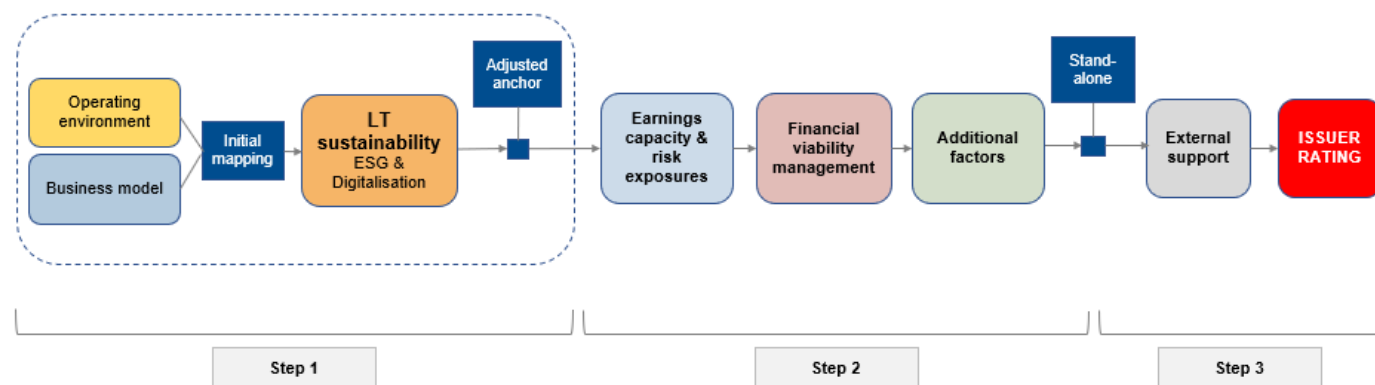
We incorporate elements of comparative analysis throughout our assessment. This reflects our belief that a compare-and-contrast analysis and the identification of outliers can significantly add to our ability to spot potential credit problems early on.

2.1.3. Step 3: Integration of external support to derive an issuer credit rating.

If appropriate, we complement our review of the issuer's standalone credit assessment with a review of the potential for external support.

The above-mentioned steps are detailed in the following sections.

Figure 1: Methodology outline and analytical framework



2.2. Operating environment assessment

In this first stage, we assess whether the environment in which the issuer operates is supportive of banking and/or other financial activities, or in itself a source of risk to the performance of financial activities. The starting point for our analysis is the identification and assessment of the main markets in which the issuer operates, within or beyond the limits of its country of domicile, to capture the local, regional, national or international characteristics of these markets. Two broad areas form the core of our operating environment assessment:

- Economic assessment.** Our economic evaluation of an issuer's main markets (international, national, regional or local) underpins our fundamental assessment of its rating, providing the context for trends in an issuer's financial fundamentals. We focus on relative levels and structural, long-term dynamics, rather than short-term shifts in GDP, interest rates or cyclical indicators. Our economic assessment is de-linked from our view on the sovereign's debt-servicing capacity, though it may include considerations on the room for fiscal and monetary manoeuvre to counteract potential shocks. Understanding the phase of the business cycle in the various markets in which the issuer operates is crucial to interpreting its financial performance.
- Soundness of the financial sector.** We assess the soundness of the industry (depending on the types of financial institutions) in terms of its competitive structure and the quality of its legal and regulatory framework. We examine the extent to which competitive pressure favours risk-taking strategies across the industry and whether the legal and regulatory frameworks are supportive of sound financial activities. This may be because an efficient legal system facilitates such activities or because the regulator has a record and the capacity of proactive and measured intervention to prevent default risk. For non-bank lending institutions that are typically subject to a lower amount of regulation and less intense supervision (or may even be completely non-regulated), we assess the extent to which it translates into heightened risk-taking practices across the sector.

We summarise our view on the riskiness of an issuer's operating environment by assigning a qualifier, based on a five-degree scale ranging from very supportive to very constraining (Figure 2).

Figure 2: Operating environment assessment

Qualifiers	Typical characteristics (rating approach, see mapping below in Figure 4)
Very supportive	Highly diversified and wealthy economies, well-developed capital markets and an outstanding record of resilience to economic shocks. Record and/or high expectation of material government support to the economy in case of need. Legal and regulatory frameworks providing sufficiently predictable outcomes for the performance of financial activities and market players benefitting from adequate pricing power thanks to a supportive and market-driven competitive landscape. No significant economic imbalances threatening financial stability.
Supportive	Diversified and wealthy economies, with developed capital markets and adequate record of economic resilience to shocks. Record and/or expectation of government support to the economy in case of need. Legal and regulatory frameworks supporting the performance of financial activities and market players benefitting from adequate pricing power thanks to a supportive competitive landscape. Some of the best-performing emerging economies could fall into this category.
Moderately supportive	Economies that are less diversified, show some level of vulnerability to shocks, or that are expected to experience bouts of volatility. Financial availability from the government to support the economy in case of need exists but could be limited or restricted. Sufficiently advanced legal and regulatory systems support the performance of financial activities and market players benefit from a moderately supportive competitive landscape. Several well-performing emerging markets would fall into this category.
Constraining	Economies that have limited economic diversification and have a lower level of wealth. The high vulnerability to shocks and volatile economic cycles could negatively affect financial performance of the financial sector in the long run. Poor regulation, weak supervisory practices and aggressive price competition do not support a fair and stable development of the financial sector.
Very constraining	Extremely volatile and weak economies that could experience very deep business cycles, periodic bouts of political instability, and prolonged periods of hyperinflation or deflation. Very weak legal systems, highly unstable regulatory environments, or unreliable supervisory systems that do not provide reasonable support for a fair and stable development of the financial sector.

2.3. Business model assessment

Our business model review examines the ability of an issuer to consistently deliver stable and solid risk adjusted performance.

Our assessment starts with a review of the issuer's business lines and compares the business mix within the consolidated group and across geographies. Many large banking groups are universal in nature and their business model consists of a specific mix of different business lines, which can often be clustered into three categories: retail and commercial banking, wholesale and investment banking, and wealth and asset management. Alongside the larger banking groups, several more specialised business models coexist, including private banks, specialised lenders (mortgages, consumer, leasing etc.), specialised trading and/or investment banks.

The key drivers of our business model assessment are:

- **The overall risk-adjusted return profile of the business mix.** Some activities are inherently riskier than others due to the specific focus on certain products or client segments. Our business model assessment reflects such a risk return profile. Highly volatile key performance indicators (KPIs) typically point to riskier business models. Similarly, activities that are structurally unable to generate enough revenue to cover their overall cost base typically weigh down our business model assessment.
- **The issuer's market position and pricing power.** Dominance in a product segment in a specific market tends to correlate with higher pricing power. The stability of an issuer's franchise, including its customer base, effectiveness of distribution and strong brand recognition can also inform our business model assessment.
- **The degree of geographic and product diversification.** Revenue diversification is generally positive for a business model. Diversification, especially in lowly correlated markets or product segments, results in a more resilient financial performance against idiosyncratic shocks.
- **Implementation of medium-term strategy.** To ensure our business model assessments anticipate the evolution of business models, we review the group's strategic direction, recent corporate activity (such as M&A, divestments) and appraise the strategy and its likely impact on the business model. As well as the clarity and coherence of the announced strategy, we consider the company's and management's execution track record.

Having analysed a bank's business model in light of the above factors, we assign a business model assessment qualifier ranging from very resilient to narrow (Figure 3).

Figure 3: Business model assessment

Qualifiers	Typical characteristics (rating approach, see mapping below Figure 4)
Very resilient	Issuers with very strong and well-rounded business franchises, typically with a high degree of effective, well executed business and geographic diversification with adequate pricing power in several core markets and products. Leadership in domestic retail and commercial banking is often the anchor for the business model. KPIs are expected to remain very resilient and display very limited volatility even in stressed environments.
Resilient	Issuers in this category typically display a strong market position in their domestic retail and commercial market, where they may also be an important player in investment banking, insurance and wealth management. The domestic franchise is often complemented by some degree of international diversification. KPIs are expected to remain resilient and display low volatility through the business cycle.
Consistent	A consistent assessment still requires a certain degree of revenue and earnings stream predictability, as is the case for most domestic retail and commercial banks. Regional franchises with strong local market positions or that focus on very low-risk customers or technical forms can also fall in this category. Specialised lenders with well-established franchises or a high degree of geographic diversification could also fall into this category. KPIs are expected to display manageable volatility through the business cycle or in more stressed economic environments.
Focused	Issuers that operate on a small local scale and/or focus on a limited product range, making them more vulnerable to changes in the operating environment. It also includes issuers with challenged franchises, and business models in need of reshaping. KPIs could display significant weaknesses or volatility through the business cycle or in more stressed economic environments.
Narrow	Business models with very high revenue volatility or a restricted revenue base would typically include monoliners operating locally and lenders specialised in highly cyclical sectors or products with limited pricing power. A lack of business or geographic diversification limits the assessment.

Factoring operating environment and business model assessment into the rating process

The combination of our operating environment assessment and business model review provides the starting point for our rating process. Based on our qualitative assessment of these two factors, we map the issuer to a rating category and, in some cases, to the high or low end of the rating category (Figure 4).

Figure 4: Mapping table

		Operating environment				
		Very supportive	Supportive	Moderately supportive	Constraining	Very constraining
Business model	Very resilient	a/a+	a/a+	a cat	bbb cat	bb cat
	Resilient	a/a+	a cat	bbb cat	bb cat	b/b+
	Consistent	a cat	bbb cat	bb cat	b/b+	b cat
	Focused	bbb cat	bb cat	b/b+	b cat	b-/b
	Narrow	bb cat	b/b+	b cat	b-/b	b-/b

When the initial mapping leads to a broad rating category (e.g. the a category), we further refine the position of the initial mapping by placing it in the 'high' or 'low' end of the rating category (for instance 'a/a+' or 'a-/a'). This is based on a combined review of the previous two factors, also taking their interaction into account and considering the mapping positioning relative to peers in the same rating category.

Credit dynamics and fundamentals can only be fully understood and assessed in a peer group context, by performing a compare-and-contrast analysis. Therefore, we incorporate peer group analysis in our rating assessment from this early stage. This is because our ratings and the analysis behind them measure credit risk from a relative perspective.

2.4. Long-term sustainability (ESG-D factors) assessment

A further refinement, leading to a notch-specific adjusted anchor, stems from our assessment of relevant environmental, social and governance (ESG) factors, with a specific focus on an issuer's preparedness for digital transition (D) – which we refer to as long-term sustainability.

ESG-D encompasses a broad spectrum of topics. Our assessment, however, focuses on how ESG-D factors may impact an issuer's creditworthiness. Our approach takes into account the absolute level of sophistication of the issuer as well as the relative level of sophistication of the market(s) in which it operates. We aim to capture the extent to which proactive management of sustainability-related issues, including proper disclosures, reflects good risk management practices and provides a competitive edge to financial institutions in the market where they operate, and therefore justifies a rating uplift. We also flag exceptionally weak ESG-D profiles, which we believe add to the risk profile of the issuer, justifying a downwards adjustment of the rating.

To date, D (digitalisation) and G (governance) factors remain most relevant in the credit risk assessment of financial institutions. However, the importance of E (environment) and S (social) factors is growing. Public and investor confidence are critical for financial institutions. Numerous ESG factors influence this perception, particularly those related to E and S. These include an issuer's relationships with its various stakeholders, its management of human capital (e.g. employee welfare, skill development, diversity), its impact on the environment, and its role in environmental stewardship (i.e. support for sustainable growth and investment).

The long-term sustainability of an issuer is likely to suffer if it is not considered a responsible corporate citizen. Those most advanced on this front have identified the issues most relevant for their stakeholders, developed strategic responses, and set key performance indicators. Issuers benefiting from a superior reputation in an ESG context may find it easier to develop their business and have a larger investor base, while issuers suffering from a poor reputation in an ESG context may find it more difficult to develop their business and face reduced investor demand, and consequently higher funding costs.

ESG integration is still in its infancy insofar as the credit-risk aspect is concerned. ESG-D factors are often difficult to measure and benchmark as disclosures are not sufficient or consistent. We expect the availability and quality of information to improve gradually and markedly as there is increasing demand from both supervisors and investors for ESG-related disclosures, transparency, and risk assessments. As supervisory expectations are further codified, financial institutions that cannot meet them face potential regulatory consequences and additional costs. We also recognise that perceptions and expectations regarding ESG-D may vary

across regions. In our assessment, we look for signs that management is focused on these expectations and is taking steps to meet them.

Our assessment of sustainability-related risks and opportunities is centred around the following:

- **Governance.** We identify aspects of governance that may lead to higher credit risk, such as complexity in a group's structure, a lack of independence among the board of directors, excessive power of (and reliance on) a key executive, or evidence of deficiencies in internal risk control and management. We also consider an issuer's track record on business conduct. Examples include incidents of product mis-selling, benchmark manipulation and money laundering. Misconduct can be a source of reputational and legal risk on top of regulatory fines. Remedial measures often involve direct costs and legal risks can represent a significant loss contingency. Established financial institutions would in most cases display strong governance structures – at least on paper. Supervisory guidance, stock market governance codes and investor expectations have led to some convergence in the governance arrangements of larger institutions. As such, governance is unlikely to be a positive differentiating factor for larger institutions. Governance failures, on the other hand, are likely to drive credit differentiation. Small, unlisted or unregulated institutions are more likely to have weaker governance arrangements, partly due to a lower level of investor and supervisory scrutiny.
- **Digitalisation.** To remain competitive, financial institutions need to make sufficient investments in their IT infrastructure, not only in client-facing functions but also in middle and back offices. We determine to what extent managing the digital transition is at the heart of strategic initiatives. Not all issuers will have the earnings capacity and expertise to do so. Failure to keep up with evolving technologies and trends may not result in immediate losses but may jeopardise the business franchise in the long term. With financial services becoming increasingly digital, cyber risks are also becoming more prominent. This is no longer only an operational issue as failures in IT security, with respect to the loss of customer data, can lead to significant reputational damage and ultimately customer losses – affecting the longer-term sustainability of the business.
- **Environmental factors.** Our focus is on how an issuer addresses environmental issues from a risk management perspective, i.e. its efforts to identify risks and manage them. This is particularly the case when regulators have set expectations in this area. We also evaluate the availability and quality of disclosures on these risks and consider how an issuer is supporting sustainable growth and investment as this may be relevant for its stakeholders and even represent a business opportunity.
- **Social aspects** impacting financial institutions' creditworthiness are often tilted to the downside and linked to governance issues. Issuers in the financial services industry are generally large employers, with sizeable customer bases, which also maintain close ties with local communities. The social repercussions of management actions may alter an issuer's reputation and constrain future growth prospects or the quality of its franchise. Aggressive pricing, high remuneration policies or workforce adjustments tend to create more publicity than actions supporting social objectives, which are now more widely expected.

We summarise our assessment of an issuer's approach to long-term sustainability by assigning a qualifier, ranging from best in class to lagging, using a weak-link approach. For example, an issuer that suffers from governance issues would rank lower despite having advanced risk management capabilities covering environmental risks or superior digital capabilities.

We also consider current constraints on peer comparisons, such as the level of industry disclosures, the ongoing development of standards, and the varying relevance of sustainability-related issues across geographies from a credit standpoint.

These considerations are gaining importance and may be further reflected in other steps of the rating process if needed. Exceptionally strong (unlikely) or weak (more likely) ESG-D profiles, which warrant additional credit differentiation, could be reflected as additional factors (2.9).

Factoring long term sustainability into the rating process

Based on the refined initial mapping assessment, for instance a-/a or a/a+, described in paragraph 2.4, we establish an adjusted (notch-specific) anchor by factoring in our views on an issuer's long-term sustainability. In practice, this means opting for the upper bound of the split mapping results in an uplift of the adjusted anchor, while the lower bound provides no uplift. We can also position the adjusted anchor at a lower level if appropriate (minus one or two notches below the lower bound of the split mapping). The range of qualifiers, from lagging to best in class (Figure 6), allows for granular differentiation among peers, indicating the relative strengths and weaknesses of an issuer's operating model in this area:

- Best in class or advanced assessments both position the adjusted anchor in the upper bound of the initial mapping, for instance 'a' for an initial 'a-/a' split mapping.
- Developing or constrained assessments both position the adjusted anchor in the lower bound of the initial mapping, a- in this case.

- A lagging assessment positions the adjusted anchor one or two notches below the lower bound of the split mapping depending on the severity of sustainability shortcomings, for instance major governance flaws; either bbb+ or bbb in this case.

Figure 5: Long-term sustainability assessment

Qualifiers	Typical characteristics	Rating approach
Best in class	The issuer stands out as an early adopter of the most advanced industry sustainability-related standards or practices. The issuer's approach to long-term sustainability, including target setting and commitment to delivery, clearly enhances its credit standing.	Upper bound of the split mapping
Advanced	The issuer is effectively and proactively managing sustainability-related considerations and stands out as a frontrunner in at least one sustainability theme that enhances its credit standing.	Upper bound of the split mapping
Developing	The issuer is embracing changes in the ESG-D area, in line with peers. Progress made may be tangible but does not warrant further credit differentiation.	Lower bound of the split mapping
Constrained	The issuer is embracing changes to cope with stakeholder demand in relation to sustainability but needs to address some identified and manageable shortcomings that constrain our overall assessment.	Lower bound of the split mapping
Lagging	The issuer's management of material sustainability considerations displays significant shortcomings, which need to be addressed in the short term to catch up with evolving industry standards or market perception.	-1 or -2 notches from the lower bound of the split mapping

We further refine our assessment by analysing an issuer's financial profile, including earnings capacity, risk exposures and financial viability management.

2.5. Earnings capacity and risk exposures

Earnings, the first line of defence

An issuer's earnings capacity measures its ability to build and preserve economic value over time, as well as to create a sufficient level of risk protection – primarily in the form of credit provisions and equity capital. We view earnings favourably, primarily as an element of risk protection, as they are often an issuer's first line of defence to absorb potential losses.

Our assessment of an issuer's earnings capacity is a look-through approach of its earnings in light of its unique mix of risk exposures, which could be primarily credit risk, market risk or operational risk. Whereas our review of business profiles assesses the issuer's capacity to generate predictable and sustainable operating revenue, we focus here on an issuer's ability to generate sufficient income to: i) cover its operating costs; ii) absorb losses on an ongoing basis including exceptional losses or incremental losses through the cycle; and iii) generate profit above its capital needs to remunerate providers of equity capital.

Our ratings provide a medium-to-long term view of an issuer's creditworthiness. This means that a temporary dip in earnings is not in itself a reason to downgrade the issuer rating. Conversely, a one-off boost to profitability would generally not warrant higher ratings.

Disregarding temporary spikes or earnings dips should contribute to ratings stability and predictability over time. However, deeper cyclical fluctuations may inevitably lead to more material changes in financial fundamentals, which will be reflected in the ratings. Our assessments are geared toward future expected trends and developments.

Our assessment of earnings capacity rests on the record and expected financial performance of the issuer. We look at changes in financial performance using a compare-and-contrast analysis, analysing the issuer's financial ratios relative to peers. As such, our assessment is not based on benchmarks – and we do not identify pre-set fixed thresholds for rating changes.

We look at a broad range of measures, depending on the issuer's business model. For banks, we typically focus on two key earnings metrics that inform our views on its capacity to absorb losses:

- Average pre-provision profitability, to provide a buffer to absorb credit and other losses

- Bottom-line profitability, to finance growth and remunerate providers of equity capital

Risk exposures

For most financial institutions – in particular banks – asset quality is a key focus of risk analysis, as credit risk (encompassing both the lending and the investment portfolio) is often the primary driver of losses. The quality of underwriting criteria and the permanence of effective protection mechanisms such as insurance or collateral may represent important mitigating factors. We focus on relevant exposures that are more cyclical and are most likely to suffer higher credit losses in a downturn. When problem loans surface, we assess the issuer's capacity to remedy them and its conservativeness in managing the cleaning of its balance sheet.

Concentrated exposure to individual risks, including sovereign risks, can constrain an issuer rating, although we do not apply mechanistic caps to issuer ratings based on sovereign ratings. For financial institutions benefiting from effective supra-national support frameworks, such as banks in the euro area, we see no valid reason to mechanistically link their overall creditworthiness to, for instance, rating caps at the level of some sovereign ratings.

Specialised lenders would often be exposed to specific risks arising from the peculiarities of their business models.

Depending on the business model, market risk, in particular interest rate and foreign exchange risks, can be a relevant source of earnings and capital volatility for financial institutions with significant market activity, or material asset-liability mismatches.

Operational risk is especially relevant for issuers with complex operations and for activities structurally carrying low credit or market risk such as, for example, asset management or custody.

We take into consideration the execution risk of specific material transactions (such as acquisitions or divestitures) or sizeable IT system migration processes, if this risk is not already sufficiently captured by our long-term sustainability assessment. Legal and litigation risks may be significant in some cases, limiting visibility on future earnings and capital trends.

Other risks, inherent to a financial institution's business model, could be considered under this section.

How we factor earnings capacity and risk exposures into the rating process

We summarise our views on earnings capacity in light of a financial institution's risk exposure mix by assigning a qualifier based on a five-degree scale ranging from very supportive to very constraining. A notching grade is attached to each qualifier, leading to an uplift or a lowering of the adjusted anchor from +2 notches to -2 notches.

Figure 6: Earnings and risk exposures modifier

Qualifiers	Typical characteristics	Rating approach
Very supportive	Earnings capacity is highly stable through economic cycles and consistently supports the accumulation of loss absorption buffers. Provisioning and dividend distribution policies are conservative. There is no relevant concentration of risk exposures. Asset quality metrics and loss experience are better than peers. Risks are very low and well-managed, and unlikely to lead to losses capable of undermining the issuer's viability.	+2 notches
Supportive	Earnings capacity is stable through economic cycles and provides a strong buffer against losses. Asset quality metrics are relatively better or at least in line with peers. There is no relevant concentration of relatively high risk exposures. Risks are well managed and are highly unlikely to lead to losses capable of undermining the issuer's viability.	+1 notch
Neutral	Earnings capacity may be variable over economic cycles but is sufficient to cover expected losses. Asset quality is in line with peers. Some risk concentration may exist but is not expected to be high or to generate high losses. Risks are unlikely to generate losses capable of undermining the issuer's viability.	0
Constraining	Earnings capacity is weak. Earnings and loss experience may show high volatility. Concentration risks require monitoring and can weigh on future performance. Asset quality metrics are below peers. Management is addressing risks but these may still lead to material losses, putting pressure on the issuer's viability.	- 1 notch
Very constraining	Earnings capacity is very weak. Earnings and loss experience may show very high volatility. There are material concentration risks. Asset quality metrics are materially poorer than those of peers. Risk management is insufficient to build or rebuild loss absorption buffers, undermining the issuer's viability.	-2 notches

2.6. Financial viability management

We assess the way an issuer manages its financial resources, including its capital and funding. For banking institutions and other regulated financial institutions, our analysis of capital, funding and liquidity acknowledges the need for institutions to continuously comply with regulatory requirements and supervisory expectations. Regulatory ratios are typically not available for non-regulated issuers. In these cases, our analysis will identify appropriate measures of capitalisation, liquidity and funding stability. For both banks and other financial institutions, we evaluate the stability and diversity of an issuer's funding structure as well as the management of structural mismatches from an asset and liability perspective.

Banking is a regulated business. Compliance with regulatory requirements is a prerequisite for banks to continue operating, often referred to as a 'licence-to-operate risk' or failure risk. With the increased sophistication of regulatory frameworks, maintaining a sufficient distance to regulatory minimums has become a source of complexity for banks, an important driver of their medium-term strategies and a confidence-sensitive issue, attracting both management and investor attention. Maintaining a sufficient distance to minimum regulatory requirements often drives strategy, e.g. capital allocation if capital resources are scarce or regulatory requirements are high. The need to comply with a variety of requirements can also significantly hamper the ability of a bank's management to implement its strategy.

The breach of a regulatory minimum requirement is not always precisely sanctioned, with some regulatory breaches having more severe implications than others. Alternatively, a well-defined regulatory regime could be amended at discretion to adapt to changing operating conditions in a pragmatic manner and without much advanced notice. The most relevant regulatory viability indicators may vary over time and jurisdiction. We aim to identify requirements that are critical to a bank's viability and, under stressed conditions, scrutinised by market participants, potentially exacerbating default risk. Requirements relating to capital adequacy, funding and liquidity are the most common determinants of a bank's regulatory viability. The build-up and maintenance of bail-inable debt buffers, for instance total loss absorbing capacity and minimum requirements for own funds and eligible liabilities requirements for European banks subject to resolution regimes, form part of our assessment for the relevant banks. Given the dynamic regulatory environment, the relevant metrics may evolve over time. For instance, the introduction of minimum coverage for non-performing loans (known as the prudential backstop) could represent significant provisioning efforts for banks and qualify for inclusion in our assessment.

We assess how an issuer manages its financial viability in light of a selected set of enforced regulatory requirements, most often ratio-driven measures, and how it maintains at least a sufficient distance to minimum requirements to continue operating. For issuers operating in less regulated business segments, we will select measures that are commonly seen as industry benchmarks and also focus on management's ability to operate at a sufficient distance above what the market perceives as minimum levels.

For each area we deem relevant, we analyse three aspects:

- **Actual positioning.** What is the issuer's position in comparison to the minimum required levels and peers' positions?
- **Quality review.** How has the issuer managed to build, proactively or not, a buffer above minimum requirements? Has it opted for a buffer composition that is more or less supportive of its creditworthiness, and to what extent does it differ from peers' buffers?
- **Expectations.** What are the issuer's medium-term dividend policy, strategic objectives, or room for manoeuvre; how do they compare to peers in this context and to what extent do we consider these objectives to be realistic?

Our assessment is informed by management's strategic approach (level of conservativeness) to maintaining buffers above minimum requirements, including the time dimension of management action (proactive or reactive). If a bank has comfortable ratios under a framework that is about to be amended, we take into account the issuer's ability to transition toward the end regime i.e. efforts to comply upfront with fully loaded regulatory requirements. We take into account tangible measures already taken by management, or planned actions for which we are confident that management will deliver on time, for instance if the issuer commits to a publicly stated target, with an articulated execution plan and an established record of strategic execution.

We evaluate the capacity of a bank to operate freely and sustainably above these requirements. We generally do not expect excessively large buffers to become sound and permanent features for banks. Consequently, we do not grant extra weight to buffers significantly in excess of regulatory minimums. We consider a maximum two-notch uplift under this assessment to strike a balance between a certain level of conservatism and balance sheet optimisation considerations. We would assess a breach of regulatory requirements or regulatory forbearance in context.

We do not set prescriptive, pre-defined thresholds above minimum requirements that we consider appropriate for an issuer's operations. Our assessment does not hinge on the monitoring of a specific ratio, a pre-defined set of ratios, or pre-determined thresholds. The relevant indicators are assessed at individual bank level but are intended to be similar for peers operating in the same jurisdiction. For instance, we typically review the following set of regulatory viability indicators for banks operating in continental Europe:

- Capital adequacy management: common equity Tier 1 ratio, Tier 1 ratio, total capital ratio, leverage ratio
- Funding and liquidity management: liquidity coverage ratio and net stable funding ratio
- When relevant, bail-inable debt buffer management: minimum required own funds and eligible liabilities and total loss absorption capacity

Funding stability is a highly confidence-sensitive issue, and we consider that the analysis of funding adequacy is less easily performed through the prism of regulatory compliance. These frameworks tend to be less refined and are not necessarily able to cater for the diversity of funding sources from one country to another, and one business model to another.

National discretion or regulatory forbearance may ease the challenge of complying with regulatory requirements for some banks, and less so for others. While relaxed regulatory requirements may facilitate management's ability to execute its medium-term strategy, they could also foster an aggressive risk appetite or insufficient protection against risk, which we would capture in our analysis of key risk exposures.

[Factoring financial viability management into our rating process](#)

We summarise our views on financial viability management by assigning a qualifier based on a six-degree scale ranging from ample to at risk. A notching grade is attached to each qualifier, leading to an uplift or a lowering of the adjusted anchor assessment from +2 notches to -5 notches.

Figure 7: Financial viability management modifier

Qualifiers	Typical characteristics	Rating approach
Ample	We generally consider that the issuer's management effectively and consistently maintains an ample buffer to relevant regulatory requirements and we expect it to continue to do so. We expect the issuer's financial viability to prove resilient to tail-risk events.	+2 notches
Comfortable	We generally consider that the issuer's management effectively maintains a comfortable buffer to relevant regulatory requirements and we expect it to largely continue to do so. We expect the issuer's financial viability to prove largely resilient to tail-risk events.	+1 notch
Adequate	Financial viability management provides some buffer and, under a base case scenario, could not imminently push any metric close to minimum requirements or jeopardise its financial viability.	0
Limited	We consider that the issuer's management of its financial resources, deliberately or not, puts pressure on its ability to conduct its medium-term strategy independently and free of regulatory or financial viability considerations	-1 notch
Stretched	We consider that the issuer's management of its financial resources is too aggressive or that compliance with minimum regulatory requirements is stretched, which hampers management's ability to drive business strategies.	-2 or- 3 notches
At risk	We consider that the issuer's compliance with minimum regulatory requirements is too stretched and puts its regulatory and financial viability at risk.	-4 or- 5 notches

2.7. Additional factors

This final step captures rating strengths and weaknesses that were not already captured or insufficiently captured earlier in the rating process. We intend to use this open-ended step marginally.

This additional factor can reflect transitory situations, for instance restructuring measures not fully implemented, processes leading to ownership changes or M&A transactions. The full execution of these strategic moves often entails transition risks, which may temporarily but materially constrain or support an issuer's creditworthiness. By isolating analytical factors under this category, we explicitly signal their material but transitory nature and the possibility that they could eventually be incorporated elsewhere in the rating process.

This step also captures specific business model characteristics and risks relating to non-bank lending institutions and more generally, narrower business models exposed to specific risks and/or with a high dependency on one specific factor, leading to a material concentration risk that may not otherwise be reflected or only be insufficiently captured in other parts of the methodology.

Figure 8: Additional factors

Qualifiers	Typical characteristics	Rating approach
Significant upside factor	We consider that a qualified rating factor, or set of factors, not already captured in the rating process, provides a significant uplift to the issuer's creditworthiness.	+2 notches
Material upside factor	We consider that a qualified rating factor, or set of factors, not already captured in the rating process, provides a material uplift to the issuer's creditworthiness.	+1 notch
Neutral factor	We consider that the previous steps in the rating process adequately reflect the issuer's creditworthiness.	0
Material downside factor	We consider that a qualified rating factor, or set of factors, not already captured in the rating process materially weighs down the issuer's creditworthiness.	-1 notch
Significant downside factor	We consider that a qualified rating factor, or set of factors, not already captured in the rating process, significantly weighs down the issuer's creditworthiness.	-2 notches

2.8. Standalone rating

The standalone rating, resulting from the refinement of the adjusted anchor in step 2, represents the intrinsic credit strength of the issuer, irrespective of any expectation of extraordinary external support.

2.9. External support

We generally incorporate ongoing operational support (ordinary support) in the standalone analysis. For instance, stable distribution agreements with shareholders could boost our assessment of an issuer's business model; risk-sharing or buyback agreements could boost our assessment of asset quality; and the existence of standby funding commitments could boost our assessment of financial viability.

Beyond the analysis of these intrinsic rating factors, external support notches can be appropriate if we assess that an issuer is likely to benefit from an external source of support under exceptional circumstances.

Our assessment of external support focuses on both the ability and the willingness to support the issuer under exceptional circumstances such as financial distress.

Sources of support may take different forms, such as:

- **Government support**, for entities qualifying as government-related entities and for which we apply a bottom-up approach (see our Government Related Entities Rating Methodology)
- **State support**: as resolution regimes have been implemented in various jurisdictions across the world and in particular across Europe and in the US, timely external state support for banks in distress (bail-out) has become less likely. We therefore believe that bank ratings cannot generally be boosted by the expectation of extraordinary state support in those jurisdictions. Our rating assessment may incorporate the possibility of state support for banks domiciled in jurisdictions without resolution regimes if the systemic importance of those entities indicates a significant likelihood of extraordinary state support. The expectation of state support will be assessed considering the specific characteristics and systemic importance of the issuer, the characteristics of the legal and regulatory framework, including the record of government interventions in the sector, as well as the creditworthiness of the potential source of support.
- **Parental support**, either from a single owner, in the case of subsidiaries, or from several owners in the case of joint-ventures or other forms of joint ownerships.
- **Other forms of group membership such as joint liability schemes or solidarity mechanisms**: in many countries, financial services are provided by members of associations, through the amalgamation of joint liabilities or solidarity mechanisms. If there are mutual support mechanisms or cross-guarantees within a group of entities, as in the case of certain cooperative or savings bank groups, expectation of support may provide an uplift the issuer rating beyond standalone factors.

The expectation of support, assuming the source of support has the capacity to support, depends on:

- The source of support appearing more creditworthy than the issuer.
- There should be no legal impediments, regulatory limitations or other constraining factors that would prevent the supporting entity from providing support to the issuer, for instance in case of international groups facing transfer or convertibility risks. Such a limitation would likely weigh on the possibility of providing rating uplifts.

We do not need to perform an assessment of the credit strength of the source of support if we assign a credit rating based on the sole intrinsic credit strengths of an issuer. An issuer could be rated higher than its parent (or the relevant source of support) based on its standalone credit fundamentals. Typically, the difference would be one notch, but it could be wider if, for instance, a financially healthy subsidiary has a ring-fenced structure or benefits from other forms of credit enhancement.

Support may be provided by a single entity or jointly by several entities that would require an estimate of their combined credit strength if appropriate. In order to determine if the source of support is more creditworthy than the issuer, and therefore able to provide support, we may rely on different credit assessments depending on its degree of control over the issuer, as described in Figure 9 below.

Figure 9: Standard source for assessing the credit strength of parental support

		Expected support*	
		Full or high support	Moderate support
Shareholding	50%- 100%	Public or private rating by Scope	Public or private rating by Scope
	15%-50%		Credit estimate
	Less than 15%		Not performed

*as indicated in Figure 10

For highly cohesive groups that also prepare consolidated financial statements and share significant functions, we may apply a consolidated credit approach, in which we align the rating of core member institutions with the combined credit strength of the group. The regulator's own view of the cohesiveness of such groups would be a key element informing our decision on which rating approach to pursue. For example, a consolidated group approach would typically apply for banks belonging to officially recognised European institutional protection schemes.

Factoring external support for group members

We summarise our views on the likelihood of external support for issuer members of a group by assigning a qualifier based on a four-degree scale ranging from no support to full support. The rating approach remains conditional upon the absence of other constraints (external to the group) as highlighted above.

Figure 10: Group support

Likelihood of support	Typical group membership characteristics	Rating approach
Full support	<p>The issuer benefits from an implicit guarantee or legal commitments or a record of support that confirms the likelihood of effective and timely support.</p> <p>The activities of the issuers are fully aligned with the strategic goals of the supporting entity(ies).</p> <p>The issuer is fully integrated operationally.</p> <p>The absence of support would be highly detrimental to the supporting entity in terms of financial, reputational or franchise developments, potentially threatening its own credit standing.</p> <p>An entity only established to perform a specific function, such as providing funding, would qualify for this category.</p>	Equalised with credit strength of the source of support
High support	<p>Activities are of high strategic importance and in line with the group's strategic direction. The issuer is largely integrated to the group from an operational standpoint.</p> <p>The financial, reputational and strategic downside from a no-support decision could be material.</p>	One notch below the credit strength of the source of support
Moderate support	<p>The source of support is under no obligation to support the issuer. However, the financial, reputational and strategic downside from a no-support decision could be material. The issuer is of strategic relevance and benefits from some degree of operational integration.</p>	Bottom-up approach: up to maximum 1 notch below credit strength of supporting entity
No support	<p>Evidence that the third party is under no obligation, explicit or implicit, to support the issuer, or there is no record of support actions. The financial, reputational, and strategic downside from a no-support decision is very limited.</p> <p>The degree of operational integration is limited. It may be due to external constraining factors such as ring-fencing. The entity is strictly separated from the assets of the group.</p>	No uplift

3. Ratings on debt instruments

While the issuer rating does not automatically equate to specific ratings on an individual security, it is the starting point for assigning credit ratings to various classes of liabilities. The ratings on individual securities normally reflect their ranking in the issuer's capital structure, with the most senior unsecured bonds typically rated in line with the issuer rating. Other considerations, such as the expectation of a different treatment of a liability class due to financial stability or political considerations may also inform the final ratings, depending on the jurisdiction.

Figure 11: Typical notching structure for classes of bank debt securities

Typical notching structure for classes of bank debt securities	
Deposit ratings	X+1
Issuer rating	X
Senior unsecured debt	X
Senior unsecured debt (subordinated)	X-1
Subordinated debt	X-2
Tier 2 debt	X-3
Additional Tier 1 debt	X-5

Debt ratings assigned to covered bonds instruments follow our covered bonds methodology.

Deposit ratings are generally aligned with the issuer rating. However, deposits can be rated one notch above the issuer rating if they are considered to be more protected than senior unsecured debt. This is the case in countries with a depositor preference regime.

Senior unsecured debt ratings are aligned with the issuer rating. However, senior unsecured debt is rated one notch below the issuer rating if it is issued as statutorily non preferred, structurally subordinated, or otherwise subordinated to other senior unsecured debt.

Subordinated debt is rated two notches below the issuer rating.

Banks' capital structures typically also include Tier 2 and Additional Tier 1 securities. Our approach to rating these securities reflects their role in strengthening banks' capital positions, including their loss absorption features. The methodology applies solely to Basel III/CRR-CRD compliant capital securities and does not apply to hybrid securities issued before the global financial crisis.

Tier 2 debt is rated at least three notches below the issuer rating, reflecting its loss absorbing features and junior status in the priority of claims. Tier 2 securities can be written down or converted into equity as part of early regulatory intervention or when an issuer has reached the point of non-viability (PONV). In a resolution bail-in scenario, Tier 2 securities are considered capital securities and rank below subordinated and senior debt.

When rating specific Tier 2 securities, there may be a further notching beyond the minimum three notches. This would be the case when we see additional risk factors that may be security-specific or issuer-specific. For example, the notching on a Tier 2 security may widen as an issuer's fundamentals deteriorate towards the PONV. Depending on the severity of the capital need and the amount of capital resources available, Tier 2 securities may be converted or written down.

Additional Tier 1 debt (AT1) is rated at least five notches below the issuer rating, reflecting its loss absorbing features and deeply subordinated status in the priority of claims. More specifically, investors are subject to coupon-cancellation risks in the following situations: i) the issuer lacks available distributable items; ii) the issuer has breached its combined buffer requirement (CBR); and iii) the issuer utilises its discretion not to pay.

Further, AT1 securities may be written down or converted into equity when the issuer's common equity Tier 1 capital ratio breaches the specified trigger or when the issuer has reached the PONV.

When rating specific AT1 securities, there may be further notching beyond the minimum five notches. This may be the case when we see additional risk factors. These may be security- or issuer-specific, such as a narrower distance to the MDA level compared to peers, the existence of high triggers for write-down, or material earnings volatility due to an issuer's higher risk business model.

[Additional considerations related to AT1 securities and their loss absorbing features](#)

Coupon-cancellation risks

As mentioned above, AT1 investors may not receive a coupon due to issuer discretion or a breach of the CBR. In general, we do not believe that financially viable issuers with sufficient available distributable items would willingly utilise this discretion as the potential reputational damage could be very significant and harm future market access. Further, before failing to pay coupons on AT1 securities, issuers could reduce variable compensation and dividends.

We believe, however, that there is a risk that regulators may influence an issuer's discretion to make AT1 coupon payments. Further, regulators may use their supervisory powers to restrict coupon payments. Such regulatory action occurred during the financial crisis and is very likely to occur again if warranted.

The most probable risk is that an issuer is prevented from making coupon payments due to a breach of the CBR. Factors that may prevent an issuer from meeting the CBR include: i) losses; ii) unexpected provisions or charges related to litigation or conduct issues; iii) a material increase in risk-weighted assets due to internal model changes or evolving regulatory requirements; iv) an increase in the CBR due to changes in countercyclical capital-buffer rates or various systemic-risk buffer requirements; and v) material changes to Pillar 2 requirements.

Impact of coupon cancellation on AT1 ratings: no automatic downgrade

The terms and conditions of AT1 securities allow for coupon payment discretion. Consequently, an issuer who does not pay does not breach any regulatory or contractual obligations and would therefore not be in default.

In this scenario, we would evaluate the reasons for the coupon cancellation and assess whether this is a temporary or more permanent change in the issuer's ability to make distributions. If the reason for the coupon cancellation were a one-off event, which does not impair the issuer's future capacity to make payments, we may not change the rating on the AT1 security. More specifically, we will not automatically consider such an event to be a default.

However, if coupon cancellation were due to negative credit developments, such as a permanent deterioration in the issuer's earnings capacity or capital position that is unlikely to be promptly restored, this would lead to a downgrade of the issuer rating and, potentially, a concomitant widening of the notching gap for the AT1 security rating.

Principal-loss-absorption risks

Under the terms of AT1 securities, write-down or conversion occurs when an issuer's common equity Tier 1 capital ratio hits the specified trigger level, or the issuer has reached the PONV. Depending on the terms of the AT1 security, it may be written down on a permanent or temporary basis or be converted into equity.

Principal loss absorption when the contractual trigger level is breached is relatively straightforward to understand. However, the PONV is less clearly defined and remains subject to interpretation. It is our understanding that AT1 securities may be written down or converted in early regulatory intervention and before resolution – when supervisors decide that actions must be taken to remedy an issuer's deteriorating condition.

Our AT1 ratings do not account for any potential recovery value following principal loss absorption. However, we acknowledge that the ultimate loss profile on AT1 securities upon principal loss absorption may vary according to the loss absorption mechanism: an AT1 security, which converts into equity, may mean lower potential losses for an investor, provided the issuer recovers and its shares retain some value. With a temporary write-down, the value of an AT1 security may also recover over time. By contrast, with a permanent write-down, AT1 investors would suffer a full loss with no chance of recovery.

Credit ratings do not factor in whether securities will be called by the issuer or what the interest reset rate will be although these are important considerations for investors.

Impact of write-down or conversion on AT1 ratings

The terms of AT1 capital securities allow for write-down or conversion under certain conditions. In such a scenario, investors would experience a material loss on their principal investment.

If an AT1 security is converted into equity, we would downgrade to default status and withdraw the credit rating. Similarly, when an AT1 security is written down permanently, it ceases to exist. We would also downgrade to default status and withdraw the credit rating.

If an AT1 security is written down temporarily, we continue to rate it as it remains outstanding. The rating on the temporarily written-down security would be kept at D. We would then monitor and modify the rating as appropriate – for example, as the likelihood of coupon payment or write-up evolves.

Bank holding companies/non-operating holding companies

For European financial institutions that take the form of a holding company structure, we consider the credit fundamentals of the entire group, i.e. on a consolidated group basis, when assigning an issuer rating to the holding company. This is in line with the regulatory approach followed in Europe and reflects the inherent connection and interdependence among group constituents.

Where the credit risk profile of the holding company is not essentially related to the performance of the consolidated group (e.g. due to material additional leverage or large equity investments), the rating of the holding company could be notched down relative to the group to reflect a potentially higher credit risk.

For debt issued by the various operating and non-operating entities of a group (including the holding company), this will be rated according to their ranking in the creditor hierarchy and within the context of the group's liability structure. For instance, we would typically rate senior debt issued by a holding company one notch below senior debt issued by the main operating bank as the holding company debt has a lower ranking in the context of the group's liability structure.

Branches issuing debt

We may assign issuer ratings to the local or foreign branches of a financial institution. A key attribute of a branch is that it has no separate legal existence compared to the reference issuer (generally identified as the head office).

A branch located in the same country of operation as the issuer's head office would be rated at the same level. The issuer rating of a foreign branch may be rated lower than the issuer rating of the reference issuer in case of specific country characteristics potentially limiting the ability of the reference issuer to repay its debt obligations via foreign branches in a timely manner. We consider this unlikely for advanced economies.

When we consider that there is no such limitation, we may assign debt ratings to debt instruments issued by branches of a financial institution without necessarily assigning an issuer rating to the branch.

Low issuer ratings

For banks subject to resolution with very low issuer ratings, typically in the B range and below, the likelihood of preferred senior debt (or equivalent) being bailed in would be higher. In these cases, we may notch down all senior unsecured debt ratings from the respective issuer rating to reflect the expectation of heightened bail-in risk for these securities.

Banks under regulatory intervention

For banks undergoing a resolution process or equivalent regulatory action, we would take a view on the likelihood of a successful intervention returning the bank to the market as a going concern, as well as the credit strength of the resulting institution, which would be captured by a new issuer rating level. Securities not bailed in as part of the process would be notched off the new issuer rating level.

Local- and foreign-currency debt ratings

We may assign local-currency and foreign-currency ratings using our long-term and short-term rating scales. For financial institutions located in countries with weaker sovereign credit (for instance due to weak external fundamentals), we may consider that there is a higher risk that debt denominated in non-domestic currencies would not be reimbursed including because of transfer and convertibility risks. While the issuer may still have the willingness and theoretical ability to repay its debt, it may be prevented from doing so by government-imposed restrictions on foreign-currency payments leading to a default on foreign-currency liabilities. To capture such risk, we can assign a different rating to local-currency and foreign-currency denominated debt instruments.

Covered bond ratings

We view covered bonds as part of the general on-balance sheet funding of a bank, a view further confirmed during the great financial crisis, when covered bonds managed to keep many banks afloat.



Financial Institutions Rating Methodology

Financial Institutions

The introduction of resolution/bail-in regimes in several markets, e.g. the Bank Recovery and Resolution Directive in the EU, has had significant implications that are reflected in our separate methodology for covered bond ratings. The former base case for covered bond analysis – in which the cover pool becomes the sole source of repayment upon the insolvency of the issuer – has become unlikely in a resolution regime.

Our rating approach for covered bonds therefore reflects our view that:

- The issuer rating is the fundamental anchor point for covered bond analysis
- The combination of legal and resolution frameworks is the most important element supporting the covered bond rating
- The cover pool represents a second recourse after a chain of events affecting the issuer. It is limited but provides additional security and stability to the covered bond rating.

For more details, see our Covered Bond Rating Methodology¹.

¹ Available on www.scoperatings.com.

Appendix: Financial ratios for financial institutions

The financial ratios and metrics listed below are typically used in the analytical process for our financial institutions ratings, in accordance with the present methodology. Not all ratios may be applicable to each rated financial institution. On occasion, we may use more appropriate [additional ad-hoc] ratios for specific analytical aspects.

Figure 12: Financial ratios

Earnings and risk exposures
Net interest margin (%)
Net interest income/average RWAs (%)
Net interest income/operating income (%)
Net fees & commissions/operating income (%)
Cost/ income ratio (%)
Operating expenses/average RWAs (%)
Pre-impairment operating profit/average RWAs (%)
Impairment on financial assets/pre-impairment income (%)
Loan loss provision/average gross loans (%)
Pre-tax profit/average RWAs (%)
Return on average assets (%)
Return on average RWAs (%)
Return on average equity (%)
Net loans/assets (%)
Problem loans/gross customer loans (%)
Loan loss reserves/problem loans (%)
Net loan growth (%)
Problem loans/tangible equity & reserves (%)
Asset growth (%)
Financial viability management
Net loans/deposits (%)
Liquidity coverage ratio (%)
Net stable funding ratio (%)
Common equity Tier 1 ratio (%)
Tier 1 capital ratio (%)
Total capital ratio (%)
Leverage ratio (%)
Asset risk intensity (RWAs/total assets, %)
Dividend payout ratio (%)



Financial Institutions Rating Methodology

Financial Institutions

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