FitchRatings
KNOW YOUR RISK

Financial Institutions

Global
Master Criteria

Global Financial Institutions Rating Criteria

Analysts

Joo-Yung Lee
+1 212 908-0560
joo-yung.lee@fitchratings.com

Gerry Rawcliffe
+44 20 7682 7419
gerry.rawcliffe@fitchratings.com

Thomas Abruzzo
+1 212 908-0793
thomas.abruzzo@fitchratings.com

James Moss
+1 312 368-3213
james.moss@fitchratings.com

David Marshall
+1 65 6796-7211
david.marshall@fitchratings.com

Julia Peach
+44 20 7682 7433
julia.peach@fitchratings.com

Peter Shaw
+1 212 908-0553
peter.shaw@fitchratings.com

Summary

This report outlines the methodology used by Fitch Ratings to analyze the credit quality and financial strength of financial institutions (FIs) and will provide insight into the rating methodology for all key parties involved in the rating process, including the rated entities and users of Fitch's FI issuer and issue ratings, such as institutional investors, financial counterparties, regulatory bodies, and rating advisory personnel at investment banking firms. It also details the suite of different ratings that may be assigned by Fitch to FI issuers and issues, as well as the rationale behind these ratings. The guidelines in the report are purposely broad in scope, recognizing that Fitch's analytical process is dynamic and that each issuer possesses unique characteristics that cannot be captured by a narrow or overly rigid approach.

This master criteria identifies rating factors that are considered by Fitch in assigning ratings to a particular entity or debt instrument within the scope of the master criteria. Not all rating factors in this criteria may apply to each individual rating or rating action. Each specific rating action commentary or rating report will discuss factors most relevant to the individual rating action.

Scope

For the purpose of this report, the term financial institution includes any financial institution that is principally engaged in banking, financial services, or other primarily financial activities, excluding insurance companies and real estate investment trusts. While Fitch makes some distinctions between its analysis of banks and nonbank financial institutions, which are addressed throughout this report, Fitch's definition of a bank or nonbank FI for the purposes of which this criteria is applied in rating an institution is not bound by jurisdictional, legal, or regulatory definitions of banks or nonbank financial institutions. As a result, some nonbanks will be rated under the bank elements of the criteria and, conversely, some banks with banking licenses may be rated using nonbank elements of this criteria or nonbank subsector criteria, particularly when the bank, as determined by Fitch, has a primary purpose of facilitating the operations of affiliated entities or primarily conducts nonbanking activities.

The term bank, for the purpose of this report, includes but is not limited to commercial banks, savings banks, bank holding companies, and bancassurance holding companies, bancassurance companies operating as single legal entities, state-owned banks, and private banks. Fitch notes that for bancassurance companies, elements of insurance analysis may also be incorporated. Fitch rates a variety of banks, including but not limited to retail, investment, mortgage, cooperative, saving, and private banks. The term nonbank financial institutions, for the purpose of this report, includes any financial institution that is principally engaged in financial services or activities not defined as a bank. Fitch rates a variety of nonbank financial institutions that include, but are not limited to, government-sponsored enterprises, financial holding companies, finance companies, securities firms, investment management companies (alternative and traditional), leasing companies, factoring companies, and derivative product companies.

Related Research

- *The Rating Process, July 2006*
- *Revisions to Rating Definitions March 2009, March 3, 2009*
- *Definitions of Ratings and Other Scales, March 2009*
- *Bank Holding Companies, Dec. 30, 2009*
- *Rating Linkages in Parent and Nonbank Financial Subsidiary Relationships, Dec. 30, 2009*
- *Recovery Ratings for Financial Institutions, Dec. 30, 2009*
- *Criteria Report on Rating Banks Above the Local Currency Sovereign Rating, Aug. 28, 2007*
- *Rating Banks Above the Local Currency Sovereign Rating, Aug. 28, 2007*
- *Rating Hybrid Securities, Dec. 29, 2009*
- *Equity Credit for Hybrids & Other Capital Securities, Dec. 29, 2009*
- *Evaluating Corporate Governance, Dec. 12, 2007*
- *Short-Term Ratings Criteria for Corporate Finance, June 12, 2007*
- *National Ratings Methodology Update, Dec. 18, 2006*
- *Country Ceilings, Sept. 12, 2008*
- *Criteria for Model Management, Sept. 30, 2009*
- *Guidelines for Developing and Revising Criteria, Sept. 30, 2009*
- *A Universal Spreadsheet for Bank Analysis, April 14, 2009*

While the basic analytical approach to all these institutions is usually the same, there are specifics and differences in the degree of risk relating to each type of subsector, activity, or institution type that may warrant additional detail. The universe of companies encompassed in this report covers a broad spectrum of products, markets, and franchises. Therefore, while financial institutions share the common characteristic of providing financial products and services, the business model employed by each can produce a different hierarchy of risks that may lead to differences in how various FIs are ultimately evaluated. While the key rating drivers Fitch considers in rating FIs are outlined below, a framework for financial ratios that may also be used in the analysis of a particular institution is outlined in Appendix A *(see page 22)*, along with some definitions. Further details on ratios and more detailed application of this master criteria report are also addressed in sector-specific and special criteria reports. In addition, since banks do not have a sector-specific criteria report, Appendix B *(see page 24)* highlights some of the typical ratios used in bank analysis. Fitch also rates FIs globally that have unique structural features or issue various instruments that warrant further examination. In this context, there are several sector-specific criteria and special reports available on Fitch's Web site at www.fitchratings.com that discuss more specific features of the analytical process for these different types of FIs, structural features, or instruments. In particular, Fitch's ratings of subordinated, hybrid, or preferred stock instruments are typically covered in Fitch Research on "Rating Hybrid Securities," dated Dec. 29, 2009, available on Fitch's Web site at www.fitchratings.com.

Fitch's analysis of an FI includes an assessment of both qualitative and quantitative factors, external and internal, that drive the issuer default ratings (IDRs) assigned to FIs. Examples of qualitative factors include franchise and management. Examples of quantitative factors include capitalization, profitability, and asset quality. The relative weightings of these factors may vary according to specific circumstances. External factors include the economic environment in which the FI operates, the legislative, regulatory, and fiscal framework, and the structure of the financial system in the country in question.

The five key elements of Fitch's analysis of any FI, most frequently the main drivers of the rating decision, are discussed in more length below. The relative importance of each in the ultimate rating decision can vary from institution to institution.

The key elements are as follows:

- Industry profile and operating environment.
- Company profile and risk management.
- Financial profile.
- Management strategy and corporate governance.
- Ownership, support, and group factors.

The agency does not use a preset weighting for each of these rating categories or for the various elements within each category, as Fitch considers the appropriate weightings can change given particular circumstances. As a general guideline, where one category is significantly weaker than others, this weakest element tends to attract a greater weight in the analysis.

Limitations

Ratings are primarily based on a review of public information together with Fitch's judgments and forecasts. In many cases, Fitch will meet with management and receive nonpublic information. Where management interaction is forthcoming, the information derived may or may not influence the rating based on Fitch's judgment with respect to the usefulness of such information. In certain cases, Fitch's forward-looking views related to risk exposures or forecasts may dominate a rating conclusion, and such forward-looking views may be based on factors that are highly judgmental. The absence of participation by an FI's senior management in the rating process does not necessarily prevent Fitch from establishing and maintaining a rating if there is sufficient public information available to perform the credit analysis process.

Another limitation to Fitch's ratings of FIs includes event risk. Event risk is defined as an unforeseen event that, until the event is known, is not included in the existing ratings. Event risks include management's decision to unexpectedly acquire another company, undertake a sizable share buyback, or unexpected losses arising from an operational breach. Some ratings may already include a reasonable assumption that management is acquisitive, prone to utilizing existing financial flexibility, or has a weak operational infrastructure, but specifics of the event and its effect on funding, capital, and liquidity will not be known until the event is announced or consummated, at which point ratings can be ascertained.

FI ratings are subject to the limitations that are outlined in Fitch Research on "Definitions of Ratings and Other Scales," dated March 2009, available on Fitch's Web site at www.fitchratings.com.

Financial Institutions Ratings

Fitch assigns short-term and long-term issuer default ratings (IDRs) to FI issuers. Occasionally a short-term IDR may not be assigned if an issuer does not have material short-term obligations. The assignment of short-term IDRs follows Fitch Research on "Short-Term Ratings Criteria for Corporate Finance," dated June 12, 2007, available on Fitch's Web site at www.fitchratings.com. In addition, support ratings, support floors and individual ratings are typically assigned to banks and selectively to nonbank FIs when deemed appropriate. Often, although not always, an individual rating is assigned to institutions with support ratings. The individual rating reflects the stand-alone risk of an FI getting into difficulties, and the support rating reflects the likelihood of the FI being supported by a third party, either the state or an institutional owner. For many nonbank FIs institutional support is more typically seen than sovereign support. In cases where an individual rating is assigned, an FI's long-term IDR is driven by the higher of the Individual and support ratings. *(For a demonstration of the mapping from the individual rating scale to Fitch's long-term rating scale, see Appendix C on page 26, which provides definitions for the individual and support ratings, as well as the mapping diagram.)* This approach is different than a pure joint probability of default approach, which is in effect a statistical method of assessing the likelihood of two events (in this instance an FI failing and its owner failing to provide support) occurring simultaneously. The following outlines Fitch's support rating and individual rating approach for institutions where these ratings would apply.

The Fitch Support Rating

One of the main differences between banks and nonbank FIs is that nonbank FIs typically do not benefit from state support, except in limited circumstances. As such, sovereign support generally plays less of a role for this universe of entities than it would for banks. However, government-sponsored, government-owned, or government-linked enterprises would be a clear example where support is a significant rating factor for nonbank FIs. Support ratings incorporate an assessment of a potential supporter's (either a sovereign state's or an institutional owner's) propensity to support an FI and its ability to support it. Its propensity to support is a judgment made by Fitch. Its ability to support is set by the potential supporter's own Fitch long-term IDR, both in foreign currency and, where appropriate, in local currency. support ratings have a direct link to long-term IDRs, and for those FIs whose support is based on sovereign support, they set a support rating floor *(see Support Rating Floors on page 5)*. Support ratings do not express an opinion of an FI's intrinsic credit quality; this is typically reflected in the individual rating *(see Fitch Individual Rating on page 5)*. It should be emphasized that support ratings are exclusively the expression of Fitch's opinion, even though the principles underlying them may have been discussed with the relevant supervisory authorities, the sovereign state, and/or owners (private or public).

Support ratings are predicated on the assumption that any necessary support, either in foreign currency or, where appropriate, local currency, is provided on a timely basis. They are also predicated on the assumption that any necessary support will be sufficiently sustained so the FI being supported is able to continue meeting its financial commitments until its financial strength is restored.

For cases where Fitch considers sovereign or institutional support would be forthcoming, it is assumed that typically the following obligations will be supported: senior debt (secured and unsecured); insured and uninsured deposits (retail, wholesale, and interbank); obligations arising from derivatives transactions and from legally enforceable guarantees and indemnities, letters of credit, and acceptances; and trade receivables and obligations arising from court judgments. In cases where depositors have preferential status, this may have a significant effect on the risk of default and consequently the recovery rates for other debt holders.

Likewise, it is assumed that typically the following capital instruments will not be supported when sovereign support is involved: preference/preferred shares or stock; hybrid capital (Tier I and upper Tier II for banks); and common/ordinary equity capital. It is also assumed there will be no support for any moral obligation on securitizations. The sovereign support status of subordinated debt is difficult to categorize in advance; it is assessed on a case-by-case basis, distinguishing among different jurisdictions.

Not surprisingly, the propensity and ability of emerging market states and of owners of FIs in emerging market states to support their FIs are subject to many more extraneous influences than is the case in developed states. As a consequence, support ratings and support rating floors for FIs in emerging markets are likely to be more volatile than in developed countries. The other major threat in such economies is force majeure, i.e. such developments as the imposition by the national political authorities of foreign exchange controls, bank deposit freezes, interruption of payment systems, expropriation of businesses, or war. These risks are reflected in the sovereign rating of the country in question and are, therefore, factored into support ratings and support rating floors (if they are assigned) either directly, where the sovereign is the provider of support, or indirectly by means of a country ceiling cap in the case of institutional support.

As already mentioned, two sources of potential support are predicated: sovereign states (whether they are the owners or not) and institutional owners. Individuals and families who own FIs are not taken into account, as their ability and propensity to support cannot usually be assessed. The following are taken into account as determinants of the propensity of sovereigns and institutions to support FIs.

- **Sovereign unitary or federal state support.** There are three broad criteria: state guarantees and commitments; relationship with the state; and the importance of the FI to the state.
- **Institutional owner or owners.** Here there are four broad criteria: guarantees and commitments; percentage control; the nature of the owner; and the importance of the FI to the owning institution(s).

It should be emphasized that a support rating does not assess how good or bad an FI is, but merely whether it would receive support if it ran into difficulties. The likelihood of support being forthcoming is expressed in relative rank order on a rating scale of '1' to '5' *(see Appendix C on page 26 for precise definitions of support ratings)*. In some cases, a fully supported (support rating of '1') FI's IDR will reflect the rating of its supporting entity, particularly in cases where a stand-alone rating cannot be derived.

Support Rating Floors

As a further measure to enhance the transparency of the rationale behind its ratings, Fitch publishes support rating floors. An FI's support rating floor is derived directly from its support rating and defines the minimum long-term IDR that would be assigned to that FI. *(See Appendix C, page 26, on support rating definitions for minimum long-term IDRs by support rating.)* However, these floors, expressed on the international long-term rating scale, are currently reserved for those FIs whose support rating is based on sovereign support. An additional rating of 'No Floor' ('NF') may be assigned in cases where, in Fitch's opinion, there is no reasonable likelihood of potential sovereign support forthcoming. In practice, this generally equates to a probability of less than 40% sovereign support. Fitch's support ratings and support rating floors express support in foreign currency only. When local currency ratings are assigned, a feature in emerging markets, Fitch assesses the effect of support in local currency based on the supporter's local currency rating, but there are no explicit local currency support rating floors.

The FI's IDR will not fall below this floor as long as the assessment of support factors does not change. Like the support rating, the support rating floor is based on the agency's judgment of a potential supporter's propensity to support a bank and of its ability to support it and does not assess the intrinsic credit quality of a bank. Rather, they communicate the agency's judgment on whether the bank would receive support should this become necessary.

Fitch Individual Rating

The individual rating is designed to assess an FI's exposure to, appetite for, management of, and absorption capacity for risk and, thus, it represents Fitch's view on the likelihood that the FI would fail and therefore require support to prevent it from defaulting. While the individual rating is largely an assessment of the stand-alone entity, Fitch recognizes that some elements of support cannot be entirely divorced from the individual rating assignment, such as the lower funding costs or greater franchise strength associated with its supporting entity. In those cases, the individual rating is likely to incorporate these funding benefits or franchise strength in the stand-alone assessment.

Fitch assigns individual ratings to most banks and may assign individual ratings to nonbank FIs. Examples where nonbank FIs may be assigned individual ratings may include circumstances where support is a meaningful rating driver and there is sufficient information to assign an individual rating. It is important to note that if an FI is assigned a support rating it may or not be assigned an individual rating. An individual rating may not be assigned for several reasons that include, but are not limited to, FIs that carry a guarantee from another entity and whose businesses are not sufficiently discrete from its guarantor, or whose business is conducted as an instrumentality of another entity.

In assigning an individual rating to an FI, Fitch analysts evaluate several different factors; the principal ones among these include an FI's industry profile and operating environment, company profile and risk management, financial profile (including capitalization), management strategy and corporate governance, and ownership, support, and group factors. These topics are all covered in greater detail later in this report.

The scale of individual ratings ranges from ‘A’ (the best) to ‘F’; the latter rating was introduced in 2007 to provide additional transparency and differentiate between those FIs, on the one hand, that require or are likely to require external support (thus complying with the definition of an ‘E’ individual rating) and, on the other, those FIs that have actually failed, i.e. defaulted, or, in Fitch’s opinion, would have defaulted if they had not received external support (now rated ‘F’). The ‘F’ rating is retrospective in character, and those FIs that are downgraded to ‘F’, but that can rely on external support, tend to remain in this category only until support measures are clarified and implemented. Having said this, FIs downgraded to ‘F’ will remain at this level for at least one month before being re-rated on the basis of their supported financial strength. Precise definitions of all individual ratings are detailed in Appendix C on page 26.

Details of the full range of Fitch’s rating definitions may be found under “Fitch Rating Definitions” available on Fitch’s Web site at www.fitchratings.com.

Rating of Financial Institution-Issued Structured Notes

Some financial institutions, in particular (but not exclusively) large universal banks and investment banks, are regular issuers of debt securities that return amounts referenced to an external market risk, i.e. a risk essentially independent of the issuing bank’s own creditworthiness. Fitch refers to these notes collectively as structured notes. In some cases only the coupon stream references the market risk (principal-protected notes), and in others both coupon stream and principal repayment are driven by the reference market risk (nonprincipal protected notes). Structured notes reference a very broad array of risks, most commonly equities, currencies, and commodities. Each of these can be referenced on a single-name basis or on a basket or index basis. In some cases the structured note may also contain other structural features that determine the return to the investor such as caps, collars, call or put options, and embedded leverage. This huge variety arises because structured notes are often specifically tailored to a client request (often referred to as reverse inquiry). Structured notes are typically issued off standard programs, which may or may not also be used to issue nonstructured debt.

Fitch does not believe it is possible to factor these highly varied embedded market risks into a conventional credit rating. Nevertheless, the ability of the issuing institution to meet its obligations, albeit variable, under a structured note is of considerable interest to an investor, and conventional debt ratings do address that risk. Therefore, Fitch assigns ratings to structured notes that solely address the counterparty risk of the issuing bank. Almost all such notes are issued as senior obligations and will therefore carry a rating identical to that of the issuer’s other senior obligations. Should a structured note be issued in a subordinated format, it will carry the same rating as the issuer’s other pari passu subordinated obligations.

The variability of return to both coupon and principal created by the embedded market risk and any other embedded structural features is fully excluded from the rating assigned to the note. In an extreme case, where the embedded market risk has materially moved in an adverse manner, the return to the investor may be very low or even zero. Provided the issuer has fulfilled its contractual obligations, such an outcome has no bearing on the rating of the structured note, and under no circumstances would this outcome be regarded as a default or nonperformance.

To reinforce the limitation in scope to the counterparty risk, Fitch has decided to append a subscript (‘emr’) to its structured note ratings. This addresses solely the exclusion of the embedded market risk from the rating. It does not indicate any limitation in the analysis of the counterparty risk, which in all other respects follows published Fitch criteria for analyzing the issuing financial institution. The subscript will be rolled out in the first quarter of 2010.

This approach only applies to structured notes that are directly issued by banks. It does not apply to issuance from a special purpose vehicle unless that issuance is the beneficiary of an explicit guarantee from the rated bank. In that case, the issuance would be rated on the basis of the guarantee, again excluding the embedded market risk. Any other structures would, if appropriate under their criteria, be rated by Fitch's Structured Finance group.

Specifically excluded from the above approach are any directly issued structured notes where the embedded risk is the credit risk of a third-party or of a basket of third parties. These credit-linked notes are not rated by Fitch's Financial Institutions Group. If appropriate under their criteria, these would be rated by Fitch's Structured Finance Group. Where the underlying risk is the market risk of a credit index, this is ratable as a structured note under these criteria.

For the purposes of these criteria, inflation is not regarded as a market risk, and inflation-linked notes in the absence of additional embedded market risk are rated without the addition of the 'emr' subscript.

Industry Profile and Operating Environment

The starting point for Fitch's FI rating analysis is to obtain an understanding of the FI's operating environment. This allows analysts to make better judgments on the unique attributes of individual institutions by discerning their risks and opportunities on a relative basis and an absolute basis.

Background factors typically assessed include sovereign risk and other economic issues that contribute to the environmental conditions affecting an FI, particularly among developing countries. Fitch will comment on these factors when these factors constitute a meaningful rating driver, otherwise background factors are unlikely to be mentioned. Analysts usually look at the basic economic indicators of the country in question (derived if available from the sovereign risk analysis undertaken by Fitch's Sovereign group), such as the size and composition of its economy, GDP growth, inflation, growth in consumer lending, growth in real estate lending, savings and investment, trends in unemployment, exchange rates, bond yields, and national and/or regional property price indices. Political and cultural aspects of a country, as well as demographic trends, may also be considered important factors in the analytical process. However, many FIs are global and compete in many markets and economies, where individual country analysis may be less relevant and meaningful to the rating decision.

Other factors often taken into account in the assessment of an FI's operating environment include the following:

- Characteristics of the FI's relevant market(s), existing and potential competition and barriers to entry, and the degree of concentration within the sector.
- Accounting practices and requirements for public reporting by FIs.
- Regulatory framework, including the role and functions (if any) of the appropriate supervisory authorities in the country in question, as well as the degree of state control (or privatization) of that country's banking system.
- Legal framework under which the FI operates.

A key difference between banks and many nonbank FIs is that many nonbank FIs are subject to significantly less regulatory oversight and restrictions. Banks generally are heavily regulated and usually subject to meaningful operating restrictions that may factor into the rating process. However, the current regulatory environment for many nonbank FIs continues to evolve, and Fitch monitors the effect of new regulations and restrictions on each issuer. To the extent that new regulations affect a company and become ratings drivers, Fitch will indicate this in its public commentary.

Fitch's public commentary in rating action commentaries and published reports will generally mention an FI's industry profile and operating environment when relevant to the rating action. Generally, a weak or stressed operating environment combined with other factors may pressure a firm's rating because of the effect on a firm's earnings prospects or potential for heightened losses. Conversely, a benign or positive operating environment on its own may not have an affect on an FI's ratings, but, coupled with other positive rating factors, it may stabilize a rating or allow for positive rating momentum.

Company Profile and Risk Management

Evaluating the strength and depth of an FI's franchise, as well as the FI's ability to safeguard existing business and gain new business, is subjective although important in Fitch's analysis and often a driving factor behind earnings growth.

Some of the main considerations Fitch may take into account in its analysis of business franchise include the following:

- Management expertise and depth relative to key business activities.
- Size of the FI and critical mass in key activities.
- Its market position in core operations.
- Its ability to exercise pricing power and/or differentiate itself through efficiency.
- The nature and concentration of its customer base.
- Its current business mix and competitive advantages/disadvantages in each segment.
- The geographic and industrial sector diversification of its activities, both domestic and international.
- The diversity of services and products it provides to customers and the ability to create new products.
- The systemic importance of an institution, domestically and internationally.
- The quality of the FI's distribution network.

Fitch's assessment of risk management, another fundamental element of its analytical process, incorporates an evaluation of an FI's risk appetite as well as the adequacy and robustness of the systems it has in place. The ability of an FI's management to identify, measure, manage, and monitor risk is often dictated by these systems. However, Fitch's rating process does not involve an audit of these risk management systems or practices.

Key areas that analysts may take into consideration are:

- The independence and effectiveness of the risk management function.
- Whether all risks are managed centrally or can be easily compiled to establish an enterprise-wide view of risk.

- The procedures and limits in place, who sets these limits, and the degree to which these procedures and limits are adhered to.
- Senior management's understanding and involvement in risk management issues and the reporting lines in place.

Analysts examine a broad set of risks, the most significant of which, for most FIs, are discussed below.

Credit Risk

Fitch, as part of its analytical process, looks at credit risks whether they arise from on-balance-sheet activities (including loans, counterparties, lease receivables, fixed income securities, and interbank deposits and loans) or off-balance sheet activities (such as off-balance-sheet commitments or securitizations). It also looks at the possible additional risk for senior unsecured creditors arising from securitization and other forms of secured borrowings undertaken by the FI when such represent a meaningful component of equity or assets. A key attribute of a well-run institution is one that establishes clear parameters around risk appetite and expected returns (profit) for risks being taken. Asset quality indicators are a primary tool to assess the level of risk being taken *(for relevant asset quality ratios by type of institution, see Appendix A on page 22, and depending on the institution see the Key Nonbank FI Ratio Definitions table on page 23 or Appendix 2 on page 24 for banks)*. Fitch analysts may consider a broader range of asset quality indicators than is reported under GAAP or IFRS, such as managed loss and delinquency measures that include the effects of off-balance-sheet securitizations. The level and volatility of asset quality indicators will be viewed in the context of returns achieved and the adequacy of risk management to determine how the risk return equation may evolve in different phases of the business cycle. Indications of poor asset quality or credit risk management will typically lead to lower ratings, whereas strong asset quality and credit quality are positively factored into a rating decision, absent other material weaknesses.

Typically, a key element of Fitch's analysis of credit risk lies in the structure of the FI's balance sheet, including the relative proportions of different asset categories. However, in some cases FIs may not have significant balance sheet exposure (such as some investment managers), or in other cases some FIs may have more credit risk concentrated in counterparty risk. Banks typically have significant balance sheet exposure, where loans are often the most significant proportion of a bank's assets. There are also many nonbank FIs where lending is a primary activity, such as finance companies.

For FIs where there is significant credit exposure, usually in the form of loans or guarantees on loans, a comprehensive review of the loan or guarantee book is often essential. In this context, analysts may ask for a breakdown of lending by type of loan, size, maturity, currency, economic sector, and geography. They also look at concentrations of credit risk, including large exposures (generally more than 10% of equity) to individual customers and credit risk concentrations in particular industries and economic sectors. Single-credit risk concentrations in particular industries or economic sectors are often typical for many FIs, particularly finance companies and government-sponsored enterprises. Analysts may liaise with analysts in Fitch's other analytical groups to gain a full and prospective view of various credits and sectors. The evaluation of the loan or guarantee portfolio will also place importance on growth and the role of new types of exposure. Loan or guarantee growth in excess of the growth in the economic market the institution is operating in will generally warrant further investigation of strategies being employed to achieve such growth with a particular focus on underwriting and pricing standards. Expansion of lending activities into new sectors, geographic markets, new customer segments, or new product types will receive additional attention.

In evaluating credit quality metrics, Fitch considers when an FI stops accruing income on a loan or guarantee, classifies it as delinquent, impaired, or nonperforming, and charges it off. To the extent there is a material level of loans or guarantees considered problem, whether they are sensitive or watchlist (i.e. still performing), impaired, or restructured, analysts may seek additional information from the issuer regarding these loans. Fitch also takes into account changes to an issuer's policies, articulation of its loan loss reserve methodology, and comparisons to peers. It is Fitch's expectation that FIs have a well-articulated loan loss reserve methodology. Fitch views reserve methodologies that are dynamic and forward looking as preferable to those that rely solely on historical performance; although Fitch recognizes that reserve methodologies are often limited by accounting principles.

In assessing the underlying risk of problem loans or guarantees, the adequacy of collateral and impairment allowance is taken into account to the extent this information is available. As far as impairment allowances are concerned, analysts examine the different types of allowances (i.e. specific and collective), the FI's overall policy toward taking impairment charges, its historical loan loss experience, and its writeoff and recovery policies. Asset quality is usually assessed using both absolute and relative criteria. In instances where Fitch believes the future performance of the loan or securities portfolios run the risk of performing considerably weaker than historical norms, the analytical team may at its discretion conduct various stress scenarios that may be used to evaluate the adequacy of loan loss allowances or performance of that asset class. These scenarios can range from portfolio-wide assessments to a scenario targeted at a specific geography, product type, or origination period.

Many FIs also maintain sizable securities or investment portfolios. Fitch analyzes the general quality of the securities or investments, their maturity, liquidity, any undue concentration such as by product type, year of origination, or by large individual exposures and the valuation of these securities. For fixed income securities, the analysis of the securities may include a review of the seniority of the given instruments. Analysts assess the adequacy of valuation allowances and impairment policies on all material nonloan assets.

For some FIs, counterparty risk can be significant or even the largest component of credit risk. For these institutions, counterparty risk often arises from trading activities typically seen in securities firms, large commercial banks, and investment management companies. Fitch will often review counterparty limit structures, how counterparty limits are maintained and monitored, whether collateral posting requirements have been established, and the concentration and exposures to individual counterparties.

The analysis of an FI's off-balance sheet commitments makes up an equally important element of Fitch's overall analysis of an FI's risks. These commitments can take on several different forms, including the more traditional guarantees and letters of credit, derivatives (including interest rate and credit default swaps), assets that have been securitized and are held by special-purpose vehicles, and exposures to conduits and structured investment vehicles.

Derivatives

To the extent an FI engages in derivatives activity, Fitch's derivative portfolio review is scaled appropriately, taking into account the institution's size, sophistication, and level of credit risk posed. It generally includes an evaluation of counterparty credit risk characteristics, the types of derivatives and their purpose, the notional and market value of the portfolio, the net exposure to counterparties, and the extent that the derivatives portfolio creates potential calls on liquidity (for example, collateral posting requirements, rating triggers, and unwind events). Fitch seeks transparency on credit derivatives in particular, as sellers of credit derivatives are exposed to the credit risk of the underlying credit, which may have different termination provisions than in the cash market. Depending on the size (in terms of notional and risk exposure) and scope of an institution's credit derivatives exposure, Fitch may need to conduct an analysis similar to its review of fixed income securities. Fitch may or may not comment publicly on an FI's derivatives portfolio, particularly if the risk is considered relatively low and its rating is not affected by its derivative exposure. However, if an FI's exposure to derivatives is significant and the FI is significantly exposed to meaningful liquidity events from its derivatives, such as collateral posting, ratings triggers, and termination events that could create liquidity problems for the institution, the ratings may be adversely affected.

Securitization

Securitization can provide FIs with additional liquidity and access to cost-effective funding, aid them in the management of their credit risk exposure, provide regulatory capital relief, and enhance earnings performance measures. However, while in many cases it brings benefits to an FI, there are also risks inherent in securitizations that can result in recourse to the FI that have to be taken into account. As part of the rating process, Fitch evaluates the level of risk that is potentially transferred through securitization. In some cases, very little risk is transferred since the issuer holds residual interests in the securitization and has an ongoing servicing relationship with the sold receivables. When this is the case, Fitch may add back securitized receivables to the FI's balance sheet (if accounted for off balance sheet) in calculating various metrics that can include leverage, profitability, and credit quality. Many FIs, particularly finance companies, use securitization as a primary financing mechanism, and therefore Fitch assesses the reliance on securitization and the effect closure in the securitization market can have on an issuer. Analysts may liaise with their colleagues in Fitch's Structured Finance department for further details of these securitizations. To the extent an issuer has meaningful recourse on its securitizations and depending on the quality of the underlying assets, the securitizations may affect the FI's rating.

For institutions with meaningful securitizations, Fitch also evaluates the performance of securitized receivables. Performance of sold receivables can be materially different from what remains on the balance sheet. The performance of securitized receivables could have an adverse effect on an FI because of representation and warranties, holding of credit enhancement assets, and the ability to access the securitization market in the future. An FI may provide liquidity or other assistance to an underperforming transaction to maintain access to the market, which would likely lead to Fitch including these securitizations on balance sheet (if off balance sheet). To the extent possible, Fitch will review whether there is adverse selection on its securitized receivables, which can also have negative rating implications if there is potential recourse or poor performance on balance sheet.

Conduits and Special Purpose Vehicles

While only a small number of institutions have made use of special purpose vehicles (SPVs), the potential risks to liquidity and capital of these vehicles can be significant. Often, the off-balance sheet vehicle is sponsored by the FI, which in turn may have committed to provide back-stop liquidity to the entity. ABCP conduits pose potentially more significant liquidity risks, as they rely exclusively on bank liquidity agreements to meet maturing debt needs. Accounting standards entities are moving to increase public disclosure requirements of these off-balance sheet vehicles to bring them on balance sheet; however, varying disclosure globally creates situations where limited information can make it difficult to gauge risks posed to the issuer. Fitch attempts to derive as much information as possible about risks in these vehicles from the sponsor institutions. Such information may include the underlying credit quality of the SPV's assets, potential liquidity draws on the sponsor entity, and reputation risk posed by not supporting the off-balance sheet vehicle that could be consolidated or brought onto the entity's balance sheet. Fitch analysts evaluate the effect of consolidation of such vehicles on an institution's balance sheet as well as the level of capital that they would need to support them, to the extent possible.

Market Risk

While most, although not all, financial institutions are exposed to some level of market risk, the degree and relevance of this exposure varies by institution. Therefore, Fitch's analysis of an FI's market risk will vary by institution. Generally, Fitch's analysis of market risk incorporates structural risks when present (such as interest-rate risk management) and/or trading risks when present. The vast majority of FIs are subject to structural interest-rate risks due to the shorter nature of their liabilities (including deposits for banks) compared with the duration of their assets. Many FIs are also exposed to structural foreign exchange risks. For firms predominantly exposed to such structural market risks, analysts typically review the asset and liability management strategy to assess the risk appetite of the institution. Board and management policy limits are typically expressed as earnings at risk limits. These are usually evaluated along with reports from management systems if available. Analysts may also review historical net interest margin trends against the industry and peers, use of swaps to adjust fixed to floating payments, and any potential prepayment risks.

Institutions that possess higher levels of market risk often have relatively large trading books that can entail a variety of additional risks, the most common being counterparty, interest rate, foreign exchange, and equity risks. There can also be significant market risk in credit products. FIs with a significant trading book are more likely to warrant an in-depth review of their market risks. Some principal areas examined include the firm's general trading strategy, a breakdown of the trading book by product and market, the proportion of proprietary trading in its book compared with market-making activities or trading on behalf of clients, a breakdown of trading revenues, and the effect of the trading book on the company's overall profitability.

To the extent possible and when market risk is material to a rating, analysts will review management reports that provide insight into the firm's risk appetite and how the firm is measuring and managing market risk. For firms with more complex market risk exposures, when information is available, analysts will review value at risk (VAR), stop-loss limits, concentrations and stress tests, and the relative performance of the institution in measuring risk as demonstrated through backtesting when information is available. In this context Fitch may also review board limits or other policies that set the FI's risk tolerance levels when available. Fitch believes scenario stress testing can also provide valuable insight into the risk exposures of an entity. When available and relevant, Fitch will evaluate stress tests conducted by the FI and, to the extent possible, may run its own scenarios to assess the FI's exposure to remote but possible adverse market conditions.

In many emerging markets, FIs conduct business in both local and foreign currency, potentially exposing themselves to significant capital impairment from devaluation of the local currency on a short foreign currency position. Analysts review an FI's compliance with local regulations on maximum open foreign currency positions, the willingness of management to expose the FI to currency risk, and appropriateness of hedging techniques.

Market risk on its own may not be a rating driver; however, poor market risk management or aggressive market risk-taking without mitigants (such as hedges) would likely pressure an institution's ratings.

Operational Risk

Operational risk has historically been defined as all risks other than credit, market, and liquidity risk. Operational risk incorporates what the Basel Committee on Banking Supervision defines as "the risk of loss resulting from inadequate or failed internal processes, people and systems or external events." Typically, issues that may be evaluated as part of Fitch's assessment of operational risk include ascertaining the entity's definition of such risk, the quality of its organizational structure and operational risk culture, the development of its approach to the identification and assessment of key risks, data collection efforts, and overall approach to operational risk quantification and management. Often operational risk is evaluated through the prism of economic capital. Where it is deemed necessary, assumptions, input, and other pertinent information are evaluated to explore the appropriateness of the operational risk identification system. Where possible, Fitch reviews the external auditor statements to determine whether operational risks were detected. Scenarios where concerns have arisen from the external auditor's report or a loss resulted from a shortcoming in the control environment may be the impetus for further exploration and determination of the extent of its operational risk liability. However, Fitch notes that it does not audit the operational risk functions and may not be able to independently fully assess this risk.

Debtholders can be susceptible to losses arising from operational deficiencies, such as systems failures or limit breaches (e.g. rogue trading incidents); therefore, if analysts determine an institution's operational risk infrastructure or control environment is weak, this would most likely lead to negative rating actions.

Reputation and Legal Risk

Reputation and legal risk typically are not often stand-alone ratings drivers but can be when they are significant. In cases where they are significant, typically reputation and legal risk would adversely affect an issuer's rating. Reputation risk, although difficult to evaluate, can be significant for some issuers, particularly those reliant on institutional funding, those active in private banking, or those with large sums of assets under management.

Legal risk is likewise difficult to assess but may, in some cases, have significant potential ramifications for an issuer. It may arise from contracts drawn up with a third party that turn out to be unenforceable, as well as lawsuits or legal actions taken against an institution.

Financial Profile

The key elements of an FI's financial profile reviewed by analysts include profitability, funding, and liquidity and capitalization. Asset quality, also often an important rating driver that may be considered part of an FI's financial profile, is discussed on page 9 of this report under Credit Risk.

Profitability

Fitch generally starts by looking at the historical trend of an FI's earnings performance, the stability and quality of its earnings, and its capacity to generate profits. It also examines earnings prospects, if possible backed up by budgets and forecasts made available by the issuer, as well as any medium-term plan it may have. While management's track record in providing reliable budgets is an important consideration, analysts nevertheless endeavor to test the robustness of any projections given to them by the issuer. They may also incorporate forward-looking assumptions about future performance in the analysis.

The diversification of an FI's earnings is another key factor in the analysis of its profitability, and, where possible, Fitch analyzes earnings for each of the institution's significant business lines. For banks and FI issuers that are more spread driven, Fitch will usually look at trends in the following:

- Net interest revenue, including the evolution of interest spreads in each business line, trends in lending volumes, and evolution of funding costs.
- Non-interest income, including more stable revenues in the form of commissions, management fees, or other revenues, such as more volatile trading revenues.
- Non-interest expenses, breaking down personnel and other expenses, and comparing the expense level with other variables such as total revenues and earning assets.
- Impairment charge levels, together with the capacity of the FI's earnings to absorb impairments.
- Exceptional income and expenditure items as well as developments in taxation charges.

For other FIs where interest spread is not as meaningful a component of earnings, such as securities firms and investment managers, Fitch usually looks at trends in the following:

- Core operating revenues, which can include commissions, management fees, and more volatile trading revenues.
- Core operating expenses, including compensation and other expenses, comparing the expense level with other variables such as total revenues.
- Impairment charges, unrealized/realized gains and losses, and the ability for the institution to absorb these losses.
- Exceptional income and expenditure items as well as developments in taxation charges.

As a rule, Fitch analysis is based on accounts drawn up under local or international regulatory accounting regimes such as IFRS and U.S. GAAP. If Fitch considers it necessary in its rating analysis, it may make adjustments to an issuer's reported income statement figures, so that financial performance indicators are as comparable as possible from one FI to another and from one country to another. However, given the differences in accounting and reporting standards, cross-border comparisons are not always meaningful.

Generally, earnings can be a meaningful ratings driver. Fitch's evaluation of earnings will focus on absolute levels, quality of earnings, and volatility of returns. Weak or negative profitability, poor earnings prospects, and/or profitability that is trending weaker are likely to negatively influence an FI's rating. However, while positive profitability can add to some positive rating momentum, positive earnings performance alone may not be sufficient to warrant an upgrade, although the ability to sustain profitability, particularly in times of stress, is likely to help an issuer maintain its ratings.

Funding and Liquidity

Since a shortage of liquidity is typically a key driver in bank failures and many other financial institutions failures, an analysis of the liquidity risk profile is an essential part of Fitch's overall financial institutions analysis and a significant ratings driver. Weak or poor liquidity or liquidity risk management will translate into lower ratings and negative ratings momentum, and strong, well-managed liquidity in conjunction with other rating factors often equates to higher rated institutions. However, a strong liquidity position alone will not garner a high rating or provide upward rating momentum. A key difference between banks and nonbank FIs lies in their funding. Banks typically can rely on relatively more stable deposit funding, while nonbank FIs typically have a higher preponderance of wholesale funding, which can be more confidence sensitive than deposits. Since nonbank FIs in particular encompass a broad array of financial entities with different funding structures, liquidity analysis is covered more specifically in subsector criteria pieces.

Depending on the level of liquidity risk, FIs substantially exposed would be expected to have a detailed funding plan and a contingency funding plan to meet liquidity needs to draw on when there are market disruptions. Fitch assesses potential on- and off-balance-sheet calls on liquidity, which may be as varied as meeting maturing debt payments, collateral posting requirements, or redemption requests in underlying assets under management when and where applicable. Fitch analyzes the FI's internal liquidity sources (such as marketable securities and maturing loans) and external sources (such as access to capital markets, stand-by or committed lines from banks, and access to other third-party facilities, which can include sovereign or central banks). However, this analysis often includes management assumptions on the sources and uses of funds making transparency important when reviewing liquidity. To mitigate against being unable to cover a cash flow shortage, most institutions hold a portfolio of marketable securities and other assets, which can be sold quickly for cash if required. In addition, collateral available for repurchase transactions can be used for short-term borrowing. It is important to assess the marketability of an FI's so-called marketable securities portfolio and whether such securities would be sufficiently liquid in a crisis. Fitch generally defines marketable securities in developed markets as those that can be sold or pledged within one day and in developing markets as those that can be sold or pledged in less than a month.

Fitch analysts review the structure and diversification of an FI's funding base (in particular the weighting of retail and wholesale funding for banks), including any marked concentration of deposits or borrowing, as well as significant trends in funding sources. For banks, recourse to wholesale funding is a particularly important element of analysis, as those banks with high levels of wholesale funding tend to be more vulnerable in a more stressed environment. In addition, many banks, unlike most nonbank FIs, have access to central bank liquidity.

It is also important to look at funding concentrations to establish any potential liquidity risks, paying attention to near-term maturities and how well these are matched with assets on the balance sheet and how these maturities will be met. An FI with a high proportion of short-term debt may be more susceptible to liquidity risk, particularly if there are concentrations in tenor. Generally, laddered maturities are viewed more positively, as it is often easier to roll over smaller amounts of maturing debt than large concentrations. The risk of liquidity drying up in a deteriorating credit market is likely to be heightened, as an institution may be required to reissue or roll over maturing debt at a higher cost, and there is also the possibility of noncommitted liquidity sources disappearing. Fitch would expect the management of larger, more sophisticated institutions exposed to liquidity risk to provide details of the stress testing that is carried out on their liquidity position. Fitch may also conduct independent stress tests on liquidity that may include assumptions regarding reliance on funding sources and how an FI's liquidity position would fare if funding sources are shut down temporarily. Fitch will usually evaluate liquidity on a legal entity basis as well as on a consolidated basis. While Fitch recognizes most legal entity structures allow for cash to move freely between entities and is fungible, times of stress can greatly reduce and even eliminate this flexibility.

The main risk for an institution's funding is not being able to renew or replace maturing liabilities, either at all or at a reasonable cost. A well-diversified and stable funding base and a good spread of suppliers of funds within each source can limit this risk. It is therefore important to analyze borrowing by size, maturity, geography, and currency. Analysts also examine the role of securitization as part of an FI's funding plan *(see Securitization on page 11)*. If Fitch analysts deem an entity's funding position to be susceptible to shutting down, this will negatively influence a rating. Otherwise, strong access to funding is typically expected in highly rated institutions.

As part of its funding and liquidity analysis, Fitch will typically review an FI's major credit agreements, incorporating any covenant, security, collateral posting requirements, or other features in the funding that may bear on an issuer's ability to conduct its business or disrupt its liquidity. When present, these funding features are closely monitored to ensure that any triggers are not tripped and technical defaults or actions exercised adversely against the issuer. If these features are tripped, they are most likely to have an adverse affect on the issuer's rating.

Capitalization and Leverage

For the most part, capitalization is an important rating factor for an FI company. Typically equity capital provides a cushion to absorb unreserved losses and thereby allows it to continue as a going concern, thus staving off insolvency, or if insolvency does become inevitable, to some finite degree absorbing losses which would otherwise have to be borne by creditors. In fact, for banks the quality of a bank's capital base, the absolute size of a bank's equity capital, and its capital adequacy (i.e. the size of its capital in relation to its risks) are thus fundamental considerations when analyzing its creditworthiness. For some FIs, capitalization may not be as material a rating factor. For example, investment managers that simply manage third-party assets often do not have sizable balance sheets that require meaningful loss absorption or funding and, as such, capitalization is unlikely to be as important as an institution that conducts significant lending.

For institutions where capital is a fundamental consideration in analyzing creditworthiness, the quality of the issuer's capital base is also an area of keen focus for Fitch. Generally, the greater loss absorption ability of a capital element will carry as much if not more weight in Fitch's evaluation of capital than the absolute size of the capital base. Some institutions covered by this criteria report are heavily regulated and may have various capital thresholds that the entity will be strongly committed to achieving. While adherence to regulatory capital standards may be a factor in Fitch's analytical review, it is quite possible Fitch may assess capital more harshly or more generously than would be indicated by the institution's capital levels relative to regulatory minimums or regulatory classification of capital. For nonbank FIs that face less regulation, regulatory capital ratios may be less meaningful.

Assuming an issuer is well positioned among the other rating factors and capital is a meaningful rating element, strong capitalization typically leads to stronger ratings, and weak capitalization leads to weaker ratings. However, if capitalization is strong but susceptible to meaningful weakening as a result of other factors, such as impending losses due to poor asset quality or poor asset performance, strong capital alone will be insufficient to maintain a rating or to have a high rating.

Since it is primarily risk capital, there is no obligation for equity to be paid back to anyone, and there can be no obligation for it to pay the equivalent of interest. There are, however, usually expectations on the part of investors that equity capital will generate some sort of return. On the other hand, if there is any form of obligation to pay a return, then the capital in question is not pure common equity.

Fitch assesses capital and leverage through various ratios. Relevant leverage ratios can vary by subsector and are addressed in specific subsector criteria. However, Fitch does have its own standard quantitative measures of capitalization that it applies to financial institutions, the principal ones being based on an issuer's core capital and its eligible capital. Core capital is generally defined as reported equity with adjustments that include reductions for hybrid capital, any non-loss-absorbing, noncontrolling interests, net deferred tax assets related to net operating losses brought forward (if available and at a minimum value of zero) otherwise net deferred tax assets in its entirety (at a minimum value of zero), goodwill, other intangibles (including mortgage servicing rights), first loss tranches of securitizations not on balance sheet (if available), credit component of the fair value changes on an FI's own debt, net asset value of insurance companies held, and embedded value of insurance businesses.

Reported equity generally consists of the following:

- Issued and fully paid-up common/ordinary share capital.
- Treasury shares.
- Share premium/capital surplus.
- Retained earnings.
- Other general and statutory reserves.
- Noncontrolling interests.
- Other comprehensive income (including primarily changes in the fair value of available-for-sale securities, foreign exchange valuation reserves, fair value of derivatives on cash flow hedges, and fixed asset valuation reserves).

Fitch eligible capital is defined as core capital plus eligible hybrid debt and other capital securities. While hybrid debt, which encompasses all instruments that are neither common stock nor ordinary debt, such as preferred and preference shares, trust preferred securities, deferrable payment debt, and various convertible securities, is an important source of long-term funding for many FIs, it also has a key role to play in the capital structure of an FI. Fitch has a global policy of assigning equity credit to hybrid and other capital securities that range from all debt with no content to pure common equity. Equity credit is an analytical concept that expresses the extent to which Fitch views a security as containing debt-like or equity-like qualities. Equity credit assigned to securities can vary from 0%–100% depending on specific features. However, there is a 30% tolerance limit on the amount of equity capital derived from hybrids and other capital securities that may be included in Fitch eligible capital. Any hybrids beyond this limit are treated as debt (although this limit may be surpassed in exceptional circumstances, such as those where the state may be subscribing to hybrid capital issued by an FI). *(For a more detailed description of the criteria for assigning equity credit to hybrids and other capital securities, see Fitch Research on "Equity Credit for Hybrids & Other Capital Securities," dated June 25, 2008, available on Fitch's Web site at www.fitchratings.com.)*

Fitch also evaluates, when relevant, an FI's tangible common equity ratio, which is tangible common equity, defined as common equity less goodwill and intangibles divided by tangible assets, which also excludes goodwill and intangibles. This ratio provides the loss-absorbing capacity of an institution's common equity and how much is not subject to dividend payments or coupon payments.

To the extent an issuer has its own internal economic capital models, Fitch will review the general construct of these models, the processes by which they are operated, and whether they are embedded in the management culture of the institution. Where appropriate, this might involve Fitch using mathematical models to benchmark components of the FI's own results, but that is not the same as creating its own capital model. This review assists Fitch in forming a view on both the risk appetite of the issuer and the adequacy of its capital base to support that risk appetite.

Management's policies with regard to minimum capital ratio objectives, share buyback programs, and dividend payouts are taken into account, as are the issuer's ability to raise new capital and its internal capital generation record.

Cash Flow

For institutions where capital is not a key rating driver, cash flow is often a more meaningful measure of an institution's ability to meet its obligations. For example, some nonbank FIs, including asset management firms, often have little in the way of assets on their balance sheets and therefore rely on cash flow from management fees or other activities to meet all financial commitments. In addition, as financial institutions' ratings migrate below investment grade, cash flow metrics often become more meaningful as the source of repayment for outstanding obligations, particularly if an institution's balance sheet becomes more encumbered. Typical measures used can include fee-related earnings measures, earnings before interest, taxes, depreciation and amortization (EBITDA), debt to EBITDA, EBITDA to interest expenses or debt service (if there is amortization), and EBITDA to fixed charges. Often, many of these measures are adjusted for various analytical considerations, including but not limited to nonrecurring items, performance-related items, or other noncash expenses (such as stock compensation).

Management Strategy and Corporate Governance

One of the most difficult yet critical aspects of Fitch's analysis is the assessment of a company's management team and its stated strategies. Strong management teams are effective at communicating and executing their strategic vision and helping the company increase the value of its franchise. It is important that management demonstrates a high degree of credibility, dependability, experience, and competence. The evaluation of an issuer's management is often a relative exercise; analysts may identify management teams with clear weaknesses through the evaluation of the institution's financial strength and risk management practices — for instance, a poor financial performance may reflect the quality of a company's management's strategy. Fitch can also gain a perspective on the quality of management by assessing a management team's ability to articulate its risks and how it chooses to manage such risks and balance risk and return as it responds to opportunities for growth.

As part of its assessment of an issuer's management, Fitch looks at the following:

- The organizational structure of the entity, the dependence of the management team on one or more persons, the coherence of the team, the independence of management from major shareholders, management's culture and its track record in terms of business mix, operating efficiency and market position.
- The quality and credibility of management's business strategy, including plans for future internal or external growth both in general and in terms of target markets/segments. When evaluating future plans, it is important to determine how

realistic these are, and significant credit is given for delivering on past projections and keeping to strategies.

Corporate Governance

Corporate governance can influence many other areas of analysis and could, if not adequately implemented and effected, be detrimental to the overall health of an institution. Fitch's general approach to analyzing corporate governance is explained in Fitch Research on "Evaluating Corporate Governance," dated Dec. 12, 2007, available on Fitch's Web site at www.fitchratings.com. It is a pragmatic approach, rather than a check-the-box compliance exercise. The primary focus is on the fairly isolated instances of outlier corporate governance behavior that may have an effect on ratings, particularly on the downside. If corporate governance is not sufficiently weak to affect the ratings, it is often not commented on in published reports and rating action commentaries.

While sound corporate governance policies and practices are important for all companies, they are, arguably, even more significant for financial institutions, since these play a central and influential role in the broader economy. From a governance perspective, FIs are, in effect, unique players for several reasons, outlined as follows:

- They are not just selling products and services but are also looking after people's money often in the form of investments, which increases public vulnerability to any problems that arise.
- The systemic importance of many FIs to the economy may result in close regulation, which may promote confidence in safety and soundness of operations but can reduce the incentive for key stakeholders to monitor board and management behavior. Furthermore, although regulation has been helpful in promoting sound governance practices, it is not a cure all; Fitch considers that corporate governance is not purely a matter of compliance but a function of sound risk culture. Its analysis therefore looks beyond regulatory compliance to differentiate the governance quality of the FIs it rates.
- There may be more stakeholders in FIs than in other companies. These may include equity holders, debt holders, investors (in underlying funds, etc.), regulators, and central banks. This can help to provide various checks and balances on risk taking but can also make the task of differentiating governance quality across institutions more challenging.

Corporate governance is considered part of an issuer's general risk management culture and practices and is taken into consideration as part of Fitch's analysis of risk management. Corporate governance issues may also arise in relation to an issuer's management and strategy as well as its legal structure and ownership, and such issues are addressed accordingly by analysts when looking at these areas.

Important aspects of the corporate governance methodology covered in Fitch's credit analysis of FIs include the following:

- Independence and effectiveness of the board of directors.
- Oversight of related-party transactions.
- Executive and director remuneration.

These issues are all covered in detail in the aforementioned Fitch Research on "Evaluating Corporate Governance," dated Dec. 12, 2007, available on Fitch's Web site at www.fitchratings.com.

Evidence of fundamentally weak management or corporate governance in an FI, which could make debtholders vulnerable to potentially significant credit losses, would have a negative effect on the ratings and would be commented on in the published analysis. On the other hand, good governance or management practices may not warrant a mention in the published analysis, although exceptionally strong governance practices may do so, even if it is unlikely that this would lead to any positive rating action.

Ownership, Support, and Group Factors

As noted in the description of Fitch's Support ratings, a key driver of support ratings include an entity's ownership, support, and other relevant group factors. To the extent an institution can rely on support, the IDR may benefit from ratings uplift. Analysts assess the stability of the shareholding structure of the entity as well as the ability and propensity of its owners or the government to support the institution in case of need and, in the case of institutional support, the supported entity's strategic importance to its shareholders. In general, ownership of FIs can include institutional owners, private individuals and families, public shareholders, and state owners (national or regional). Additionally, some banks have mutual ownership structures.

Group Structure

Fitch's FI analysis incorporates the primary operating subsidiary, related financial services entities, and subsidiaries or related entities, while also considering the unique characteristics and attributes of the holding company as a stand-alone legal entity. These attributes may vary significantly from country to country and, in certain situations, from company to company within a particular country. Legal, regulatory, and tax schemes may vary considerably. In particular, regulatory issues play an important role in the analysis of a financial holding company and distinguish the analysis from that of unregulated corporate entities. Mutual support mechanisms, intercompany guarantees, and legal and/or regulatory restrictions surrounding flow of funds between subsidiaries and the parent company within a group that could ultimately impede or improve debt service capabilities in times of stress are factored into the analysis of an FI. The degree of rating difference, if any, Fitch assigns to various subsidiaries of a group will be determined by the factors listed above as well as by more subjective factors. These subjective factors can include Fitch's view of the strategic importance of a subsidiary, the reputational risk, future strategic limitations, or other ramifications the institution may expose itself to if it does not fully support a subsidiary.

Holding Company Analysis

Ratings for financial holding companies are highly correlated to the ratings of the company's main operating subsidiaries. Based on the analysis of several factors, including parent company liquidity, double leverage, profitability, cash flow, and level of complexity, holding company IDRs and debt ratings are often aligned with those of the operating subsidiaries, although holding company ratings may also be notched down. The alignment of holding company IDRs with primary operating subsidiary IDRs reflects Fitch's determination that the holding company is prudently managed and has appropriate liquidity. This builds from the belief that the probability of default of the two entities (holding company and FI subsidiary) is similar, particularly for highly rated companies. In weaker companies and/or those with less-prudently managed holding companies or whose holding companies may be experiencing stress, such as liquidity or funding stress, IDRs may be notched down from the main financial subsidiary. Typically, notching is limited to one notch for investment grade FIs. When FIs experience financial stress, holding company ratings often become more sensitive to the financial deterioration of the company, and notching may be widened based on Fitch's view of the holding company's probability of default. A more detailed analysis of bank holding companies is discussed in Fitch Research on "Bank Holding Companies," dated Dec. 30, 2009, available on Fitch's Web site at www.fitchratings.com. *(For a more detailed analysis of nonbank financial holding companies, refer to Fitch Research on "Rating Linkages in Parent and Nonbank Financial Subsidiary Relationships," dated Dec. 30, 2009, available on Fitch's Web site at www.fitchratings.com.)*

Appendix A

Ratio Framework for Financial Institutions

As noted earlier in this criteria report, Fitch's application of various ratios differs depending on the activities and type of financial institution. The Ratio Framework table, below, provides some general guidance on which category(ies) of ratios apply to various FIs by entity type or activity. However, it is important to note that this table does not incorporate all FIs, and the groupings of ratios can vary in individual issuer analysis. Therefore, these are general ratio categories for asset quality, capital, leverage, funding/liquidity, profitability, cash flow ratios, and market risk measures that may apply. Ultimately, more categories may be relevant to some issuers and fewer categories may be relevant to others.

Ratio Framework

	Asset-Quality Ratios	Capital Ratios	Leverage Ratios	Liquidity/ Funding Ratios	Profitability Ratios	Cash Flow Ratios	Market-Risk Measures
Banks	✓	✓		✓	✓		✓
Trust/ Processing Banks		✓		✓	✓		
Finance and Leasing Companies	✓	✓	✓	✓	✓	✓	
Securities Firms			✓	✓	✓	✓	✓
Investment Managers			✓			✓	

The Key Nonbank FI Ratio Definitions table on page 23 presents a more detailed description of some typical ratios one might see in each of the relevant ratio categories for nonbank financial institutions. Typical bank ratios are presented in Appendix 2 on page 24 and are therefore not addressed in the ratio definitions table below. Again, Fitch emphasizes that some FIs engage in multiple activities that run across more than one institution type or activity that may warrant additional ratio analysis, or the specific institution may engage in more limited activities or their business profile may be such that fewer ratios are used in the analysis. Therefore, this table should be used only to provide an enhanced understanding of how some of these ratios may be applied. Individual issuers are likely to incorporate more ratios in a category than are presented in the table. Further details on ratios or the application of this master criteria report for subsectors within FI are addressed in sector-specific or special reports.

Key Nonbank FI Ratio Definitions[a]

	Definition	Types of Companies to Which Ratios Are Typically Applied
Asset Quality Ratios		
Delinquent Loans/Loans	Loans or leases classifed as past due at least 30 days/period-end gross loans or leases.	Finance and leasing companies
Impaired Loans (Nonperforming Loans)/Loans	Loans or leases where income has either stopped accruing or collectability is impaired/period-end gross loans or leases.	Finance and leasing companies
Net Chargeoffs/Average Loans	Gross principal losses less recoveries/average loans for the period.	Finance and leasing companies
Reserves/NPAs	Loan or lease reserves/NPAs (NPAs equal NPLs plus repossessions).	Finance and leasing companies
Capital Ratios		
Tangible Common Equity/ Tangible Assets[a]	(Common equity less goodwill less intangibles)/(total assets less goodwill less intangibles).	Trust/processing bank, finance and leasing companies
Core Capital/Tangible Assets[a]	Core capital (as defined in this criteria)/tangible assets.	Finance and leasing companies
Leverage Ratios		
Debt or Managed Debt/Tangible Common Equity	Debt or managed debt (debt plus off-balance sheet funding)/tangible common equity.	Finance and leasing companies
Debt or Managed Debt/Core Capital	Debt or managed debt (debt plus off-balance sheet funding)/core capital.	Finance and leasing companies
Adjusted Leverage	(Total assets less reverse repurchase agreements)/adjusted equity (adjusted equity equals common equity less goodwill less intangibles less ineligible deferred tax assets plus hybrid equity credit of 0%–100%).	Securities firms
Net Adjusted Leverage	(Total assets less reverse repurchase agreements less securities borrowed)/adjusted equity.	Securities firms
Adjusted Equity/Total Assets	Adjusted equity/total assets.	Securities firms
Debt/EBITDA	Debt/earnings before interest, taxes, depreciation and amortization, with adjustments for significant noncash items such as noncash compensation expenses.	Investment managers/some securities firms (such as inter-dealer brokers)
Liquidity/Funding Ratios		
Illiquid Assets	Generally, high-yield debt plus merchant bank, private equity investments plus emerging market plus bank loans plus goodwill plus intangibles plus non-investment-grade derivatives MTM plus other assets plus non-investment-grade residual assets.	
Liquid Assets/Total Assets[a]	(Total assets less illiquid assets [as defined above])/total assets.	Finance and leasing companies, trust/processing banks, securities firms
Long-term Funding Sources/Illiquid Assets	(Adjusted equity plus adjusted debt [includes non-equity hybrid allocation])/illiquid assets.	Securities firms
ST Borrowings/Total Assets[a]	Short-term borrowings including current portion of long-term debt/total assets.	Finance and leasing companies, trust/processing banks
ST Borrowings/Total Interest-Bearing Liabilities	Short-term borrowings including current portion of long-term debt/total interest-bearing liabilities.	Finance and leasing companies, trust/processing banks
Profitability Ratios		
Net Interest Margin	Net interest income/average interest earning assets.	Finance and leasing companies, trust/processing banks
Return on Average Assets[a]	Net income/average assets.	Finance and leasing companies, trust/processing banks
Return on Average Equity	Net income/average equity.	All
Pretax Profit Margin	Pre-tax income/net revenue.	Securities firms
EBITDA Margin	EBITDA/total revenue.	Investment managers
Management Fees/Average AUM	Management fees/Average (earning) assets under managements.	Investment managers
Cash Flow Ratios		
EBITDA/Interest Expense	Earnings before interest, taxes, depreciation and amortization, with adjustments for significant noncash items/interest expense.	Investment managers/some securities firms (such as inter-dealer brokers)
EBITDA/Debt Service	Earnings before interest, taxes, depreciation and amortization, with adjustments for significant noncash items/debt service [includes debt amortization].	Investment managers/some securities firms (such as inter-dealer brokers)
Fixed Charge Coverage	EBITDAR [EBITDA plus rental expenses]/fixed charges [includes interest expense, debt service, preferred dividends, and significant rental expenses when applicable].	Investment managers/some securities firms (such as inter-dealer brokers)
Market Risk Measures		
Average Trading VaR	Average period trading value-at-risk adjusted to 99% confidence interval and one-day holding period.	Securities firms
Fitch Stress VaR	High VaRs added together linearly, adjusted to 99%, multiplied by square root of 10, multiplied by eight, compared to tangible equity excluding trust preferred.	Securities firms

[a]For FIs that actively securitize assets that are off-balance sheet, (usually U.S.-based finance and leasing companies), managed assets (defined as reported balance sheet assets less goodwill and intangibles plus off-balance-sheet securitized receivables with recourse) may be used to replace reported balance sheet figures.

Appendix B

Typical Ratios Used in Bank Analysis

As accounting standards have significantly converged in recent years, Fitch, wherever possible, seeks to use a common suite of ratios across its rated bank universe. These are listed in the table below and are mostly self-explanatory. *(For a full explanation and definitions of these ratings see Fitch Research on "A Universal Spreadsheet for Bank Analysis," dated April 14, 2009, available on Fitch's Web site at www.fitchratings.com.)* It should be noted that published data will not always be available, especially in interim financial statements, for all these ratios to be calculated, and that where calculated, the significance and weighting attached to the ratios may well vary from bank to bank and through time. As accounting standards and disclosure requirements also vary over time, the exact composition and derivation of these ratios is subject to periodic change, although their broad thrust is expected to remain stable. In countries where Fitch does not use these standard ratios, Fitch will derive local ratios designed to achieve the same analytical aims. Fitch may use additional ratios to those listed below, typically where such ratios are not so readily extracted from published financial statements. This would include market risk measures which will typically be based on a value-at-risk number.

Interest Ratios
Interest Income on Loans/Average Gross Loans
Interest Expense on Customer Deposits/Average Customer Deposits
Interest Income/Average Earning Assets
Interest Expense/Average Interest-Bearing Liabilities
Net Interest Income/Average Earning Assets
Net Interset Income Less Loan Impairment Charges/Average Earning Assets
Other Operating Profitability Ratios
Non-Interest Income/Gross Revenues
Non-Interest Expense/Gross Revenues
Non-Interest Expense/Average Assets
Pre-Impairment Operating Profit/Average Equity
Pre-Impairment Operating Profit/Average Total Assets
Loans and Securities Impairment Charges/Pre-Impairment Operating Profit
Operating Profit/Average Equity
Operating Profit/Average Total Assets
Taxes/Pretax Profit
Other Profitability Ratios
Net Income/Average Total Equity
Net Income/Average Total Assets
Fitch Comprehensive Income/Average Total Equity
Fitch Comprehensive Income/Average Total Assets
Net Income/Average Total Assets Plus Average Managed Assets
Capitalization
Core Capital/Regulatory Weighted Risks
Fitch Eligible Capital/Regulatory Weighted Risks
Tangible Common Equity/Tangible Assets
Tangible Common Equity/Total Business Volume
Tier 1 Regulatory Capital Ratio
Total Regulatory Capital Ratio
Fitch Eligible Capital/Tier 1 Regulatory Capital
Equity/Total Assets
Cash Dividends Paid and Declared/Net Income
Cash Dividend Paid and Declared/Fitch Comprehensive Income
Net Income - Cash Dividends/Total Equity
Loan Quality
Growth of Total Assets
Growth of Gross Loans
Impaired Loans(NPLs)/Gross Loans

Reserves for Impaired Loans/Gross Loans
Reserves for Impaired Loans/Impaired Loans
Impaired Loans Less Reserves for Impaired Loans/Equity
Loan Impairment Charges/Average Gross Loans
Net Chargeoffs/Average Gross Loans
Impaired Loans + Foreclosed Assets/Gross Loans + Foreclosed Assets

Funding
Loans/Customer Deposits
Interbank Assets/Interbank Liabilities

Appendix C

Support Rating Definitions

'1' denotes a financial institution for which there is an extremely high probability of external support. The potential provider of support is very highly rated in its own right and has a very high propensity to support the financial institution in question. This probability of support indicates a minimum long-term rating floor of 'A–'.

'2' denotes a financial institution for which there is a high probability of external support. The potential provider of support is highly rated in its own right and has a high propensity to provide support to the financial institution in question. This probability of support indicates a minimum long-term rating floor of 'BBB–'.

'3' denotes a financial institution for which there is a moderate probability of support because of uncertainties about the ability or propensity of the potential provider of support to do so. This probability of support indicates a minimum long-term rating floor of 'BB–'.

'4' denotes a financial institution for which there is a limited probability of support because of significant uncertainties about the ability or propensity of any possible provider of support to do so. This probability of support indicates a minimum long-term rating floor of 'B'.

'5' denotes a financial institution for which external support, although possible, cannot be relied on. This may be due to a lack of propensity to provide support or to very weak financial ability to do so. This probability of support indicates a long-term rating floor no higher than 'B–' and, in many cases, no floor at all.

Individual Rating Definitions

'A' denotes a very strong financial institution. Characteristics may include outstanding profitability and balance sheet integrity, franchise, management, operating environment, or prospects.

'B' denotes a strong financial institution. There are no major concerns regarding the financial institution. Characteristics may include strong profitability and balance-sheet integrity, franchise, management, operating environment, or prospects.

'C' denotes an adequate financial institution, which, however, possesses one or more troublesome aspects. There may be some concerns regarding its profitability and balance-sheet integrity, franchise, management, operating environment, or prospects.

'D' denotes a financial institution, which has weaknesses of internal and/or external origin. There are concerns regarding its profitability and balance sheet integrity, franchise, management, operating environment, or prospects. Financial institutions in emerging markets are necessarily faced with a greater number of potential deficiencies of external origin.

'E' denotes a financial institution with very serious problems, which either requires or is likely to require external support.

'F' denotes a financial institution that has either defaulted or, in Fitch's opinion, would have defaulted if it had not received external support. Examples of such support include state or local government support, (deposit) insurance funds, acquisition by some other corporate entity, or an injection of new funds from its shareholders or equivalent.

Notes

Gradations may be used among the ratings 'A' to 'E', i.e. 'A/B', 'B/C', 'C/D' and 'D/E'. No gradations apply to the 'F' rating.

An individual rating may be followed by the suffix "s" denoting that it is largely based on public information, though supplemented by data obtained from the rated entity.

As noted in this criteria report, in assigning the long-term IDR of an FI, Fitch takes the higher of the individual rating and the support rating. To achieve this, the individual rating is mapped on to the long-term rating scale in line with the mapping table below. There are various overlaps in the mapping to reflect the combination of qualitative and quantitative factors that are assessed to derive an individual rating. In addition, in rare circumstances the mapping may not be appropriate, and an individual rating may imply a rating outside the ranges set out in the table. It is important also to note that the individual rating is currency neutral and the mapping to foreign-currency IDRs may be affected by the application of country ceilings.

Mapping of Individual Rating to Long-Term Ratings

Individual Rating	Long-Term Rating Derived from Internal Mapping
A	AAA AA+ AA
A/B	AA+ AA AA– A+ A
B	AA– A+ A A–
B/C	A A– BBB+ BBB
C	BBB+ BBB BBB– BB+
C/D	BBB– BB+ BB BB–
D	BB BB– B+ B B-
D/E	B+ B B– CCC
E	CCC CC C