FINANCIAL INSTITUTIONS RATING CRITERIA

July 2021

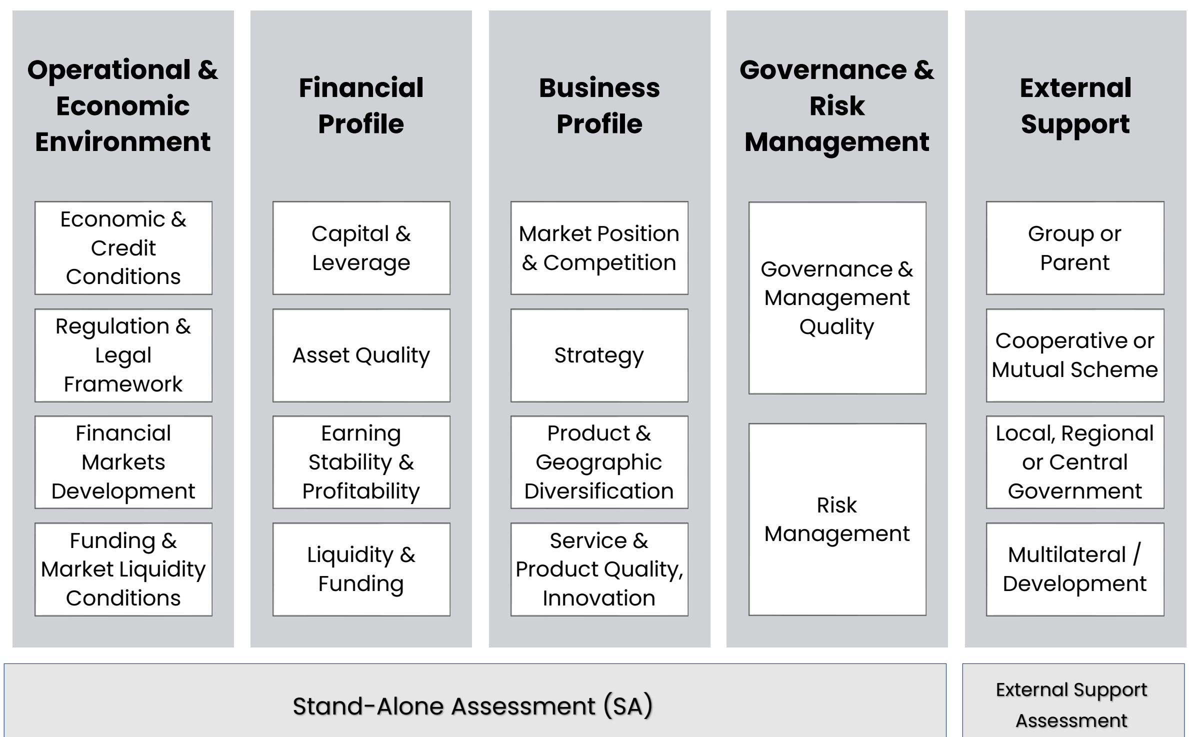
I. INTRODUCTION

This criteria report describes ARC Ratings' (ARC's) analytical framework for assigning credit ratings to financial institutions. It is applicable to institutions with different business models, with and without a banking licence, and in both regulated and unregulated industries. The definition of 'financial institution' is broad and includes banks, global broker-dealers, mortgage lenders, fintech companies, providers of consumer finance, trust banks, credit unions, building societies, custody banks and multilateral/development banks.

II. INTRODUCTION TO THE ANALYTICAL FRAMEWORK

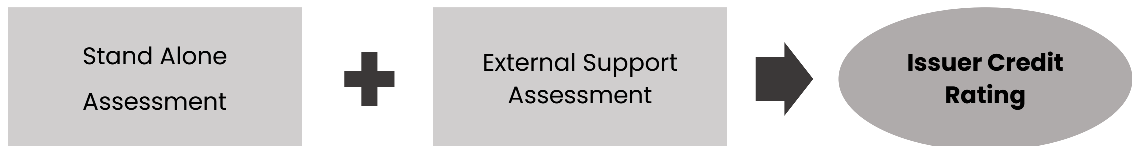
ARC has developed a comprehensive analytical approach for assigning credit ratings to financial institutions. The analysis starts with an overview of the macro factors affecting the operational and economic environment in which the entity (or group) operates, and then progresses to the particularities of the credit risk profile, finishing with an assessment of the possibility of support from an identified external support provider. This analysis will lead to the assignment of the Issuer Credit Rating (ICR).

ARC's analytical framework for financial institutions is detailed in the chart below:



ARC's analytical framework for Financial Institutions (FIs) is built on two pillars; one related to an analysis of the stand-alone profile of the entity that includes all four analytical

building blocks (Operational & Economic Environment, Financial Profile, Business Profile and Governance & Risk Management), and one related to any potential for external support (External Support Assessment) coming from an identified support provider. The combination of the stand-alone assessment and the external support assessment result in the Issuer Credit Rating, as detailed in the chart below:



THE STAND-ALONE ASSESSMENT (SA)

The SA is ARC's opinion on the stand-alone and individual financial profile of an entity. This opinion represents ARC's analytical view of the entity's financial strength based on its financial performance, business model, strategy, risk management and governance practices all based on the operational & economic environment that the entity has as base for its business. The SA does not under any circumstance represent a rating, a default indication of the debt issued by the entity or a deposit rating. Nevertheless, the opinion provided by ARC through the SA is helpful to perform direct comparisons between entities and is the main driver of the entity's Issuer Credit Rating. Details of the full analytical components applied for the SA are presented later in this document.

THE EXTERNAL SUPPORT ASSESSMENT

The External Support Assessment represents ARC's view on the likelihood of external support (from a parent entity, government or other support provider) that an entity could receive, to prevent default when in financial distress. When financial institutions find themselves in depressed economic conditions (e.g. liquidity shortfalls, large losses or capitalisation concerns), external support could be the only immediate solution to overcome financial stress or rebuild market confidence. The assessment of external support is based on ARC's view of different sources of support available for each entity; it may come from a parent company, a group, a mutualist scheme, central or regional/local government, multilateral or international organisations. The opinion on support completes the overall analysis when assessing a financial institution's credit rating. The detailed analysis used for External Support Assessment is presented later in this document.

THE ISSUER CREDIT RATING (ICR)

Long Term ICR

Long-Term ICRs are assigned to financial institutions and express ARC's opinion on an entity's ability and willingness to service its debt obligations. In the case of banks' ICR, this typically refers on the probability of default, including distressed debt exchange on specific obligations.

ARC defines Distressed-Debt Exchange (DDE) when the restructuring imposes a material deterioration in terms compared with the original contractual terms, when the restructuring or exchange is conducted to avoid bankruptcy, in case of any similar insolvency or intervention proceedings (including bank resolution) or in case of a traditional payment default.

ARC defines notching as the practice of assigning different ratings to the different sets of liabilities outstanding in an entity's financial statement.

Long-Term ICRs are accorded based on ARC's published available scale for credit ratings.

Short-Term ICR

Short-Term ICRs reflect an entity's ability and willingness to service its debt obligations in the short term. For banks and most other issuers, the "short term" typically means up to 12 months. Short-Term ICRs are assigned to all entities that have Long-Term ICRs, except where an issuer does not have, and is not expected to have, material short-term obligations. Short-Term ICRs are accorded based on ARC's published available scale for credit ratings and in accordance with a correspondence table between Long-Term and Short-Term ICRs.

III. STAND ALONE ASSESSMENT, DEFINITION AND SCALE

The SA reflects ARC's evaluation of the stand-alone, intrinsic financial profile of an entity based solely on the operational and economic environment in which it operates, its financial fundamentals, business model, strategy, risk management and governance practices. The SA is directly comparable with other entities within the financial industry since it does not include any assessment related to external support (government, parent company or any other source of support).

The SA takes into consideration the differences in operational & economic environments, business models, evaluating the complexity and target markets of each entity. ARC assesses whether the business nature of the entity is accurately represented by standard metrics. If this is not the case, adjustments to certain financial metrics may be applied to reflect the actual financial profile and risks.

The SA is the first step in ARC's process of assigning an Issuer Credit Rating. It should be noted that the SA does not, under any circumstances, represent an ultimate indication of default risk or loss severity. The SA is a simple weighted average result of all factors used in the SA framework. This result is then translated into the SA scale, similar to the credit rating scale, to provide a visual representation easy to be understood.

The SA is presented in lowercase letters to distinguish it from the Issuer Credit Rating, which is presented in uppercase letters. The SA uses the scale detailed below; except the SA of

'aaa' and 'cc/c/d', each SA can be modified by adding a plus or a minus, indicating a stronger (+) or a weaker (-) level within each category.

Stand Alone Assessment	Definition
aaa	'aaa' denotes the highest achievable score for the Stand-Alone assessment. Represents entities with solid and recognised successful business models supported by an excellent risk management framework. A sound capital base and financial performance to support organic growth is also available. Entities are typically located in highly stable economic and operational environments with highly efficient and predictable legal and regulatory frameworks.
aa	'aa' denotes a very high score for the Stand-Alone assessment. Represented by entities with solid and recognised successful business models supported by a very good risk management framework. A sound capital base and financial performance to support organic growth is available. Entities in this category are typically located in stable economic and operational environments with efficient and predictable legal and regulatory frameworks.
a	'a' denotes a strong score for the Stand-Alone assessment. It represents entities with stable business models supported by good risk management frameworks. A healthy capital base and financial performance to support organic growth is available. Entities are typically located in stable economic and operational environments with efficient and fairly predictable legal and regulatory frameworks.
bbb	'bbb' denotes a satisfactory score for the Stand-Alone assessment. It represents entities with specific or stable business models supported by an adequate but still-requiring-improvement risk management framework. An adequate capital base and financial performance to support organic growth is available while capital strengthening is still expected. Entities would be typically located in economic and operational environments with some level of stability; however some deficiencies in the level of development of legal and regulatory environment exist.
bb	'bb' denotes a moderate score for the Stand-Alone assessment. Represents entities with business models that face tough competition and with risk management frameworks that require improvement. The capital base to support organic growth is highly sensible and should be strengthened to provide more stability. Entities are typically located in economic and operational environments with deficiencies in the level of development of legal and regulatory frameworks.
b	'b' denotes a weak score for the Stand-Alone assessment. Represents entities with limited business models that face tough competition and with basic risk management frameworks that require material improvement. The capital base does not support organic growth. Entities are typically located in economic and operational environments with evident deficiencies in the level of development and with unpredictable behaviour patterns.
ccc/cc/c	'ccc/cc/c' denotes a very weak score for the Stand-Alone assessment. Represented by entities with limited business models that face tough competition and with extremely deficient risk management frameworks. The capital base is weak and should be increased. Entities would be typically located in economic environments with evident deficiencies and also with extremely unpredictable behaviour driven by individual objectives.
d/sd	'd/sd' denotes default or selective default. ARC considers that the entity has failed, which means (i) defaulted on its senior obligations to third-parties, non-government creditors or (ii) requires immediate support to fulfil its financial obligations. It could also be the case that the entity needs to impose losses on specific financial obligations to restore its financial position or could request a distressed debt exchange to restore its viability, and this triggers losses to debtholders.

When analysing financial institutions which are part of a conglomerate or group, ARC usually uses consolidated financial statements. For analytical reasons we assess not only

the financial profile of the entity on a stand-alone basis, but also the financial and business profile of the group. We therefore will usually use the group's consolidated financial statements.

The SA is determined based on historic financial data for the purpose of obtaining a 'Historic SA', as well as based on assumptions, projections and forecasts to obtain a 'Forecast SA'. The assigned SA will be the combination of the Historic and the Forecast. The Historic SA is typically derived using annual financial data for the preceding 3 to 5 years together with current year-to-date data (if available and meaningful), which allows to cover a full economic cycle. Exceptions could be made, provided that there is a reasonable rationale that justifies it. The Forecast SA is typically obtained over a 2-year time horizon. However, the time horizon could change depending on the nature and characteristics of the entity under analysis.

The SA for most financial institutions will be publicly disclosed. However, ARC does not use the SA for subsidiary banks that do not have a material standalone franchise, that could not exist without the ownership of the parent largely because of legislative/technical reasons (eg clients have to be serviced, or products provided, from a particular jurisdiction or legal entity), in cases of explicit guarantees or explicit support from a third party, in cases of high levels of financial or operational integration or because a business is in run-off. Also, the SA is not usually disclosed in the case of multilateral financial institutions or development banks or to other FIs whose operations are largely determined by their policy roles because of its business nature.

IV. FINANCIAL INSTITUTIONS ANALYTICAL FRAMEWORK

The Issuer Credit Rating (ICR) is the result of five analytical pillars that ARC believes represent the main drivers that reflect a financial institution's credit profile. The key analytical pillars include both qualitative and quantitative assessments. For ratios and quantitative factors, the analysis is based on internal benchmarks produced by ARC and built using publicly available information and ARC's proprietary information.

Section	Sub-Section	Factors and Sub-Factors	Type of Analysis
(I) Operational & Economic Environment	Economic & Credit Conditions	GDP growth	Qualitative
		Private sector credit to GDP	
		Size of the financial services sector to GDP	
	Regulation & Legal Framework	Regulatory framework	
		Legal framework	
	Financial Markets Development	Financial markets development and stability	
	Funding & Market Liquidity Conditions	Market funding access & availability of liquidity	

(II) Financial Profile	Capital & Leverage	Regulatory capital (CET1)		Ratio
		Capital management		Qualitative
		Capital growth options		Qualitative
		Leverage		Ratio
	Asset Quality	Problem loans	Problem (or Impaired) loans to Gross loans	Ratio
			Problem loans growth	Ratio
		Reserves	Loan Loss Reserves (LLR) to Gross Loans	Ratio
			YoY changes in LLR	Ratio
	Earnings Stability & Profitability	Earnings Stability		Ratio
		Net income to Risk Weighted Assets		Ratio
		Return on Equity (RoE)		Ratio
	Liquidity & Funding	Loans to customers deposits		Ratio
		Liquidity Coverage Ratio (LCR)		Ratio
		Market funding to total funding		Ratio
		Interbank funding to total funding		Ratio
(III) Business Profile	Market Position & Competition	Market share		Qualitative
		Competitive position		Qualitative
		Growth targets		Qualitative
	Strategy	Business model		Qualitative
		Business complexity		Qualitative
		Strategic execution		Qualitative
	Product & Geographic Concentration	Product concentration		Qualitative
		Geographic concentration		Qualitative
	Service & Product Quality, Innovation	Service & product quality		Qualitative
		Innovation		Qualitative
(IV) Governance & Risk Management	Governance & Management Quality	Corporate governance		Notching
		Management quality		Qualitative
	Risk Management	Credit risk		Qualitative
		Concentration risk		Qualitative
		Market risk		Qualitative
		Liquidity risk		Qualitative
		Operational risk		Qualitative
		Other important risks (Environmental, Social, AUM etc..)		Qualitative
(V) External Support	Group or Parent Support			Notching
	Cooperative or Mutual Schemes Support			Notching
	Local, Regional or Central Government			Notching
	Multilateral or Development Support			Notching

Scores and qualitative assessments are based on a three-points scale, a five-points scale or a seven-points scale depending on the granularity that ARC believes better represents the outcome of the assessment.

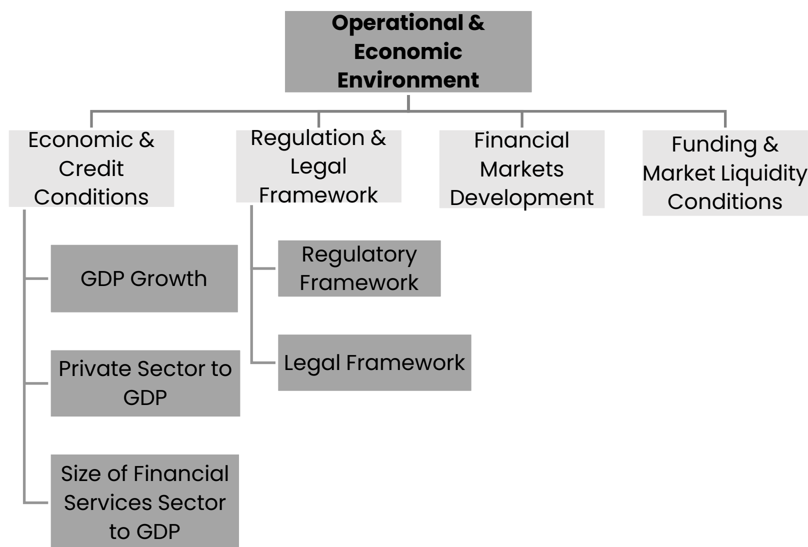
Financial ratios are compared and categorised against internal benchmarks produced by ARC using publicly available information and ARC's proprietary information.

In the case of notching adjustments, the analysis is carried out using a pre-defined set of notches, each of them described in their respective factor or sub-factor definition.

For the purpose of understanding the dynamics of the analysis and what the effect of each pillar has on the stand-alone assessment, the outcome of each sub-section will be disclosed as part of the analysis.

I OPERATIONAL & ECONOMIC ENVIRONMENT

ARC's analysis starts with an assessment of the Operational & Economic Environment. The health and characteristics of international and domestic macroeconomic conditions are crucial to the financial performance of financial institutions, setting the starting point for any fundamental and credit risk analysis.



ARC includes four sub-factors within the Operational & Economic Environment analysis which group the key elements that determine the economic, legal and regulatory environment, and characteristics of the financial market where a financial institution sets and develops its business model. In case of geographically diversified businesses, the sub-factors could be assessed considering the major countries in which the entity has material businesses as well as credit exposures.

a. Economic & Credit Conditions

Macroeconomic and credit conditions are typically strongly correlated with the performance of the financial industry. The state of the macro economy, as well as the availability of credit and healthy growth of the credit supply has direct effects on the demand for financial services and thus the ability of market players to generate growth of their balance sheets and generate healthy earnings.

For ARC, in the case of banks with operations or credit exposures to different countries, a weighted average is used in terms of annual revenues, loan portfolio composition, credit exposures or total assets (if available, depending on the disclosure of information) to assess the underlying aggregate economic and credit conditions.

The analysis and assessment of a country's economy is a key driver for the expected performance of a financial institution. In addition, economic cycles can have a strong effect on asset valuations, with a direct impact on financial institutions' balance sheets. ARC evaluates the Economic & Credit conditions primarily through the following indicators:

- GDP growth
- Private sector credit to GDP
- Size of the banking sector (or financial services sector) to GDP

In cases where any of these measures are not applicable, ARC will evaluate and use alternatives that will be suitable substitutes.

b. Regulation & Legal Framework

Regulation and legal frameworks provide a base from which an entity develops and sets its business practices. Sound and transparent regulatory and legal frameworks, set by a fully independent and credible regulator that shows evidence of empowerment and has control over entities with best practices and promotes a healthy financial industry with adequate incentives, is viewed as a strength that supports a robust Operational & Economic Environment.

Regulatory frameworks vary from multilateral agreements (e.g. Basel accords, Resolution Regimes, etc) to customised regulations based on country specifications. ARC expects that the main objective of the regulator is to promote a healthy financial system, protect depositors and support fair competition. ARC expects that the regulatory framework should be aligned with the best interests of market participants.

Financial institutions with an approved banking licence are subject to more specific regulatory standards and on-going supervision. Ready access to central bank lending or refinancing facilities provides a certain level of protection to creditors. Nevertheless, financial institutions without a banking licence can have similar control mechanisms and advantages depending on their regulatory status and country-specific enforcement, which ARC considers in the analysis.

For financial institutions that have operations in more than one country, the regulatory framework that applies for the purpose of analysis is typically the one from its home operations. However, if operations in other countries are relevant (in terms of earnings contribution, assets, loan portfolio, credit exposures, among others), the analysis could take into consideration the combination of the relevant regulatory frameworks. ARC notes that for certain financial institutions (typically large and systemically[1] important institutions), a more consolidated analysis of the regulatory framework could be applied.

The seven-points scale used to assess the Regulatory Framework is detailed below:

Regulatory Framework	Definition
aaa	Applies only to entities regulated at a global level (Globally Systemically Financial Institutions - GSFI). Fully developed and highly transparent regulatory framework with long track-record of consistent, predictable and independent decisions. Regulation is standardised with no exceptions in its application.
aa	Developed and transparent regulatory framework, with long track-record of consistent, predictable and independent decisions. Regulation is standardised with no exceptions in its application.
a	Well-developed framework with above average transparency, reliability and predictability; track- record of consistent, predictable and independent decisions. Some exceptions in the application of the regulatory framework are applied, mostly following the framework applied by national authorities in the best interest of the characteristics of the domestic market to migrate to a standardised approach in the medium term.
bbb	Regulatory framework that is moving to a consistent application of industry best practices, with average level of transparency, reliability and predictability. Track-record of consistent and independent decisions. Exceptions in the application of the regulatory framework are in place applied by national authorities in the interest of the characteristics of the domestic market.
bb	Regulatory framework that is in the process to apply industry best practices and promotes stricter self-regulation for entities. However, shows evidence of some inconsistency or lack of track-record or transparency.
b	Regulatory framework that applies a flexible approach towards industry best practices with a high degree of inconsistency or significant lack of transparency. Exceptions to the application of the regulatory framework are easy to be identified.
ccc	Undefined or unclear regulatory framework with strong political interference and track-record of inconsistent and hostile decisions.

The legal framework is also a key factor in setting a clear, level playing-field for financial institutions. A well-established and proven legal framework, with clear legal procedures, ability to enforce contracts and predictable foreclosure times is vital to provide a smooth operational environment for financial market participants. During times when financial assets are non-performing, the legal framework in place directly affects the business model on what concerns the recognition of non-performing assets and charge-offs.

[1] ARC could use its own classification to define systemically important institutions.

ARC evaluates and compares the strengths and weaknesses of each country's legal framework based also on the 'Ease of Doing Business Ranking' from the World Bank, specifically the 'Enforcing Contracts' and 'Resolving Insolvency' score if available.

The seven-points scale used to assess the Legal Framework is detailed below:

Legal Framework	Definition
aaa	Well-established and proven legal framework, with clear, objective and transparent legal procedures that allow very fast and very cost-efficient foreclosures. Degree of predictability is very high and very swift contractual enforcement.
aa	Well-established and proven legal framework, with clear legal procedures that allow fast and cost-efficient foreclosures. Degree of predictability is very high and very swift contractual enforcement.
a	Well-established and proven legal framework, with clear legal procedures. Degree of predictability is high and swift contractual enforcement and foreclosure times.
bbb	Adequately established and proven legal framework, with standard legal procedures and adequate transparency. Adequate degree of predictability and contractual enforcement and foreclosure times.
bb	Established and proven legal framework, with rather complicated and not fully transparent legal procedures. Degree of predictability is moderate and contractual enforcement and foreclosure times can be lengthy.
b	Developing legal framework, with complicated legal procedures and low transparency. Degree of predictability is low and contractual enforcement and foreclosure times is rather slow.
ccc	Developing legal framework, with very complicated legal procedures and very low transparency. Degree of predictability is very low and contractual enforcement and foreclosure times is very slow.

To combine the regulatory and legal framework assessments in a meaningful way, ARC establishes a matrix in which they do not average out. That means that if a country has a very strong regulatory framework with a score at 'aaa' but a legal framework that in ARC's view is at 'b', the outcome of the section will typically be the lower of the two, as illustrated by the following combinations:

	Regulatory Framework						
Legal Framework	**aaa**	**aa**	**a**	**bbb**	**bb**	**b**	**ccc**
aaa	aaa	aa	a	bbb	bbb/bb	bb/b	ccc
aa	aa	aa	a	bbb	bbb/bb	bb/b	ccc
a	aa	a	a	bbb	bb	b	ccc
bbb	bbb	bbb	bbb	bbb	bb	b	ccc
bb	bbb/bb	bbb/bb	bb	bb	bb	b	ccc
b	bb/b	bb/b	b	b	b	b	ccc
ccc	ccc	ccc	ccc	ccc	ccc	ccc	ccc

c. Financial Markets Development

A highly developed and reasonably diversified banking sector are positive factors for the stability and growth potential of financial markets. These market features will usually help banks and other financial institutions to grow their franchises, achieve economies of scale and protect margins. The existence of effective institutional frameworks to support the banking system, such as credit bureaus or depositor protection schemes, may also be positive for the financial markets' industry.

Conversely, a small, developing or highly fragmented banking sector may be negative for the industry and therefore limit the ability of an entity to develop its business. Overcapacity and other competitive distortions can result in irrational pricing and weak underwriting standards, ultimately resulting in higher credit costs (or actual losses) to the financial services industry. Financial innovation and liberalization matter because, while they can bring long-term benefits, they often act as a trigger for a period of rapid credit expansion. For example, in some countries, credit is subject to government restrictions. If suddenly lifted, this can unleash a risky credit boom as banks seek to deploy capital more quickly. The ending of capital controls can have a similar impact.

The five-points scale used to assess Financial Markets Development is detailed below:

Financial Markets Development	Definition
Very Strong	Highly developed and very diversified financial services sector, highly effective institutional frameworks to support financial activities (credit bureaus, depositor protection schemes, etc…), highly open and transparent market that allows new competition.
Strong	Well-developed and well diversified financial services sector, effective institutional frameworks to support financial activities (presence of credit bureaus, depositor protection schemes, etc…), very open and transparent market that allows new competition.
Neutral	Developed and fairly diversified financial services sector, adequate availability of institutional frameworks to support financial activities, open and transparent market that allows new competition.
Weak	Financial services sector still developing and improving diversification, limited availability of institutional frameworks to support financial activities, limited openness and markets transparency to allow new competition.
Very Weak	Financial services sector under a precarious stage, very limited availability and reliability of institutional frameworks to support financial activities, very limited openness and markets transparency limiting new competition.

d. Funding & Market Liquidity Conditions

The depth and liquidity of domestic capital markets allow significant stability for the financial services sectors.

Liquidity conditions at country level are key to determining the ability of financial institutions to manage their funding structure, moving from more liquid positions in the short-term to more stable funding structures in the long-term.

The role of financial institutions as intermediaries between relatively short-term deposits and longer-term loans makes them highly vulnerable to withdrawals of funding following a loss of market confidence, which can also have consequences in overall market liquidity and funding availability for all sectors.

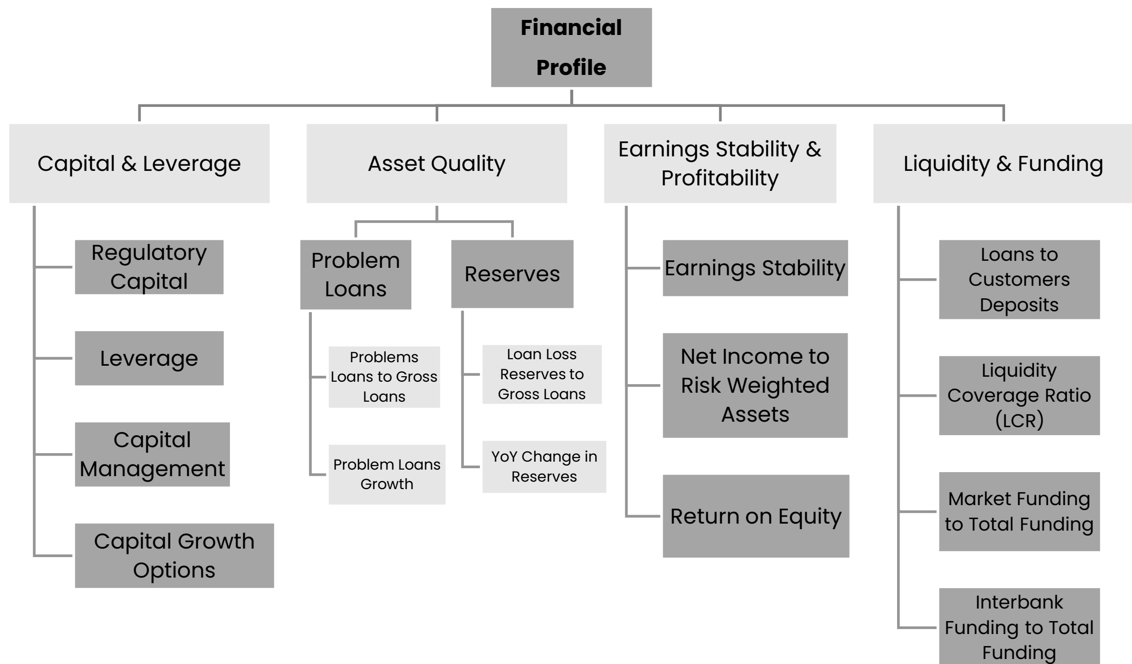
Funding problems often develop at the level of a particular banking system when concerns are not confined to individual banks. In highly interconnected systems, a problem with one institution can be swiftly transmitted to another through counterparty exposures. As such, liquidity and funding problems can both reflect and create systemic vulnerabilities.

The five-points scale used to assess Funding & Market Liquidity Conditions is detailed below:

Funding & Market Liquidity Conditions	Definition
Very Strong	Wide and stable access to central bank funding and liquidity, extremely low and stable (or eventually negative) cost of funding, very large base of institutional investors and market participants that can provide alternative funding sources.
Strong	Large and stable access to central bank funding and liquidity, low and stable (or eventually negative) cost of funding, large base of institutional investors and market participants that can provide alternative funding sources.
Neutral	Ready access to central bank funding and liquidity, relatively low and stable (or eventually negative) cost of funding, large base of institutional investors and market participants that can provide alternative funding sources.
Weak	Limited access to central bank funding and liquidity, relatively high and volatile cost of funding, limited base of institutional investors and market participants to access alternative funding sources.
Very Weak	Very limited and sporadic access to central bank funding and liquidity, very high and volatile cost of funding, very limited base of institutional investors and market participants to access alternative funding sources.

II FINANCIAL PROFILE

ARC considers the Financial Profile as a key indication of how the financial entity is performing across the economic cycle. ARC typically use audited financial statements and published regulatory reporting, but it also uses unaudited interim financial statements if needed. ARC could derive its own financial metrics to achieve better comparability across jurisdictions.



a. Capital & Leverage

Capital is fundamental to the financial stability of any financial institution. It is the most certain source of funds to absorb potential and unexpected losses, when earnings are weak or non-existent, independent of their origins (credit, market and operational). It represents the sole source of funding which is completely reliable in supporting any organic growth expansion.

ARC reviews the composition of an entity's capital base, the tools the management has in place to control and review capital needs and the internal limits and minimum capital levels that it tolerates within its business cycles. ARC regards an entity's minimum internal capital limit as an important indicator of risk tolerance and ability to manage the capital adequacy under tight financial scenarios.

In addition to the Tier 1 ratio to assess an entity's capitalisation, ARC analyses also the leverage ratio. The risk weighting of assets can vary significantly, even between institutions with similar risk and asset profile. This can be due to different regulatory frameworks on risk-weighting applications, or, for example, variations in business sophistication of the institution. In order to compare better between entities' true capital base – available to cover losses – the leverage ratio is considered by ARC as an alternative measure.

Capital is an immediate buffer to mitigate financially distressed scenarios, but if management does not prospectively identify the risks held in the balance sheet, no matter the capital level kept by an entity, the effect on the financial profile can be material.

On the other hand, in periods of economic growth and subsequent expansion of assets, financial institutions are usually tempted to finance this growth through debt, therefore

increasing leverage. In this context, the analysis of balance sheet growth in terms of quality, stability and funding mix is addressed carefully.

In terms of capital management and growth alternatives analysis, the ability of financial institutions to obtain additional capital if necessary is also important. In general, financial institutions have two sources to obtain capital, as described below:

- **Earnings generation:** The ability of an entity to generate positive and consistently growing earnings and retain them in the balance sheet, through dividend pay-out ratios that allow sound and stable capital growth, is the most valuable source of capital. Adequate management of risk-adjusted returns, which aligns with stakeholder expectations, facilitates earnings retention. If profitability is weak and risk-adjusted return levels are not in alignment with the expected financial profile of an entity, stakeholders could demand additional compensation and therefore reduce the internal capital growth level because of high dividend pay-outs.
- **External capital injection:** The ability to raise capital could come from external and new stakeholders through stock issuances or from current stakeholders through capital injections, e.g. rights issues.

Financial institutions can choose any alternative based on their own needs and specifications. The timing and ability to obtain capital without adding extra distress to the financial profile should be the key factor in the choice of the source of capital.

For ARC, the ratios and factors to assess the capital and leverage position are:

- **Regulatory capital (CET1).** In cases in which there is no available regulatory capital (e.g. for non-regulated financial services) ARC could use an internal calculation of capital as proxy. In the case of regulated entities, for banks that show a Tier I Capital ratio too close to regulatory minimum levels which could jeopardise the financial profile if no remedial actions are taken, ARC could apply a cap to the stand-alone assessment based on the potential risk of rapid capital erosion, with detrimental effects on the financial profile of the entity.
- **Leverage.** In cases in which there is no disclosure of regulatory leverage ratio (e.g. for non-regulated financial services), ARC could use an internal calculation of leverage as proxy.
- **Capital Management.** The five-points scale used to assess Capital Management follows the definition detailed below:

Capital Management	Definition
Very Strong	Outstanding quality of capital, very stable management of RWAs[2], outstanding ability to withstand extreme stresses. TLAC[3] or MREL[4] usage with significant buffer.
Strong	High quality of capital, stable management of RWA, strong ability to withstand material stresses. TLAC or MREL usage with ample buffer.
Neutral	Adequate quality of capital, relatively stable management of RWAs, ability to withstand moderate stressed scenarios TLAC or MREL usage with adequate buffer.
Weak	Relatively poor quality of capital, some variability on RWAs management, limited ability to withstand stressed scenarios TLAC or MREL usage with limited buffer.
Very Weak	Very poor quality of capital, significant variability on RWAs management, lack of ability to withstand stressed scenarios. TLAC or MREL usage with no buffer.

– **Capital Growth Options.** The scale used to assess Capital Growth Options follows the definition detailed below:

Capital Growth Options	Definition
Very Strong	Consistent and proven track-record ability to generate internal capital, dividend pay-out that strongly support capital growth, excellent ability to raise capital from existing and new shareholders.
Strong	Consistent ability to generate internal capital, dividend pay-out that support capital growth, strong ability to raise capital from existing and new shareholders.
Neutral	Adequate ability to generate internal capital, dividend pay-out that typically support capital growth, ability to raise capital from existing and new shareholders.
Weak	Limited ability to generate internal capital, dividend pay-out that shows variable support for capital growth, limited ability to raise capital from existing and new shareholders.
Very Weak	Very weak ability to generate internal capital, dividend pay-out that does not support capital growth, inability to raise capital from existing and new shareholders.

b. Asset Quality

ARC's analysis of asset quality focuses primarily on the loan book, because lending is the predominant source of asset quality risk. Nevertheless, we also analyse other on-and off-balance sheet exposures to the extent these are relevant for an assessment of an entity's asset quality. In the case of bank, the core metric, problem loans/gross loans, has the greatest explanatory power for the asset-quality assessment because it is the simplest expression of the extent of problem exposures in what is usually its main asset class.

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[2] RWAs: Risk Weighted Assets

[3] TLAC: Total-Loss Absorbing Capacity

[4] MREL: Minimum Required for own funds and Eligible Liabilities

The factors and ratios analysed under Asset Quality are:

- Problem Loans:
- Problem Loans to Gross Loans
- Problem Loans Growth
- Reserves:
- Loan Loss Reserves to Gross Loans
- YoY changes in Loan Loss Reserves

In cases where any of these measures are not applicable (due to different business nature of the FI under analysis), ARC will evaluate and use alternatives that are suitable substitutes.

c. Earnings Stability & Profitability

The ability of an entity to overcome market stresses is based on the sustainability and stability of earnings generated through a healthy business model. The ability of an entity to generate and maintain strong, sustainable and stable earnings is key to the continuity of the operation and long-term solvency. A detailed analysis of profitability, including key business activities, sources and composition, allows to identify the stability and predictability of earnings. ARC pays particular attention to those entities with business models that lead to volatile earnings. In addition, the strength of a traditional lending model with a high component of earnings from interest (mainly from the loan book), as opposed to, e.g., origination fees, is viewed as positive. Depending on the business model, core earnings are identified and analysed. By contrast, a high degree of reliance on activities subject to greater swings in customer confidence, investor sentiment or individual trades typically gives less comfort, due to less certainty that such earnings will be available to absorb losses at the point of need. In general, retail and commercial institutions with a stock of income-generating assets are more likely to have stronger profitability than wholesale banks subject to more volatile flows of business. A business model that lacks stable core earnings is more exposed to market and economic volatilities and therefore compares poorly with peers with more stable core earnings.

A deviation from the defined business model, to obtain 'one-off' earnings or to take advantage of market momentum, is not viewed as positive in the profitability analysis. In fact, ARC may adjust on a case-by-case basis the calculation of net income for extraordinary items.

The factors and ratios used to assess Earnings Stability & Profitability are:

- Earnings Stability;
- Net Income to Risk Weighted Assets;

– Return on Equity;

In cases where any of these measures are not applicable (due to different business nature of the FI under analysis), ARC will evaluate and use alternatives that are suitable substitutes.

d. Liquidity & Funding

Financial solvency is highly correlated with liquidity and funding risks, including the concept of 'market contagion' that could result from the financial instability of even a small and isolated entity, affecting larger and more solid franchises. ARC requests entities to demonstrate their ability to manage liquidity and funding shortfalls under stressed economic scenarios.

An entity's funding structure has a strong bearing on its probability of failure or requiring financial assistance, because some sources of funds are less reliable than others. For example, in the case of a bank that makes significant use of an unreliable funding source - perhaps short-term in nature, or from particularly risk-sensitive counterparties, or excessive reliance on securitisation - it is more likely it will suffer periodic difficulties in refinancing its debt, putting it at greater risk of needing support. There are many different sources of funding, each with its own characteristics. At the most granular level, particularly for banks, each retail depositor has a different tolerance for risk and each deposit behaves differently. However, in aggregate, a well-diversified deposit base is typically relatively stable under most conditions. This is due to the presence of deposit protection schemes, a feature of most countries, which provides guarantees for most depositors up to a certain amount.

The ratios used to assess Liquidity & Funding are:

– Loans to Customers Deposits

– Liquidity Coverage Ratio (LCR)

– Market Funding to Total Funding

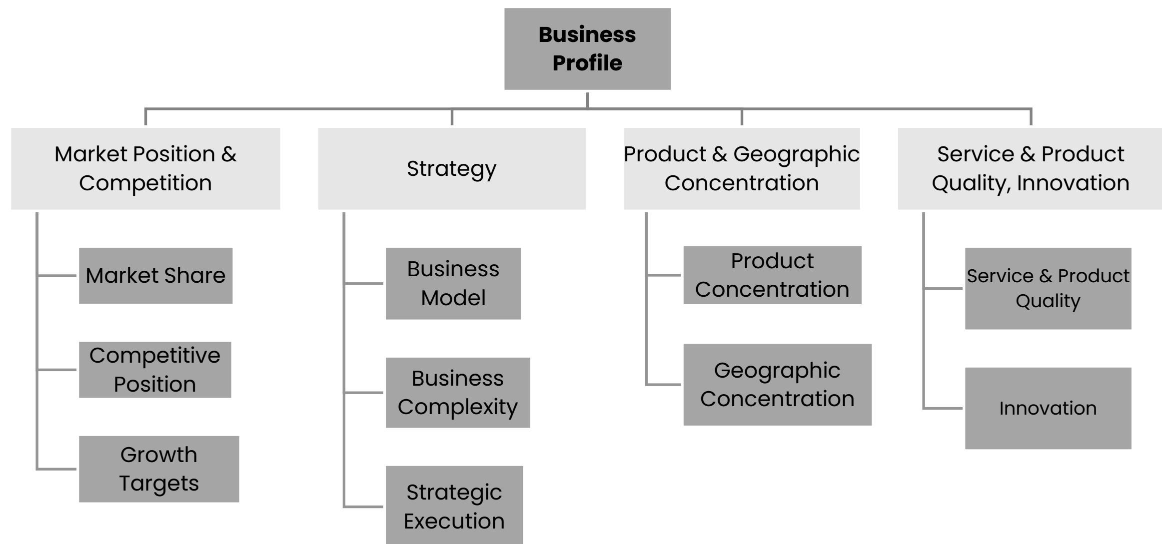
– Interbank Funding to Total Funding

In cases where any of these measures are not applicable (due to different business nature of the FI under analysis), ARC will evaluate and use alternatives that are suitable substitutes.

III BUSINESS PROFILE

The assessment of the Business Profile of any financial institution ranges from a basic review of the market position to a more in-depth analysis of the quality of the services provided, that help to fulfil the strategic plan and focus on the long-term sustainability of the business model without jeopardising the financial profile. ARC has divided the Business

Profile analysis into four sections: Market Position & Competition, Strategy, Product & Geographic Concentration, Service & Product Quality and Innovation.



a. Market Position and Competition

The ability of a financial institution to develop a competitive advantage provides a basis to generate stable profits and returns. In that context, an entity should carefully manage and monitor the competitive environment to foresee the effects that any competitive change would have on its market share, business model and, eventually, competitive position. The competitive advantages can be a result of an internal strength or an external factor that allows the entity to provide a distinctive product or service. A sound and recognised franchise is more stable in times of financial stress, benefiting from the loyalty and preference of customers and debt counterparties. However, this depends on the level of financial or economic stress that affects the market or the entity in particular.

– **Market Share.** The five-points scale used for assessing Market Share is detailed below:

Market Share	Definition
Very Strong	Global or multimarket dominant market position, leader in the majority of markets and countries in which it operates.
Strong	Dominant regional market position, leader in several markets in which it operates.
Neutral	Satisfactory regional or target market position, within the larger players in the markets and countries in which it operates.
Weak	Regional or target markets player with a limited competitive position.
Very Weak	Very limited regional or local market position.

– **Competitive Position.** The seven-points scale used to assess Competitive Position is detailed below:

Competitive Position	Definition
Excellent	Excellent client and brand recognition; among top players in the majority of the markets, pricing is not the leading competitive factor.
Very Strong	Very strong client and brand recognition; among top players in the majority of the markets or leader in a niche market position with extremely strong protections/competitive advantages.
Strong	Strong client and brand recognition; among top players in the majority of the target markets or among the top players in a niche market position with strong competitive advantages.
Neutral	Satisfactory client and brand recognition in its target markets; among the largest players in a niche market position with average competitive advantages.
Substandard	Substandard client and brand recognition in its target markets; pricing is used as an important competitive advantage.
Weak	High competition pressure with weak competitive advantages; weak client and brand recognition in its target markets; pricing is used as the main competitive advantage.
Very Weak	High competition pressure with very weak competitive advantages; unclear client and brand recognition in its target markets; pricing is not sustainable; long-term viability at risk.

– **Growth Targets.** The five-points scale used to assess Growth Targets is detailed below:

Growth Targets	Definition
Very Strong	Evidence of successful and organic growth outperforming industry averages using diverse market opportunities and mitigating risks.
Strong	Evidence of organic growth strategy outperforming industry averages and balanced in terms of opportunities and risks.
Neutral	Evidence of organic growth strategy aligned to industry averages and balanced in terms of opportunities and risks.
Weak	Evidence of high-risk appetite for organic growth and M&A that did not show success.
Very Weak	Evidence of aggressive organic growth and M&A with significant uncertainties and risks involved that resulted in losses.

b. Strategy

The analysis of the strategy focuses on the objectives for organic growth opportunities as well as the analysis of any potential for merger and acquisitions (M&A). Since organic growth is a traditional and slow process, we consider that it has limited risks but at the same time offers reduced potential for material changes in the short to medium term. It is well known that M&A as a main growth strategy involves risks that are sometimes difficult to identify. The success and value creation through M&A depends heavily on an adequate strategic fit between/among the merging entities.

– **Business Model.** In any business model, the strategy plays a key role in determining the long-term objectives and risks that the management is willing to undertake to achieve its strategic goals. It is important that the management's philosophy and actions

provide realistic strategies that reflect the real competitive advantages and disadvantages of an entity. Unrealistic expansionary strategies may lead to pressure, relaxing credit risk controls and unnecessary increase of the entity's overall risk appetite and therefore misalign the real performance from approved policies. On the other hand, an overly conservative management strategy may result in missed business opportunities and reduced competitive strength in the long-term. The need to update business models in alignment with market needs and trends is also considered an important factor. For example, ARC considers that as part of the business model, financial institutions are important players that could encourage companies across all industries to transition towards a low-carbon economy.

The seven-points scale used to assess the Business Model is detailed below:

Business Model	Definition
Excellent	Thoroughly defined business model and goals, fully aligned with core competencies and market developments; excellent track-record of exceeding strategic goals and targets.
Very Strong	Very well-defined business model and goals very aligned with core competencies and market developments; very strong track-record of consistently fulfilling strategic goals and targets.
Strong	Strong business model and goals aligned with core competencies and market developments; strategic goals and targets met.
Neutral	Adequate business model and goals aligned with core competencies and market developments; strategic goals and targets mostly met.
Substandard	Business model and goals not fully aligned with core competencies and market developments; strategic goals and targets not fully met.
Weak	Business model and goals not thoroughly defined, overly ambitious or not aligned with company or market developments; some underperformance against targets in the past.
Very Weak	Business model not defined or unrealistic business model and goals not aligned with company or market developments; track-record of consistent underperformance against targets.

– **Business Complexity.** Complexity increases the challenges for management and heightens the risk of strategic and business wrongdoing. In addition, complex organizations tend to be more difficult to manage, opaque and slow to react to market changes or crisis.

  By contrast, a relatively simple financial institution can achieve more transparency with less disclosure. Simplicity does not guarantee transparency, however some business activities are inherently more opaque than others.

The five-points scale used to assess Business Complexity is detailed below:

Business Complexity	Definition
Very Low	Exposure to derivatives widely hedged or not material; extremely simple legal structure, clear and transparent accounting, complex operations with many business lines managed with outstanding oversight or very simple operations with limited business lines managed without difficulties.
Low	Exposure to derivatives is largely hedged or not material; very simple legal structure, clear and transparent accounting, complex operations with many business lines managed with clear oversight or simple operations with limited business lines managed without difficulties.
Neutral	Exposure to derivatives adequately hedged or not material; simple legal structure, clear and transparent accounting, complex operations with many business lines managed depending on their importance or relatively simple operations with limited business lines managed without material issues.
High	Exposure to derivatives with limited hedge or relatively material for the size of the bank; relatively complex legal structure, relatively opaque and differences in accounting standards, complex operations with many business lines managed with difficulties or very simple operations with limited business lines evidencing lack of oversight.
Very High	Exposure to derivatives with very limited hedge or largely material for the size of the bank; complex legal structure, unclear and opaque accounting standards, complex operations with many business lines managed with significant difficulties or very simple operations with limited business lines evidencing large lack of control.

– **Strategic Execution.** A comprehensive analysis of management's ability to implement the business strategy and its competency in achieving it are fundamental in ARC's view. As a key tool to analyse the quality of management, ARC requests access to the entity's management reports to address the soundness of the information and data shared for decision-making purposes and successful execution.

  Management's business decisions and plans for poorly performing business units or those that no longer make strategic sense represent another relevant area for analysis. Objective appraisals and disciplined approaches in dealing with underperformers (divestiture, restructuring, discontinuation etc.) are reviewed.

  The five-points scale used to assess Strategic Execution is detailed below:

Strategic Execution	Definition
Very Strong	Consistently meets targets (business and financial objectives) through the economic and market cycles.
Strong	Regularly meets targets (business and financial objectives) with very limited variability over economic and market cycles.
Neutral	Meets targets (business and financial objectives) with very limited variability over economic and market cycles.
Weak	Fails to meet targets (business and financial objectives) with variability and execution challenges over economic and market cycles.
Very Weak	Does not meet targets (business and financial objectives) with high variability over economic and market cycles and shows lack of execution track record.

c. Product and Geographic Concentration

Diversification is an important factor in the analysis of any financial institution. If existing, it can decrease dependence on the performance of a specific market and improve the entity's ability to face any distressed conditions of isolated markets or business segments.

Diversification can add more stability and therefore represent a strength or can add volatility and represent a weakness. This is related to the nature of the diversification, the entity's ability to manage it and finally, the overall contribution to the entity's consolidated business model.

Developing business segments that are outside the entity's expertise, or in markets where high investment or large business intelligence are required to be successful, could be viewed as a potential weakness instead of a business opportunity. On the other hand, a reasonable or strong diversification rationale would be one in which an entity is able to either develop a franchise simultaneously and successfully in a different country (or countries) or develop different business lines. This is proven as a factor of mitigation in terms of financial performance helping to overcome different economic cycles or specific business risks.

– **Product Concentration.** The three-points scale used to assess Product Concentration is detailed below:

Product Concentration	Definition
Strong	There is a balanced business composition, with business units adequately contributing to the overall results. It can apply to assets or to liabilities.
Neutral	Some concentration of business units as main contributor to results is present. It can apply to assets or to liabilities.
Weak	Concentration of one business unit as a main contributor to results.

– **Geographic Concentration.** The five-points scale used to assess Geographic Concentration is detailed below:

Geographic Concentration	Definition
Very Strong	Significant presence in major, well-diversified and developed geographic regions, single market concentrations below 60% and not material exposure to underperforming regions.
Strong	Presence in one or more well-diversified geographic regions; single market concentrations below 70% and limited exposure to underperforming regions.
Neutral	Presence in one well-diversified geographic region; single market concentrations below 80% and limited exposure to underperforming regions.
Weak	Presence in one relatively diversified geographic region/area; single market concentrations are above 80% and exposure to underperforming local regions/areas exists.
Very Weak	High concentration in local areas and/or underperforming local areas/regions affects performance.

d. Services & Product Quality, Innovation

For financial institutions, service and product quality can be a key element that customers consider to decide to engage and request a mortgage, a loan, or a current account among other services, and therefore establish a long-term relationship. ARC assesses the service and product quality to identify potential strengths or weaknesses that could affect the implementation of the strategy in the medium-term. ARC also evaluates the level of sophistication and capabilities of the entity's innovation in its target market(s). ARC considers that an entity's position relative to its peers in terms of technological advance can affect its market position in the long-term.

- **Services & Product Quality.** The five-points scale used to assess Services & Product Quality is detailed below:

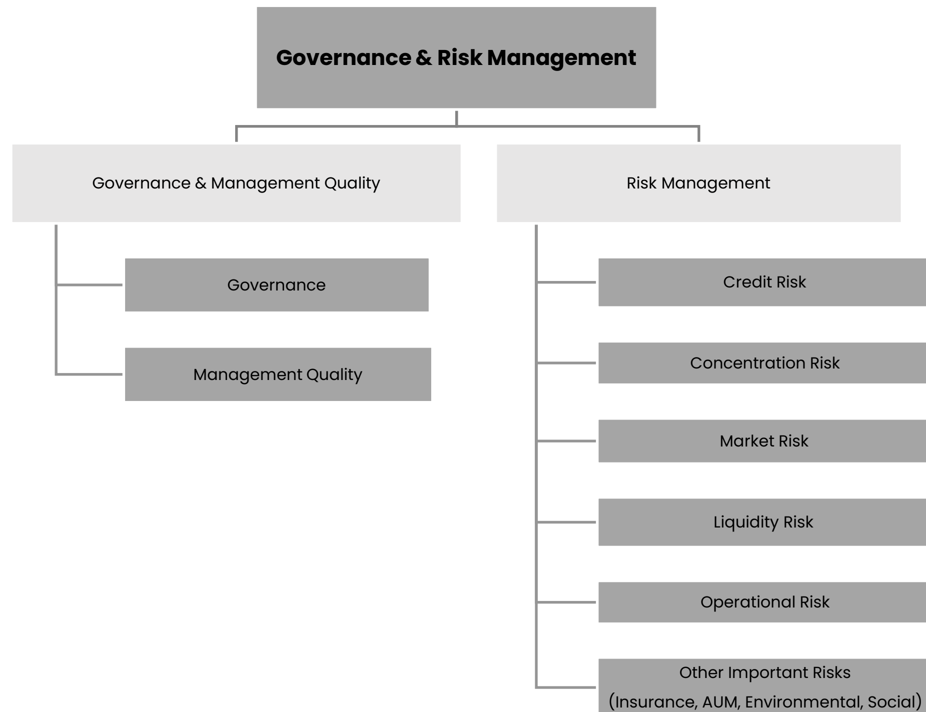
Services & Product Quality	Definition
Superior	Services and product quality perceived as superior compared with all market participants, outstanding brand recognition and very positive customers' feedback.
Above Average	Services and product quality perceived as above average compared with all market participants, strong brand recognition and positive customers' feedback.
Average	Services and product quality perceived as average compared with its peers, average brand recognition and adequate customers' feedback.
Below Average	Services and product quality perceived as below average compared with its peers, below average brand recognition and poor customers' feedback.
Poor	Poor services and product quality compared with its peers, poor brand recognition and very negative customers' feedback.

- **Innovation.** The five-points scale used to assess Innovation are detailed below:

Innovation	Definition
Superior	Innovation efforts provide a superior competitive advantage compared to peers and allow an outstanding response to shifting market dynamics and consumer preferences.
Above Average	Innovation efforts provide an above average competitive advantage compared to peers and allow an above average response to shifting market dynamics and consumer preferences.
Average	Innovation efforts are aligned to its peers and allow a timely response to shifting market dynamics and consumer preferences.
Below Average	Innovation efforts are below market average and do not allow an immediate or timely response to shifting market dynamics and consumer preferences.
Poor	Innovation efforts are very limited and do not provide any competitive advantage compared to peers, response to shifting market dynamics and consumer preferences is behind its peers.

IV GOVERNANCE & RISK MANAGEMENT

Governance & Risk Management are a key factor to assess the management's ability to execute operational plans in a consistent manner, to address the risk-appetite strategy, strategic competences and operational effectiveness. Any financial institution is required to have a clear set of risk policies, procedures, and tools to fit its risk profile and contribute to its strategic and commercial development. When they are above or below its average peers, the performance could result in outstanding or below average results.



a. Governance and Management Quality

– **Governance.** The assessment of a financial institution's governance framework is an important factor in determining the quality of management, the fulfilment and predictability of the strategic plan and long-term performance. It therefore affects the financial stability of an entity. Since the approach to governance can be very different depending on the ownership structure of an entity, the qualitative judgment made by ARC also takes into account the complexity of the ownership structure. The assessment includes an opinion on how the entity manages its relationship with all stakeholders including shareholders, financial markets, regulatory entities, employees and any other relevant parties. A review of the entity's own definitions, procedures, internal policies and business practices is crucial to understand and identify potential risks from lack of governance or management vulnerability.

  A comprehensive list of questions and topics when evaluating corporate governance include, inter alia:

  - Composition of the Board of Directors/Supervisory Board, background and

independency.

- Concentration of power of decision-making processes.
- How are strategy and objectives communicated within the organisation and if those are aligned within the organisational structure
- Risk tolerance appetite clearly determined and communicated
- Risk management function well structured and managed
- Experience of the senior management
- Are internal procedures and practices clearly defined, communicated and applied?
- Outcome of the last inspection by the regulator/central bank
- Evidence of complexity of the ownership structure
- Structure of the management compensation packages. Are the incentives for management compensation aligned with a sustainable long-term perspective of the institution?
- Evidence of moral hazard risks
- Quality of reporting, controls and monitoring of the Board to management level
- Evidence of any legal or regulatory disputes that can affect the reputation of the entity
- Any compliance breach, exception, or fine from a regulatory institution
- Sizable related-party lending
- Other relevant aspects

The notching definitions used to assess governance are detailed below. It should be noted that good governance is expected as best practice, therefore the only notching applied is downwards:

Governance	Definition
Neutral	Satisfactory governance with an existing framework and full application across the organisational structure, management follows best practices, no evidence of key man risks, no accounting challenges, full transparency on financial information and excellent relation with stakeholders.
-1 notch	Relatively weak governance with an existing framework that is in the process to be updated or improving, application across the organisational structure is in place but still does not fully cover all functions, management is aiming to follow best practices across all functions, limited potential of key man risks and accounting challenges, adequate transparency on financial information and fair relation with stakeholders.
-2 notches	Weak governance with an existing framework that requires to be updated or improved, application across the organisational structure is limited, management following a process to implement best practices across all functions, existing key man risks and accounting challenges, limited transparency on financial information and weak relation with stakeholders.
-3 notches	Very weak governance with existing framework that requires significant update or improvements, very limited application across the organisational structure, evidence of high key man risks and accounting challenges, poor transparency on financial information and very weak relations with stakeholders.

– **Management Quality.** ARC assesses the capabilities and quality of the management and the Board of Directors. ARC's assessment of the management includes the evaluation of the quality and level of oversight and support of all of the entity's activities. In this process, ARC focuses on the ability of the Board and management, in their respective roles, to plan for and respond to risks that may arise from changing business conditions or the initiation of new activities or products. ARC examines the corporate structure and various divisions and subdivisions within the organisation, determining the level of complexity and depth of the management and operational systems, and whether the accuracy, timeliness and effectiveness of the management information and risk monitoring systems are appropriate for the institution's size, complexity and risk profile. The adequacy of audits and internal controls to promote effective operations and reliable financial and regulatory reporting, safeguard assets, and ensure compliance with laws, regulations and internal policies is also assessed.

  One of the key areas in the analysis of the entity's performance is an evaluation of the quality of the strategic and financial planning. For this purpose, ARC uses a comparison of the entity's financial results with management's plans and budgets.

The three-points scale used to assess Management Quality is detailed below:

Management Quality	Definition
Strong	Management team has a high degree of credibility, experience and competence and, commensurate with the size and complexity of the entity; appropriate depth of experienced, capable management with employee turnover considered in the context of the market competitiveness and evidence of strengths to attract new talent.
Neutral	Management team has an adequate degree of credibility, experience and competence and, aligned with the size and complexity of the entity; experienced and capable management with employee turnover considered in the context of the market competitiveness.
Weak	Management team has limited degree of credibility, experience and competence; management with limited experienced and high employee turnover; lack of strength to attract new talent.

b. Risk Management

For ARC, the ability, expertise and proven record of successful risk management is a key qualitative factor for the analysis. The ability of a financial institution to generate revenues under a solid risk management framework is analysed and challenged. The business model that financial institutions undertake carry credit, market and operational risks, among others, that need to be managed well in order to provide profitability, which needs to be properly adjusted based on the identified risk appetite. Since the overall profitability that financial institutions achieve is mostly determined by the level of risks accepted and rejected, the management of risks is expected to be economically profitable and controlled accordingly.

The analysis of the management framework to monitor and control risks is assessed in the business context the entity is set for. The coherence of the risk management framework with the business model is the starting point for the analytical assessment. In this context, ARC assesses the complexity and performance of several sources of risks, as detailed below:

- **Credit Risk.** For financial institutions, the key driver of recurrent earnings comes primarily from lending activities, which commonly represent the largest portion of assets. The large size of loan portfolios gathers a variety of credit counterparts in nature, industries, loan specifications etc. In that context, the quality of the loan portfolio represents a key driver of the financial profile and earnings prospect of any entity.

  An entity's credit risk appetite represents the starting point of the analysis. ARC discusses and reviews an entity's credit risk policies in order to understand the rationale of its lending practices. The analysis of credit operations and risk management processes provides a basis for comparison with peer and industry benchmarks. This allows ARC to identify whether an entity follows the industry best practices and regulation, or has any other business approach in its development of credit activities.

The analysis includes a review of the entity's credit policies and standards, collateral, management of recoveries and other related matters on loan write-offs policies.

It is worth noting that although credit risk diversification can reduce the effect of a deterioration of specific counterparties or industries on the loan portfolio, in cases of economic downturn, typically the loan portfolio as a whole is adversely affected. In those cases, it is necessary to carefully analyse the macro context and the ability of each entity to successfully overcome the economic scenario with limited shocks on asset quality. Understanding the cause of credit losses is key to evaluate the expected performance of an entity's asset quality. Benchmarking and peer comparison allows ARC to identify the complexity and specific characteristics that apply for each entity and therefore, the expected asset quality stresses under different economic scenarios.

To evaluate the composition of the loan book in more detail, ARC requests detailed information on the most relevant large credit exposures (or borrowers) including internal ratings, guarantees (and some transaction specific conditions if applicable), data on industry exposure, concentration by lending products and any other additional data the agency considers relevant for analytical purposes.

The Credit Risk assessment is determined following the definitions detailed below:

Credit Risk Assessment	Definition
aaa	Very conservative credit risk policies with clear commitment to highest credit quality; very low risk appetite or very long and consistent track record of balanced risk and return from credit risk; fully independent risk and business functions.
aa	Conservative credit risk policies with clear commitment to highest credit quality; low risk appetite or very long and consistent track record of balanced risk and return from credit risk; fully independent risk and business functions.
a	Relatively conservative credit risk policies with clear commitment to strong credit quality; relatively low risk appetite or consistent track record of balanced risk and return from credit risk; fully independent risk and business functions.
bbb	Credit risk policies aligned with the industry standard, with clear commitment to benchmark to industry average credit quality; risk appetite aligned to industry averages and track record of balanced risk and return from credit risk without material effects on profitability or capital; independent risk and business functions.
bb	Credit risk policies relatively more aggressive than the industry standard, with commitment to benchmark within a higher range compared to industry average credit quality; risk appetite relatively above industry averages and track record of risk and return from credit risk with effects on profitability or capital.
b	Credit risk policies focused on shareholder returns and more aggressive than the industry standards; risk appetite above industry averages and track record of risk and return from credit risk weakening capital or profitability; not independent risk and business functions for major transactions with sometimes not transparent, non-consistent or modest credit decision governance structure.
ccc	Credit risk policies focused on shareholder returns and aggressive compared to industry standards; risk appetite above industry averages and track record of risk and return from credit risk largely weakening capital or profitability; not independent risk and business functions for major transactions with sometimes not transparent, non-consistent or modest credit decision governance structure.

- **Concentration Risk.** Recent events in several European countries have shown how high borrower or industry concentration can cause large charge-offs and finally a deterioration of capital. Therefore, an adequately diversified and granular credit portfolio is an indicator of reasonable credit risk management that can help to reduce and mitigate credit losses. This is also related to large exposures to specific industries, countries or any other niche that is heavily dependent on market trends or economic conditions.

  The Concentration Risk assessment is determined following the definitions detailed below:

Concentration Risk Assessment	Definition
aaa	Excellent granularity and uncorrelated portfolio of assets; large number of counterparties, no single industry sector concentration, largest exposures are modest relative to capital.
aa	Very high granularity and uncorrelated portfolio of assets; large number of counterparties, no single industry sector concentration, largest exposures are modest relative to capital.
a	High granularity and modest correlation of portfolio of assets; large number of counterparties, modest industry sector concentration.
bbb	Adequate granularity and some level of correlation of the portfolio of assets; adequate number of counterparties with largest exposures, limited industry sector concentration.
bb	Limited granularity and correlation of the portfolio of assets; limited number of counterparties, industry sector concentration exists, largest exposures are relevant relative to capital.
b	Poor granularity and highly correlated portfolio of assets; reduced number of counterparties, industry sector concentration, largest exposures are relevant relative to capital.
ccc	Very poor granularity and highly correlated portfolio of assets; deficient number of counterparties, single industry sector concentration is material, largest exposures are very relevant to capital.

- **Market Risk.** The potential consequences of poor market risk management on an entity’s balance sheet and financial profile can be significant. ARC follows a comprehensive approach to understand and analyse each specific market risk framework and risks from a qualitative to a quantitative perspective.

  The importance of the risk appetite assessment, incentives and review of the practical application of the framework is vital in analysing the complexity and management of market risks. In addition, a relevant source of returns obtained from market risk activities is a driver in determining the importance of these risks on the entity’s credit risk profile.

  The entity’s reporting of market risk, sensitivity analysis, stress testing tools and results are data upon which the market risk assessment is addressed. There are no quantitative ratios applied to market risk, due to the vast diversity of models and tools used by entities depending upon their complexity levels.

The Market Risk assessment is determined following the definitions detailed below:

Market Risk Assessment	Definition
aaa	Excellent and best in class market risk management practices; very high or very low complexity of operations managed through no history of related losses and sounds controls; very proactive and independent approach to balance risks and returns from market risk.
aa	Very strong market risk management practices; high or low complexity of operations managed through no history of related losses and sound controls; proactive and independent approach to balance risks and returns from market risk.
a	Strong market risk management practices; high or low complexity of operations managed through no history of related losses and strong controls; proactive and independent approach to balance risks and returns from market risk.
bbb	Satisfactory market risk management practices; average complexity of operations managed through limited history of related losses with no material effects on profitability neither capital; relatively proactive and independent approach to balance risks and returns from market risk.
bb	Moderate market risk management practices; high or low complexity of operations managed through history of related losses weakening profitability or capital.
b	Weak market risk management practices; high or low complexity of operations managed through history of related losses materially weakening profitability or capital.
ccc	Very weak market risk management practices; very high or very low complexity of operations managed through history of related losses largely and persistently weakening profitability or capital.

- **Liquidity Risk.** ARC gives special attention to an entity's Liquidity Management framework, including not only a qualitative analysis of liquidity plans (under contingency and normal scenarios), but also gaining an understanding of the historical liquidity dynamics that an entity has faced during economic cycles.

  In addition, it is important to identify regulatory measures put in place to prevent financial institutions (particularly banks) facing uncontrolled liquidity stresses. The analysis includes the differentiation and special conditions available (central bank funding) for specific entities (banks in most cases) and for other non-banking institutions.

  The access to central bank funding, or any other liquidity sources, is analysed accordingly and in the context of economic conditions. For ARC, sound liquidity management is supported by a reasonable and balanced funding structure, with no overdependence on specific funding sources neither concentration of maturities.

The Liquidity Risk assessment is determined following the definitions detailed below:

Liquidity Risk Assessment	Definition
aaa	Excellent ability to manage liquidity, excellent contingency plans in place updated to recent market events, existence of comprehensive stressed scenarios, no evidence of dependence of liquidity from central bank facilities, no evidence of contingent liabilities that are material.
aa	Outstanding ability to manage liquidity, very strong contingency plans in place updated to recent market events, existence of comprehensive stressed scenarios, no evidence of dependence of liquidity from central bank facilities, no evidence of contingent liabilities that are material.
a	Strong ability to manage liquidity, contingency plans in place updated to recent market events, existence of comprehensive stressed scenarios, no evidence of material dependence of liquidity from central bank facilities, no evidence of material contingent liabilities.
bbb	Adequate ability to manage liquidity, adequate contingency plans in place updated to recent market events, existence of comprehensive stressed scenarios, no significant evidence of dependence of liquidity from central bank facilities, no significant evidence of contingent liabilities that are material.
bb	Modest ability to manage liquidity, modest contingency plans in place updated to recent market events, limited existence of comprehensive stressed scenarios, evidence of some dependence of liquidity from central bank facilities, evidence of contingent liabilities that are material.
b	Poor ability to manage liquidity, weak contingency plans in place updated to recent market events, limited existence of comprehensive stressed scenarios, evidence of dependence of liquidity from central bank facilities, evidence of contingent liabilities that are material.
ccc	Very poor ability to manage liquidity, very weak contingency plans in place updated to recent market events, lack of comprehensive stressed scenarios, evidence of significant dependence of liquidity from central bank facilities, significant evidence of contingent liabilities that are material.

- **Operational Risk.** Due to the complexity of services provided by financial institutions and the volume and amount of transactions involved, operational risk can cause great damage to the financial profile, in both monetary and non-monetary terms. Operational risks could not only lead to unexpected losses in financial statements but also regulatory fines, credibility loss, litigation or other intangible brand damage. These could in turn result in a decrease in the customer base and also debt counterparties being reluctant to provide funding, which in turn can dramatically affect the scale of operation of an entity.

  There are no broadly accepted quantitative ratios applied to operational risk, due to the vast diversity of models and tools used by entities depending on their complexity levels, regulatory frameworks and business needs. Nevertheless, ARC's approach takes into account the amount of capital available (buffer) to cover any unexpected losses from operational risk and any other internal measures that the management uses to

manage this risk. In addition, the operational risk assessment is evaluated in the context of the business model complexity.

ARC also sees that operational risk has become a key factor highlighting new challenges and weaknesses in financial institutions, mostly after the significant changes to business models as a result of the Covid-19 pandemic. Therefore, we consider that improvements in operational resilience with focus on digitalization, processes optimisation, use of technology and supply chain management are key aspects to address when assessing operational risks.

The Operational Risk assessment is determined following the definitions detailed below:

Operational Risk Assessment	Definition
aaa	Excellent and best in class operational risk management practices; very high or very low complexity of operations with no history of related losses and sounds controls; very proactive and independent approach to balance risks and returns from operational risk. Best practices in digitalization and automation of processes to improve interaction with key stakeholders (clients, suppliers, employees, financial markets, etc..).
aa	Very strong operational risk management practices; high or low complexity of operations managed through no history of related losses and sound controls; proactive and independent approach to balance risks and returns from operational risk. Fastly adopting best practices in digitalization and automation of processes to improve interaction with key stakeholders (clients, suppliers, employees, financial markets, etc..).
a	Strong operational risk management practices; high or low complexity of operations managed through no history of related losses and strong controls; proactive and independent approach to balance risks and returns from operational risk. Improvements in digitalization and automation of processes to improve interaction with key stakeholders (clients, suppliers, employees, financial markets, etc..)
bbb	Satisfactory operational risk management practices; average complexity of operations managed through limited history of related losses with no material effects on profitability neither capital; relatively proactive and independent approach to balance risks and returns from operational risk. Improvements in digitalization and automation of processes to improve interaction with key stakeholders (clients, suppliers, employees, financial markets, etc..)
bb	Moderate operational risk management practices; high or low complexity of operations managed through history of related losses weakening profitability or capital. Limited digitalization and automation of processes to interact with key stakeholders (clients, suppliers, employees, financial markets, etc..)
b	Weak operational risk management practices; high or low complexity of operations managed through history of related losses materially weakening profitability or capital. Very limited digitalization and automation of processes to interact with key stakeholders (clients, suppliers, employees, financial markets, etc..)
ccc	Very weak operational risk management practices; very high or very low complexity of operations managed through history of related losses largely and persistently weakening profitability or capital. Lack of digitalization and automation of processes to interact with key stakeholders (clients, suppliers, employees, financial markets, etc..)

- **Other Important Risks.** In cases where ARC believes there are material risks not identified in the previous sections, they will be included in this section and assessed

accordingly. Additional risks that could arise and not covered in previous sections include (but not limited to):

- **Insurance, Assets under Management.** In the case that the analysed entity or group is hybrid in nature, e.g., composed of Bank, Insurance and Assets Under Management (AUM) ARC analysis will include a review of potential risks coming from the different business units. In the case that ARC considers the group as a complex hybrid conglomerate, the analysis could eventually be done following the application of a combination of available Criteria. In these cases, the approach followed will be disclosed accordingly.
- **Pensions.** Financial institutions face additional risks from potential movements in the value of the pension scheme's assets and liabilities, particularly for defined benefit pensions. When the size of the scheme's liabilities is large, a minor change in one of these underlying variables can have a relevant impact on an entity's financial strength and therefore affect its financial profile.
- **Environmental and Social Risks.** ARC incorporates Environmental and Social factors into its analysis mostly through qualitative assessments. In the case of financial institutions, ARC observes a significant trend to embrace the concept of Sustainable Finance[5] for strategic growth and market focus. ARC assesses then the ability of the entity to address environmental and social factors not only as part of potential risks to the business but also as part of the strategy to engage in a more sustainable business model.

  ARC considers the following environmental factors as part of other important risks:

  - Climate change
  - Biodiversity loss
  - Air pollution
  - Water management and pollution
  - Resources depletion
  - Energy management

  ARC considers the following social factors as part of other important risks:

  - Consumer protection, including privacy and data security
  - Labour relations and practices
  - Integration in the community and affordability

[5] Definition used by the European Commission: Sustainable finance refers to the process of taking environmental, social and governance (ESG) considerations into account when making investment decisions in the financial sector, leading to more long-term investments in sustainable economic activities and projects.

– Stakeholders' opposition

We assess both the consequences (existing or potential) from the environmental and social factors, as well as the impact of regulatory or policy initiatives aimed at minimising or preventing risks arising from these factors. For ARC, environmental and social risks are not based on quantitative data nor have a specific score; the impact of the analysis is applied using notching adjustments and disclosed accordingly.

V EXTERNAL SUPPORT

The final part to complete ARC's analytical framework and accord an entity's ICR is External Support. Support could come from an identified support provider. The support providers usually considered by ARC in the case of Financial Institutions are: (a) Parent, Holding Company or Group, (b) Cooperative or Mutualism Schemes, (c) Local, Regional or Central Government, (d) Multilateral or Development Financial Institution, or similar.

After the identification of the support provider, ARC assesses the potential support that will be translated into notching adjustments. For each support provider, we review a list of conditions that could add or reduce the potential of support from the identified support provider.

It is worth noting that group support would typically be a neutral or positive factor to the stand-alone assessment. However, in specific cases in which ARC analysts consider that because of particularities of the group structure, or due to conditions that limit the financial independency of the entity, support could negatively affect the entity and result in a notching down adjustment. These cases, although rare, will be disclosed accordingly.

a. Parent, Holding Company or Group

In cases in which the financial institution is part of a group, with a parent entity or holding company, ARC evaluates first the existence of any form of guarantee or legal obligation to support the analysed entity. In that case, due to the nature of the obligation to support, the notching up of the entity's ICR could be up to the level of the parent/holding company/group.

It is worth noting that even though the parent/holding company/group may not have any formal or explicit commitment to support the operations of a subsidiary, ARC evaluates the strategic importance of the subsidiary and the effects on the parent/holding company/group's reputation and market confidence if a potential default affects the analysed entity. In that context, ARC uses the concept of 'strategic importance' and considers giving uplift to the analysed entity's stand-alone assessment based on the financial strength of the parent/holding company/group. Although ARC evaluates prospectively the eventual support from parent/holding company/group entities, the track-record and past examples of support highlighted during past crisis is considered a key element.

The factors evaluated are as follows:

- Bailout history
- Ultimate parent financial strength
- Ownership structure
- Financial reporting
- Guarantees in place
- Strategic importance
- Operational integration
- Reputational risk

In special cases in which the analysed entity has a higher stand-alone assessment than the parent/holding company/group the support provided by the parent/holding company/group is evaluated carefully and on a case-by-case basis. In these cases, ARC applies a judgment to evaluate the degree of connection and dependence of both entities and therefore the relation of both ultimate ICRs.

b. Cooperative or Mutualism Schemes

Cooperative banking groups and mutualism mechanism schemes represent a particular type of external support since damage to one entity within the cooperative/mutualism structure can cause contagion to the overall group of entities under the cooperative/mutualism umbrella. In the case of cooperative banks, the support comes from other members of the cooperative. Support coming from other members of the cooperative is mainly a sort of intervention designed to avoid any reputational/business risk.

The support received can range from any sort of informal support, e.g. brand sharing - to a more formalised and structured legally binding support, which is assessed accordingly to determine the level of support in each case. ARC evaluates the legal framework and the specifications of the cooperative or mutualism mechanisms in place. The set of factors evaluated to assess the Cooperative/Mutualism Support will be considered strengths if they add support and weaknesses if they reduce the level of support.

The factors evaluated are as follows:

- Reporting structure
- Branding
- Organisational structure
- Legal structure

- Explicit support
- Operational dependence
- Bailout or intervention history
- Geographic correlation
- Business correlation
- Relative size

c. Local, Regional or Central Government

In regions in which the financial system has a very specific role within the local economy, there is empirical evidence of support from the regional/local government. This is not recognisable in all countries, but some examples of regional or local government support exist.

In the case of national government support, it has been historically proven. When the stability of the domestic financial system is at risk, governments are willing to support financial institutions. However, a government may be more willing to support those entities in which it has direct investment, through different mechanisms such as direct cash and capital injections, liquidity facilities, long-term debt, subordinated debt, guaranteed debt programs etc.

For systemically important financial institutions (mostly banks), the incentive for the government to provide support is driven by the catastrophic consequences of a bank facing a scenario of insolvency, with a direct effect on depositors and investor confidence, possible contagion to the financial system and the real economy. In those cases, the support to systemically important financial institutions comes from a desire to avoid any further damage to capital markets and therefore macroeconomic and social stability. It is worth mentioning that in those cases in which ARC considers that the government does not have a sound financial profile or enough resources to provide support if needed, the level of support expected is adjusted accordingly.

ARC identifies those financial institutions (mostly banks) that can be defined as systemically important and who are very likely to receive support in case of financial distress. However, in cases in which resolutions regimes are in place (for example the Bank Recovery and Resolution Directive - BRRD - applicable for the European Union), banks' shareholders and creditors are deemed to be the first layer to pay their share of the costs through a "bail-in" mechanism in case of failure. Therefore, government support because of systemic importance would be unlikely.

It is worth noting that ARC's opinion on systemic importance could differ from the definition of systemic importance that a country could set for its domestic banks.

The factors that ARC considers when assessing the potential of support from Local, Regional or Central Government are as follows:

- Importance of the banking system for the region
- Importance as national systemic bailout history
- Legal capacity
- Political and public sentiment for support
- Operational & economic environment assessment
- Strategic importance of the entity within the financial market (dominant player, market maker)/substitutability
- Geographic diversification
- Main business activity - Support needed because of losses or issues arisen from normal operations
- Existence of a Resolution Regime and its framework
- Guarantee in place
- Ownership structure

d. Multilateral or Development Financial Institutions

In the case of financial institutions created with the purpose of providing financial support to help economies and engage in social development policies, owned by a group of governments, ARC assesses the support based on their public role and the ability of the owners (so called 'member states') to provide support to these entities based on existing agreements. Generally, those entities are not subject to specific banking regulation and they are governed by their own policies and benefit from special features as preferred creditor status, do not distribute dividends, do not have profitability targets, and keep callable capital available in case the entity faces difficulties in terms of liquidity or to repay its financial obligations.

The factors evaluated to address support in the case of Multilateral or Development Financial Institutions are as follows:

- Callable capital available
- Additional support available
- Willingness of support from shareholders
- Importance to shareholders (economic interest, political interest, other)
- Financial strength of shareholders

- Relation between shareholders (economic, geographic, political, other)

V. OTHER CONSIDERATIONS FOR FINANCIAL INSTITUTIONS' CREDIT RATINGS

a. Financial Institutions Holding Companies

In the cases of pure holding companies within a group of financial institutions, for which cash flows are represented mainly by dividends received from the operating subsidiary (a rated financial institution), ARC analyses the holding either on a non-operating or operating basis.

- **Non-operating holdings:** In the case of a non-operating holding, the stand-alone assessment is anchored at the level of the operating financial institution and then notched down, due to the lack of independent earnings generation and dependency on dividends as the only income source. Further notching down applies depending on the level of leverage and any lack of financial flexibility present in the holding company.
- **Operating holdings:** An operating holding could have the same stand-alone assessment as the operating subsidiary, if it has proven additional sources of earnings or cash that contribute with stable cash flows and help the holding company to keep a very flexible and healthy financial position without over-dependency on one subsidiary only. For example, ARC could identify and consider as stable cash flows the existence of (i) significant investment assets (real estate, marketable securities) that can be easily liquidated and transformed into an immediate source of cash, or (ii) any other important and significant earning generator businesses.

b. Subsidiaries, Branches and other Vehicles

Large financial institutions usually keep small operations in non-core countries for special purposes such as alternative booking units, debt issuance or other reasons. In those cases, the subsidiary (special vehicle or branch) is highly integrated with the parent, sharing IT, funding, risk management operations and most core services. This makes the stand-alone assessment (or eventually the ICR) of the subsidiary (or branch) highly dependent on the stand-alone assessment/ICR of the parent entity. Therefore, the stand-alone assessment/ICR of the subsidiary (or branch) is mostly likely to be at a similar level to the one of the parent entity, considering that these subsidiaries (or branches) have a limited independence and that decision-making processes and operations are concentrated at the parent level.

The stand-alone assessment/ICR can instead be significantly different from that of the parent when the subsidiary (or branch) is located in countries where the jurisdiction differs substantially from that of the parent.

It is worth noting that ARC assesses these subsidiaries on a case-by-case basis in order to clearly identify the potential risks or weaknesses that debtholders could face within those specific jurisdictions and will assign a different ICR if deemed necessary.

c. Non-Regulated Financial Institutions (NRFI)

For ARC, NRFI include a variety of financial services sub-sectors, among other lenders we include commercial leasing companies and business development companies, service providers and other providers that act as financing services but do not retain loans or leases on their balance sheets. ARC could also include automotive finance companies, commercial finance companies, commercial leasing companies, consumer finance companies, debt purchasers, factoring companies, fintech companies, payday lenders, residential mortgage companies and student-loan lending companies.

NRFI can cover a broad range of business models, mix and quality of assets, geographies, regulatory environments and credit profiles. Some finance companies are well-diversified, while others are highly concentrated in a single, high-risk business line.

Typically, finance companies are monoline, with limited operational diversification. Concentration exposes the industry to higher levels of intrinsic credit cycle volatility. Asset quality is a primary driver of earnings and capital formation, and in most of the cases NRFI have a concentration in a single asset class or operate in niche sectors that have higher credit risk than a regulated entity. Asset quality deterioration in a cyclical downturn can be more pronounced for a finance company than for more-diversified lenders. In addition, unexpected asset quality problems often are among the most significant sources of risk that can negatively affect earnings, debt service capacity and capital for finance companies.

In certain circumstances, when ARC accords an ICR for a NRFI (e.g. securities firms, Fintech, financial markets infra-structure, Leasing and Consumer Finance), it can be constrained at a level below the one of a regulated entity (in case of all equal business conditions). This could happen when the NRFI stand-alone assessment is higher than the one existing for the regulated entity (all other factors being equal). However, we should note that ARC already considers in the analysis the constraints (mainly the risk of transfer and convertibility restrictions) related to the lack of regulatory oversight and framework.

d. Foreign Currency and Local Currency Ratings

ARC assigns Foreign Currency (FC) ratings in cases where the entity issues debt instruments in a currency different from the local currency. There ratings are not independent and are obtained through the Local Currency rating. The debt obligations that an issuer has committed to in a foreign currency are subject to notching adjustments (up or down) based on the entity's access to the specific foreign currency. The adjustment also considers the specific features of the foreign currency issuance and any other factor that ARC considers could constrain access to foreign currency and therefore reduce the ability of the entity to fulfil its obligation accordingly.

In addition, a ceiling on Foreign Currency would be applied if ARC believes that the entity's access to that currency is considerably restricted within its operating country, or if there is a government restriction on foreign currency access in events of financial distress. In those cases, the Foreign Currency ICR would mostly follow the external restrictions applied by that country, therefore would not be in alignment with the Local Currency ICR. The difference in notching is analysed on a case-by-case basis, depending on the rated entity's strength and ability to ring-fence the specific foreign currency debt obligation.

e. Banks' ICRs, Sovereign Ratings and Country Ceilings

Banks' ICR and Sovereign Ratings

Sovereign-related risks that are relevant for financial institutions are generally captured through the Operational & Economic Environment section of the Criteria.

Exceptionally strong specialist banks (e.g. central securities depositories or leasing companies with banking licenses) with very limited direct exposure to their domestic sovereign and economic environment and funding profiles that are likely to remain very resilient in a sovereign stress scenario could achieve a rating that is not capped at the level of the sovereign rating[6]. In addition, in cases where the bank has a high degree of diversification outside its home country, and if the bank has a low degree of dependence on confidence-sensitive funding from international capital markets, these characteristics reduce the dependency between the creditworthiness of the bank and the sovereign rating.

In other cases, banks with very high direct exposure to the sovereign may find it harder to remain solvent and liquid in case of a sovereign default because of marked-to-market losses on government securities and the disappearance of liquid markets where they can sell or refinance government debt. Banks with such high exposures will therefore, other things being equal, be less likely to be delinked from the existing sovereign rating. However, a bank with a strong funding franchise and a stable deposit base may still be able to withstand such difficulties as it would not need to raise additional liquidity, could avoid realising losses on asset sales and, in common with other banks in the system, may benefit from regulatory forbearance in terms of loss recognition. These exceptional cases will be addressed and evaluated accordingly, however ARC does not consider them as completely delinked from the existing sovereign rating.

Banks' ICR and Country Ceilings

Foreign Currency Restrictions – Transfer and Convertibility Risk

ARC's country ceilings assessment captures transfer and convertibility (T&C) risk. Country ceilings typically constrain the Foreign Currency ratings of all entities domiciled in the

[6] For details about the sovereign rating used as reference by ARC, please refer to the guidance 'ARC Ratings' Approach to Setting Sovereign Ratings and Country Ceilings', published on ARC's website.

relevant jurisdiction.

Local Currency Restrictions – Deposit Freezes and Other Intervention

During a sovereign crisis, the authorities may increase regulation of the banking sector. Measures may be introduced with several aims, including support of the banking system itself, support of the wider economy, stabilisation of broader financial markets and macroeconomic indicators, and reduction of popular discontent and/or panic.

In some cases, these measures will include restrictions such as deposit freezes or prolonged bank closures that prevent banks servicing their local-currency as well as foreign-currency obligations. Other types of intervention, e.g. directed lending, interest rate controls, forced currency conversion and forced nationalisation, may not directly prevent a bank from servicing its debt, but may seriously undermine its ability to do so. To address these risks, ARC could limit the uplift of commercial banks' local currency ratings over sovereign local currency ratings, but this will be subject to the potential support that the bank could receive eventually from a strong parent in case of high sovereign stress.

In determining the degree of potential uplift for banks' Local Currency ICRs above the sovereign, ARC will consider the rule of law and governance in the country and any previous record of imposing deposit freezes or otherwise interfering in the operations of the banking system. ARC assumes the existence of a significant linkage between the risk of foreign and local currency restrictions being imposed in a particular country, and therefore will rarely assign a Long-Term Local Currency ICR to a bank more than one notch above the bank's Long-Term Foreign Currency ICR.

Whereas, in some cases, ARC will have country ceilings at the level of the sovereign Long-Term Foreign Currency ICR, preventing uplift of bank foreign currency ICRs above those of the sovereign, it is comparatively rare for ARC to constrain banks' local currency ratings at the level of the sovereign. This is because a sovereign will normally have some incentives to maintain a functioning banking and payments system even during a sovereign crisis, making the risk of local-currency restrictions materially lower than the risk of a sovereign default.

f. Deposits Ratings

Bank deposit ratings are opinions of a bank's ability to repay punctually its foreign and/or local currency deposit obligations. Bank deposit ratings do not apply to deposits that are subject to a public or private insurance scheme (e.g. Depositor Protection Scheme); rather, the ratings apply to the most junior class(es) of uninsured deposits, but they may in some cases incorporate the possibility that support might in certain cases extend to the most junior class(es) of uninsured as well as preferred and insured deposits.

Deposit ratings do not specifically address transfer and convertibility risk for each foreign jurisdiction in which a bank operates via a branch or subsidiary, nor do they reflect branch-specific resolution risks.

g. Debt Obligations

The implementation of resolution regimes has led banks to prepare recovery plans to overcome any potential financial distress. In addition, it has set a comprehensive and effective arrangement to deal with failing banks at country level. In the case of the Bank Recovery and Resolution Directive (BRRD) applicable by the European Union, it is established that in case of failure, banks' shareholders and creditors must be the first layer to pay their share of the costs through a "bail-in" mechanism. If that is still not sufficient, the national resolution funds set up under the BRRD can provide the resources needed to ensure that a bank can continue operating while it is being restructured. The shareholders and creditors have to partially bear the losses of the failing institution; they cover the losses up to at least 8% of the total liabilities (debts or obligations) of the bank undergoing a restructuring plan. If there are still losses to cover, the resolution fund can intervene. Other powers in the hands of national authorities include the possibility to sell the institution undergoing restructuring or merge it with another one.

Therefore, with the implementation of resolution regimes (in general), banks are now able to default on certain instruments to continue operating while in the process of restructuring. The difference for each debt obligation to default or not will be if they are part of the loss absorption capacity and how far are they from the capital buffer to eventually be 'bailed-in'. Considering the different debt instruments available to be bailed-in, ARC's approach will be as detailed below:

Senior Unsecured Debt Obligations

In our opinion, senior unsecured debt obligations usually have a credit rating aligned to the bank's long-term ICR. Senior unsecured debt obligations are directly related to the overall credit risk of the bank, therefore we assess that the likelihood of default of any senior unsecured obligation is equal to a default of the bank.

However, with the incorporation of resolution mechanisms, when a bank approaches default, the balance sheet becomes tranched following the different characteristics of the obligations with loss absorption capacities or under the 'bail-in' structure and those that are not. Therefore, to differentiate further the credit rating of senior unsecured debt obligation, ARC will require detailed information of the resolution measure applied and consequently the instruments that will be absorbed as part of the action (e.g TLAC/MREL/senior-non preferred), allowing the bank to leave untouched the senior unsecured tranches. The general approach would be that senior unsecured debt obligations that are subject to bail-in would be notched down from senior unsecured debt obligations in cases the level of CET1, AT1, T2 and other subordinated debt available subject to bail-in is limited and could be highly likely to be triggered. In cases in which the buffer for bail-in is large enough to prevent any absorption of senior unsecured debt obligations, a differentiation between senior non preferred and senior unsecured would be unlikely.

In specific cases in which information on detailed balance sheet break-up for liabilities and assets is available in scenarios of financial distress, ARC could assign an ICR to senior

unsecured obligations above or below the ICR of the bank. In cases in which we see that the balance sheet has a high encumbrance of assets, or there is depositors' preference, the probability that the credit rating of the senior unsecured debt obligations will be lower than the ICR of the bank is relatively high.

Subordinated Debt Obligations

The anchor credit rating for subordinated and hybrid securities is in most cases the bank's stand-alone assessment because we see that additional support mechanisms, as well as the implementation of resolution regimes that promote burden sharing, cannot be relied upon to extend to a bank's subordinated debt. However, in particular cases for certain jurisdictions where the probability of external support is likely to be high or very high (e.g. state ownership or guarantees, development or policy banks and/or high systemic importance), the rating accorded to the debt obligations will be notched down from the ICR.

The guidelines discussed above apply to traditional debt structures within a financial institution. However, ARC notes increasing use of asset-backed instruments and higher collateralization (so called 'asset encumbrance'). Asset encumbrance has benefits for investors in asset backed debt, but can have adverse implications for investors of unsecured debt (e.g. given structural subordination, lower recovery rates). For entities where asset encumbrance provides a certain level of threat to creditors of unsecured debt, ARC increases the notching of subordinated debt described above.

Hybrid, Convertible Debt Obligations

To evaluate the scope of debt- or equity-like character of any hybrid issuance, ARC focuses on the timing and cumulative versus non-cumulative character of coupon suspension, the structural ranking of the hybrid security and its maturity. The proportion of equity versus debt recognised by ARC within an issuer's capital structure is assessed on a case-by-case basis, depending on the structure of the specific security and it is evaluated for stress test purposes only.

In general, high equity proportion is recognised for deeply subordinated hybrid securities that represent the most junior instrument in the issuer's capital structure, including strongly protective and non-cumulative coupon suspension conditions, 'can't default' or cross default other debt, and long (if any) maturity. Hybrid securities with weak loss absorption features, higher priority of claim in liquidation or short maturity (generally less than 30 years) would be treated as debt-like instruments with low or no equity proportion assigned.

ARC might, however, limit the equity content of hybrid securities to the overall capital structure in cases when the equity proportion represents a larger share of the overall issuer's equity. Therefore, ratings of any hybrid security are assessed on case-by-case basis and, in general, notched down from the stand-alone assessment. Securities with

high equity proportion tend to be subject to higher notching difference, compared to debt-like cases.

The notching differential is based on ARC's assessment of the specific debt instrument, detailed below:

Core Features	Regulatory Treatment	Notching from Stand-Alone Assessment	
		'bbb-' or above	'bb' and below
- Subordination - No coupon flexibility - Non-viability loss absorption (contractual or statutory)	Tier 2; Basel III Tier 2	-1 to -3	-1 to -3
- Subordination - No coupon flexibility - Write-oof or conversion trigger	Tier 2 contingent capital	-1 to -4	At least -2
- Subordination - Easily activated trigger	Certain legacy Tier 2	At least -4	At least -3
- Subordination - Cumulative coupon deferral often constrained	Deferrable Tier 2 (e.g. Upper Tier 2)	-2 to -4	At least -2
- Deep subordination - Non-cumulative coupon deferral, often constrained	Certain legacy Tier 1	-3 to -4	At least -3
- Deep subordination - Easily activated trigger (e.g. profit test)	Certain legacy Tier 1	At least -5	At least -3
- Deep subordination - Fully discretionary coupon	Basel III Tier 1	At least -4	At least -3

Note: When the stand-alone assessment is in the 'ccc' range, the notching applied to subordinated debt instruments could be limited to the remaining available rating categories.

VI. RATING MODIFIERS

An Indicative Rating - evidenced by the suffix (ind) – is a rating assigned by ARC to an issuer or an instrument (most commonly structured or project finance debt issues) when the assignment of a final rating is dependent upon the fulfilment of specific contingencies. Any material deviation in the fulfilment of these contingencies from the assumptions underlying the Indicative Rating can have a material impact on the final rating accorded, which accordingly may be fundamentally different to the initial Indicative Rating. Moreover, ARC reserves the right not to issue a final rating. Potential investors are advised to bear this in mind when considering any indicative rating.

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In the rating process, ARC Ratings adopts procedures and methodologies aimed at ensuring transparency, credibility and independence, and also that rating classifications are not influenced by conflicts of interest.

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