Rating Methodology
Financial Institutions

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Introduction

This document is an update of our Bank Ratings Methodology (January 2021).

With this update, Scope clarifies that the methodology is applicable to banks and to a broad range of non-bank financial institutions. The scope of application includes mortgage institutions, building societies, microfinance companies, leasing and factoring companies, as well as lending captives of car or other manufacturing companies. Consequently, the methodology has been renamed to Financial Institutions rating methodology.

The analytical guidelines for the assessment of the key rating drivers have been amended to cater to such broader range of institutions. The Initial mapping table, combining Business Model and Operating Environment Assessment, has been recalibrated, to allow for more granularity in rating transitions.

The approach to the rating of long-term debt securities has also been generalised, to allow its application to non-bank financial institutions. Notching of debt instruments now starts invariably from the issuer rating, which remains the cornerstone of our analytical work for both banks and non-bank financial institutions.

Finally, the update includes several editorial changes and clarifications throughout the text.

Scope of application

Our Financial Institutions Rating Methodology provides the framework for our rating assessment of banks and other financial institutions.

The methodology allows the analysis of and assignment of ratings to listed and unlisted credit institutions, including savings banks and cooperative groups, as well as government-owned banks. While the contribution of different analytical elements varies depending on the type of institution and its business model, the same analytical roadmap guides our analysts in the assessment of a broad range of business models. These include retail and commercial banks, investment banks, specialised lenders, diversified credit institutions, and also non-bank lending institutions, such as mortgage institutions, building societies, microfinance companies, leasing and factoring companies, as well as lending captives of car or other manufacturing companies.
1. Rating framework

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

1.1.1. The issuer rating

The issuer rating is the cornerstone of our credit assessments of financial institutions (see Rating Definitions) and signals the relative risk of a default-like event. Issuer ratings assigned using our long-term credit rating scale are forward-looking opinions on the relative creditworthiness of an issuer's ability and willingness to repay its financial obligations when due and with an original maturity of one year or more.

1.1.2. Our bank ratings reflect the likelihood of regulatory action leading to default-like events

If we look at the limited default history of banks in Europe in recent years, we see that they were often not due to commercial insolvencies or bankruptcies like in non-regulated credit sectors. For the small number of banks that were either unable to meet their financial commitments or were prevented from doing so, this was in most cases due to regulatory intervention.

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

Unlike for other private sector credits, it is regulatory action which leads to default-like situations for banks and other regulated financial institutions. This action can be in the form of: i) early supervisory intervention, e.g. to prevent payments on capital securities; ii) resolution-related debt bail-ins that affect liabilities eligible for bail-in; or iii) insolvency proceedings. Bank ratings must therefore assess the extent to which credit fundamentals and other factors evaluated in the rating process influence the likelihood of such an event.

We use the term ‘default-like’ rather than ‘default’ because neither supervisory intervention-induced non-payment on capital securities (coupons and/or principal), nor a resolution-induced bail-in of eligible liabilities, could be considered de jure defaults, although the impact for investors in these securities may be similar to a default.

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

Our Financial Institutions Rating Methodology describes how we assign ratings based on the analysis of standalone credit factors and the review of external support factors. In general, we do not intend to perform a standalone analysis for financial institutions that benefit either from an effective guarantee or a government-related entity status with a strong level of integration with the sponsoring government. In such cases we opt for a ‘top-down’ approach as defined under our GRE methodology. We also use a ‘top-down’ approach for issuers that are fully or highly integrated subsidiaries within a larger group, taking into consideration the creditworthiness of the group to which they belong (see section 2.11).

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

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

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

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

Our analysis of short-term debt ratings is a subset of our analysis of long-term debt ratings. For short-term debt ratings, the assessment is informed by a review of an issuer’s funding and liquidity characteristics – including the role played by changes in market sentiment.

Given these aspects, there is a correlation between short-term and long-term ratings, as detailed in our rating definitions (https://scoperatings.com/#/governance-and-policies/rating-scale).

1.2. Sources of data and information

Our financial institutions rating analysis is based on various sources, most of them in the public domain. They include annual reports, Pillar-3 reports, and investor presentations accompanying quarterly results and other public events. Sources of general background information on financial institutions’ activities include central bank reports, regulators’ statistics, reports from international organisations, comparative databases and industry reports. Due to the confidence sensitive nature of financial institutions, market metrics may also play a role in our rating assessment, insofar as they provide information on broader investor community views.

Publicly available information may be supplemented with non-public information from issuers engaging in dialogue with us.
2. Rating methodology

2.1. Outline of methodology and analytical framework.
To begin our analysis, we examine the range of data and information available, both macro and micro.
As indicated in paragraph 1.1.3, steps 1 and 2 might not always be needed when we rate a bank using a ‘top-down’ approach (for eligible government-related entities or subsidiaries).

Step 1: Initial mapping and anchor assessment
We arrive at an initial mapping based on a combined assessment of an issuer’s operating environment and business model. The initial mapping is not notch-specific, but rather indicates the higher or lower end of a certain rating category.
We further hone the initial mapping by analysing the long-term sustainability of the issuer’s business in the context of a changing operating environment. This analysis is based on environmental, social and governance (ESG) considerations and more specifically, given the anticipated transformational impacts of technology on the financial sector, an assessment of the issuer’s preparedness for digital transition.
The end-point of step one is a notch-specific anchor assessment.

Step 2: Determination of an intrinsic/standalone credit assessment
We refine our anchor assessment by reviewing the issuer’s financial performance:
- Earnings capacity and risk exposures. We assess the risk profile of the issuer, in particular asset quality, and the level of risk protection provided by its ability to generate adequate risk-adjusted returns that build buffers, from provisions to capital.
- Financial viability management, which assesses to what extent an issuer operates at a sufficient distance to regulatory minimum requirements, or industry benchmarks, which are also de facto binding constraints for non- or less regulated entities, and therefore manage the risk of regulatory failure, or the equivalent market perception.
- Additional factors which are not necessarily already captured in the above steps. Temporary considerations that are weighing positively or negatively on the issuer’s creditworthiness could also be captured in this step.

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

Step 3: Integration of external support to derive an issuer credit rating.
If appropriate, we complement our review of the issuer’s intrinsic credit assessment with a review of external support factors.
The above-mentioned steps are detailed in the following sections.

Figure 1: Methodology outline and analytical framework
2.2. Operating environment assessment

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

- **Economic assessment.** Our economic evaluation of an issuer’s main markets (international, national, regional or local) underpins our fundamental assessment of its rating, providing the context for trends in an issuer’s financial fundamentals. We focus on relative levels and structural, long-term dynamics, rather than short-term shifts in GDP, interest rates or cyclical indicators. Our economic assessment is de-linked from our view on the sovereign’s debt servicing capacity, though it may include considerations on the room for fiscal and monetary manoeuvre to counteract potential shocks. Understanding the phase of the business cycle in the various markets in which the issuer operates is crucial to interpreting its financial results.

- **Soundness of the banking system.** Secondly, we assess the soundness of the industry in terms of its competitive structure and the quality of its legal and regulatory framework. We examine the extent to which the degree of competitive pressure favours risk-taking strategies across the industry and whether the legal and regulatory framework are supportive of sound financial activities. This may be because an efficient legal system facilitates such activities or because the regulator has a track record and the capacity of proactive and measured intervention to prevent default risk. For non-bank lending institutions that are typically subject to a lower amount of regulation and less intense supervision (or may even be completely non-regulated), we assess to what extent it translates into heightened risk-taking practices across the sector.

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

For large banks in wealthy developed markets, operating in well-regulated environments, we would generally deem the environment supportive or very supportive. A less supportive operating environment would typically be related to lightly regulated sectors or volatile economies.

**Figure 2: Operating environment assessment**

<table>
<thead>
<tr>
<th>Qualifiers</th>
<th>Typical characteristics</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Very supportive</strong></td>
<td>An assessment of very supportive would typically apply to diversified and wealthy economies, with well-developed capital markets and a solid track record of economic resilience to shocks. The legal and regulatory frameworks provide sufficiently predictable outcomes for the performance of financial activities and market players benefit from adequate pricing power thanks to a supportive competitive landscape.</td>
</tr>
<tr>
<td><strong>Supportive</strong></td>
<td>A supportive assessment would typically apply to advanced economies with a higher degree of economic volatility, less convincing legal and regulatory frameworks, or less supportive competitive landscapes. Some of the best performing emerging economies could fall into this category. There are no significant systemic or idiosyncratic threats that could hurt financial or business fundamentals.</td>
</tr>
<tr>
<td><strong>Moderately supportive</strong></td>
<td>A moderately supportive operating environment would apply to issuers operating in economies that are more vulnerable, or that are expected to experience severe bouts of volatility, but with sufficiently advanced legal and regulatory systems. Several well performing emerging markets would fall into this category.</td>
</tr>
<tr>
<td><strong>Constraining</strong></td>
<td>The economic environment is considered constraining when it could negatively affect financial performance in the long run, independently of management’s ability to steer the issuer. Volatile economic cycles, poor regulation, weak supervisory practices and aggressive price competition all indicate a constraining operating environment.</td>
</tr>
<tr>
<td><strong>Very constraining</strong></td>
<td>An assessment of very constraining would apply to issuers operating in extremely volatile economic environments that could experience very deep business cycles, periodic bouts of political instability, and prolonged periods of hyperinflation or deflation. Very weak legal systems, highly unstable regulatory environments or unreliable supervisory systems are typical features.</td>
</tr>
</tbody>
</table>
2.3. Business model assessment

Our business model review examines the ability of an issuer’s business to consistently deliver high-quality, risk-adjusted earnings.

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

The key drivers of our business model assessment are:

- **The intrinsic risk / return characteristic of the business.** We believe that an issuer’s domestic retail and commercial banking activities provide the strength and stability to anchor a solid business model: i) the targeting of a large and stable customer base; ii) via a well-suited and efficient distribution network; iii) with the offering of a diversified range of products and services. Specialised lenders or firms relying primarily on wholesale and investment banking are more exposed to business model risk.

- **The issuer’s market position and pricing power.** Dominance in a product segment in a specific market, for example in mortgages or credit cards, may translate into pricing power, which can help revenues, although retail products are often fully commoditised. The stability of an issuer’s customer base, demand for new or existing products, as well as various metrics related to local demographics in the markets where the issuer has a material presence may also drive this assessment.

- **The degree of geographic and product diversification.** Revenue diversification is generally positive for a business model. However, some diversification is less suitable, such as pursuing revenue growth in riskier markets on the potentially false assumption that the issuer’s home expertise provides a competitive advantage in foreign markets.

Having analysed a bank’s business model in light of the above factors, our analysts assign a business model assessment, as a function of the predictability and diversification of its earnings streams. These business model assessments range from very resilient to narrow.

**Figure 3: Business model assessment**

<table>
<thead>
<tr>
<th>Qualifiers</th>
<th>Typical characteristics</th>
</tr>
</thead>
<tbody>
<tr>
<td>Very resilient</td>
<td>This qualifier would typically apply to issuers that display very strong and well-rounded business franchises, hence sustainably high and very predictable revenue and earnings stream, typically owing to a high degree of effective, well executed diversification with adequate pricing power in several core markets and products. Leadership in domestic retail and commercial banking is often the anchor for the business model.</td>
</tr>
<tr>
<td>Resilient</td>
<td>Issuers in this category typically display a strong market position in their domestic retail and commercial market, where they may also be an important player in investment banking, insurance and wealth management. As a result, they tend to display sustainable and predictable revenue and earnings stream. The domestic franchise is often complemented by some degree of international diversification.</td>
</tr>
<tr>
<td>Consistent</td>
<td>A consistent assessment still requires at least a certain degree of revenue and earnings stream predictability, as is the case for most domestic retail and commercial banks. Regional franchises with strong local market positions or which focus on very low-risk customers or technical forms can also fall in this category. Specialised lenders with well-established franchises or a high degree of geographic diversification could also fall into this category.</td>
</tr>
<tr>
<td>Focused</td>
<td>Issuers that operate on a small local scale and/or focus on a limited product range, making them more vulnerable to changes in the operating environment. Larger banks that are systematically unable to generate enough income to cover their costs (including cost of risk) would also fall into this category. It also includes issuers with challenged franchises, and business models in need of reshaping.</td>
</tr>
<tr>
<td>Narrow</td>
<td>Business models with very high revenue volatility or a restricted revenue base would typically include monoliners operating locally and lenders specialised in highly cyclical sectors or products with limited pricing power. A lack of business or geographic diversification limits the assessment.</td>
</tr>
</tbody>
</table>
2.4. The initial mapping
The combination of our operating environment assessment and business model review provides the starting point for our rating process. Based on our qualitative assessment of these two factors, we map the issuer to a rating category and, in some cases, to the high or low end of the rating category (Figure 4).

<table>
<thead>
<tr>
<th>Business model</th>
<th>Operating environment</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Very supportive</td>
</tr>
<tr>
<td>Very resilient</td>
<td>a/a+</td>
</tr>
<tr>
<td>Resilient</td>
<td>a/a+</td>
</tr>
<tr>
<td>Consistent</td>
<td>a cat</td>
</tr>
<tr>
<td>Focused</td>
<td>bbb cat</td>
</tr>
<tr>
<td>Narrow</td>
<td>bbb cat</td>
</tr>
</tbody>
</table>

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

We strongly believe that credit dynamics and fundamentals can only be fully understood and assessed in a peer group context, by performing a ‘compare and contrast’ analysis. Therefore, we incorporate peer group analysis in our rating assessment process from this early stage. This is because our ratings and the analysis behind them measure credit risk from a relative perspective. We typically compare and contrast with peers which face comparable operating conditions and with a similar business model assessment.

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

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

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

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

ESG integration is still in its infancy insofar as the credit-risk aspect is concerned. ESG-D factors are often difficult to measure and benchmark as disclosures are not sufficient nor consistent. We expect the availability and quality of information to improve gradually and markedly as there is increasing demand from both supervisors and investors for ESG-related disclosures, transparency, and risk assessments. As supervisory expectations become further codified, financial institutions which cannot meet them face potential regulatory consequences. We also recognise that perceptions and expectations regarding ESG-D may
vary across regions. In our assessment, we look for signs that management is focused on these expectations and is taking steps to meet them.

Our assessment of ESG-D risks is centered on the following:

- **Governance.** We identify aspects of governance which may lead to higher credit risk, such as complexity in a group’s structure, a lack of independence among the board of directors, excessive power of (and reliance on) a key executive, or evidence of deficiencies in internal risk control and management. We also consider an issuer’s track record on business conduct. Examples include incidents of product mis-selling, benchmark manipulation and money laundering. Misconduct can be a source of reputational and legal risk on top of regulatory fines. Remedial measures often involve direct costs and legal risks can represent a significant loss contingency. Established financial institutions would in most cases display strong governance structures – at least on paper. Supervisory guidance, stock market governance codes and investor expectations have led to some convergence in the governance arrangements at larger institutions. As such, governance is unlikely to be a positive differentiating factor for larger institutions. Governance failures, on the other hand, are likely to drive credit differentiation. Small, unlisted or unregulated institutions are more likely to have weaker governance arrangements, partly due to a lower level of investor and supervisory scrutiny.

- **Digital transition.** To remain competitive, financial institutions need to make sufficient investments in their IT infrastructure, not only in client facing functions but also in middle and back offices. We determine to what extent managing the digital transition is at the heart of strategic initiatives. Not all issuers will have the earnings capacity and expertise to do so. Failure to keep up with evolving technologies and trends may not result in immediate losses but may jeopardise the business franchise in the long term. With banking operations becoming increasingly digital, cyber risks are also becoming more prominent. This is no longer only an operational issue as failures in IT security, with respect to the loss of customer data, can lead to significant reputational damage and ultimately customer losses – affecting the longer-term sustainability of the business.

- **Environmental factors.** Our focus is on how an issuer is addressing environmental issues from a risk management perspective i.e. efforts to identify risks and manage them. This is particularly the case when regulators have set expectations in this area. We also evaluate the availability and quality of disclosures on these risks and consider how an issuer is supporting sustainable growth and investment as this may be relevant for its stakeholders and even represent a business opportunity.

- **Social aspects** impacting financial institutions’ creditworthiness are often tilted to the downside and linked to governance issues. Issuers in the financial services industry are generally large employers, with sizeable customer bases, which also maintain close ties with local communities. The social repercussions of management actions may alter an issuer’s reputation and constrain future growth prospects or the quality of its franchise. Aggressive pricing or remuneration policies, or workforce adjustments tend to create more publicity than actions supporting social objectives, which are becoming new standards.

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

We also consider current constraints on peer comparisons, such as the level of industry disclosures, the ongoing development of standards, and the varying relevance of ESG-D issues across geographies from a credit standpoint. ESG-D factors are gaining in importance and these factors may be further reflected in other steps of the rating process.

Exceptionally strong (unlikely) or weak (more likely) ESG-D profiles, which warrant additional credit differentiation, could be reflected as additional factors (2.9).
2.6. The adjusted anchor

Based on the refined initial split mapping assessment, for instance ‘a-/a’ or ‘a/a+’, described in paragraph 2.4, we establish an adjusted (notch-specific) anchor by factoring in our views on an issuer’s long-term sustainability. The range of qualifiers, from lagging to best in class, allows for some granular differentiation among peers. At this stage however, we group them in pairs, given the limitations mentioned above:

- **Advanced or best in class** assessments both position the adjusted anchor in the upper bound of the initial mapping, for instance ‘a’ for an initial ‘a-/a’ split mapping.
- **Lagging or developing** assessments both position the adjusted anchor in the lower bound of the initial mapping, ‘a-’ in this case.

From here, we further refine our assessment by analysing an issuer’s financial profile, including earnings capacity, risk exposures and financial viability management.

2.7. Earnings capacity and risk exposures

**Earnings, the first line of defence**

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

Our assessment of an issuer’s earnings capacity is a look-through approach of its earnings metrics in light of its unique mix of risk exposures, and primarily credit risk. Whereas our review of business profiles assesses the issuer’s capacity to generate predictable and sustainable operating revenues, we focus here on an issuer’s ability to generate sufficient revenues to: i) cover its operating costs; ii) absorb losses on an ongoing basis including exceptional losses or incremental losses through the cycle; and iii) build sufficient capital internally to accompany its growth pattern.

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

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

Our assessment of earnings capacity rests on the track record and expected financial performance of the issuer. We look at changes in financial performance using a compare and contrast analysis, analysing the issuer’s financial ratios relative to peers. As such, our assessment is not based on benchmarks – and we do not identify pre-set fixed thresholds for the triggering of rating changes.
We look at a broad range of measures, depending on the issuer's business model. For banks, we typically focus on two key earnings metrics that inform our views on its capacity to absorb losses:

- Supportive average pre-provision profitability, providing a buffer to absorb credit and other losses
- An adequate level of bottom line profitability, and its ability to adequately remunerate providers of equity capital

**Risk exposures**

For most issuers – in particular banks – asset quality is a key focus of our analysis, as credit risk (encompassing both the lending and the liquidity portfolio) is often the primary driver of bank losses. We particularly focus on relevant exposures that are more cyclical in nature and are most likely to suffer higher credit losses in a downturn. When problem loans start to surface, we assess the issuer’s capacity to remedy them and its conservativeness in managing the cleaning of its balance sheet.

Concentrated exposure to individual risks, including sovereign risks, can constrain an issuer rating, although we do not apply mechanistic caps to bank ratings based on sovereign ratings. For issuers benefiting from effective supra-national support frameworks, such as banks in the euro area, we see no valid reason to mechanistically link their overall creditworthiness to, for instance, rating caps at the level of some sovereign ratings. Specialised lenders would often be exposed to specific risks arising from the peculiarities of their business models. These risks would also be covered by our risk exposures assessment.

Depending on the business model, other risks may also be relevant. Examples include market risk, which can be a relevant source of earnings and capital volatility for banks with significant market activity, or material asset-liability mismatches and operational risk. This is especially relevant for issuers with complex operations and for activities structurally carrying low credit or market risk such as, for example, asset management or custody.

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

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

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

**Figure 5: Earnings and risk exposures modifier**

<table>
<thead>
<tr>
<th>Qualifiers</th>
<th>Typical characteristics</th>
<th>Rating approach</th>
</tr>
</thead>
<tbody>
<tr>
<td>Very supportive</td>
<td>The issuer’s credit portfolio is granular and evenly distributed across counterparties and geographies, resulting in asset quality metrics which are better than peers’ metrics. Earnings capacity supports the accumulation of loss absorption buffers and provisioning policies and dividend distribution are conservative. The issuer has superior loss experience metrics. Other risks (including market and operational risks) could not lead to losses capable of undermining the issuer’s viability.</td>
<td>+2 notches</td>
</tr>
<tr>
<td>Supportive</td>
<td>Credit risk is granular with no major concentration by counterparty or geography and many asset quality metrics or its loss experience are sounder than the peer group average. The issuer’s track record of bottom line results is positive and it has a supportive track record of internal buffer build-up. Other risks (including market and operational risks) are highly unlikely to lead to losses capable of undermining the issuer’s viability.</td>
<td>+1 notch</td>
</tr>
<tr>
<td>Neutral</td>
<td>Credit risk metrics are only in line with peers’ metrics and other risk metrics indicate that the issuer operates safely but without any differentiating factors. Non-core loan portfolios or activities will have been identified as part of a de-risking process. Other risks (including market and operational risks) are unlikely to lead to losses capable of undermining the issuer’s viability.</td>
<td>0</td>
</tr>
<tr>
<td>Constraining</td>
<td>The issuer has some concentration risks that require monitoring and could weigh on its future performance. Its financial performance track record has been altered by loss experience which is higher than peers' and corrective action is still being taken. Other risks (including market and operational risks) could lead to material losses or have resulted in manageable losses, constraining the rating.</td>
<td>-1 notch</td>
</tr>
<tr>
<td>Very constraining</td>
<td>The issuer is materially exposed to asset quality risk, either managing problem assets larger than peers’ or exposed to deteriorating portfolios. Earnings capacity is insufficient to build or rebuild loss absorption buffers. The loss experience is materially poorer than peers’ loss experience. Other risks (including market and operational risks) could lead to very material losses, potentially undermining the issuer’s viability.</td>
<td>-2 notches</td>
</tr>
</tbody>
</table>
2.8. Financial viability management

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

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

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

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

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

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

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

We evaluate the capacity of a bank to operate freely and sustainably above these requirements. We generally do not expect excessively large buffers to become sound and permanent features for banks. Consequently, we do not grant extra benefit for buffers significantly in excess of regulatory minimums. We consider a maximum two-notch uplift under this assessment to strike a balance between a certain level of conservatism and balance sheet optimisation considerations. We would assess a breach of regulatory requirements or regulatory forbearance in context.
We do not set prescriptive, pre-defined threshold levels above minimum requirements which we consider appropriate for an issuer’s operations. Our assessment does not hinge on the monitoring of a specific ratio, a pre-defined set of ratios, or pre-determined threshold levels. The relevant indicators are assessed at individual bank level but are intended to be similar for peers operating in the same jurisdiction. For instance, we typically review the following set of regulatory viability indicators for banks operating in continental Europe:

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

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

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

How we factor financial viability management into our rating process

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

**Figure 6: Financial viability management modifier**

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

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

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

This step also captures specific business model characteristics and risks relating to non-bank lending institutions and, more generally, narrower business models exposed to specific risks and/or with a high dependency on one specific factor, leading to material concentration risk that may not otherwise be reflected or only be insufficiently captured in other parts of the methodology. This step is also used by analysts to flag exceptionally strong (unlikely) or weak (more likely) ESG-D profiles, which could warrant additional credit differentiation not adequately reflected in our long-term sustainability assessment.

**Figure 7: Additional support and risk factors modifier**

<table>
<thead>
<tr>
<th>Qualifiers</th>
<th>Typical characteristics</th>
<th>Rating approach</th>
</tr>
</thead>
<tbody>
<tr>
<td>Significant support factor</td>
<td>We consider that a qualified rating factor, or set of factors, not already captured in the rating process provides a significant uplift to the issuer’s creditworthiness.</td>
<td>+2 notches</td>
</tr>
<tr>
<td>Material support factor</td>
<td>We consider that a qualified rating factor, or set of factors, not already captured in the rating process, provides a material uplift to the issuer’s creditworthiness.</td>
<td>+1 notch</td>
</tr>
<tr>
<td>Neutral factor</td>
<td>We consider that the previous steps in the rating process provide an adequate reflection of the issuer’s creditworthiness.</td>
<td>0</td>
</tr>
<tr>
<td>Material downside risk factor</td>
<td>We consider that a qualified rating factor, or set of factors, not already captured in the rating process materially weighs on the issuer’s creditworthiness.</td>
<td>-1 notch</td>
</tr>
<tr>
<td>Significant downside risk factor</td>
<td>We consider that a qualified rating factor, or set of factors, not already captured in the rating process significantly weighs on the issuer’s creditworthiness.</td>
<td>-2 notches</td>
</tr>
</tbody>
</table>

2.10. Standalone rating

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

2.11. External support

We will generally incorporate ongoing operational support from related parties throughout our analysis. For instance, stable distribution agreements with shareholders could boost our assessment of an issuer’s business model, risk sharing or buyback agreements could boost our assessment of asset quality, and the existence of standby funding commitments could boost our assessment of financial viability.

Beyond the analysis of these intrinsic rating factors, other external considerations could further drive the assignment of an issuer rating, either partially or totally.

**Shareholder support**

We factor in shareholders’ support based on our views of the shareholder’s/combined shareholders’ credit strength, i.e. their ability to support the issuer under all circumstances and their willingness to do so. In the case of an issuer that is directly or indirectly majority owned and/or sufficiently controlled by a government and whose activities fulfil a public sector mandate, we apply Scope’s GRE Methodology in conjunction with the FI methodology as appropriate.

In other instances, we look at the creditworthiness of the shareholders regardless of their private or public nature. We examine their ability to inject equity, or other means of support, such as hybrid capital or liquidity if needed. When appropriate, we evaluate the existence and credibility of explicit and implicit support commitments and may incorporate this assessment into our ratings.
This is also the case for state-owned banks, as long as capital injections or other forms of support under state aid rules may potentially be provided.

Subsidiaries
When determining the reliability and stability of parental support for subsidiaries of larger banking groups, we primarily look at two factors:

(i) The degree to which the respective subsidiary is considered strategic by the parent institution. Examples are mortgage or consumer finance subsidiaries of retail banks or foreign subsidiaries related to a core business activity, especially if they carry the same name.

(ii) The parent company’s track record in supporting its subsidiaries, subject to our assessment of a group’s current financial and managerial capacity to do so.

In general, the issuer rating for subsidiaries within banking groups will be either at the level of the parent bank’s issuer rating or below, rarely above:

- **Guaranteed subsidiaries** are rated at the same level as the guaranteeing institution.
- **Fully integrated subsidiaries.** We align the ratings of fully integrated subsidiaries, based on, among other factors, jurisdiction, resolution strategy, and the degree of centralisation of key corporate functions, including funding and risk management.
- **Highly integrated subsidiaries.** For highly integrated subsidiaries we typically notch down the subsidiary from the parent's issuer rating by one notch.
- **Less integrated subsidiaries.** For less integrated subsidiaries we conduct a standalone analysis of the subsidiary. We apply support notches as appropriate if we believe that the parent company would have the willingness and the ability to support the subsidiary if needed. A standalone analysis of a subsidiary may also be driven by its ring-fenced status.

- **Subsidiary ratings above parent.** If the subsidiary’s fundamentals are stronger than the parent’s, we may rate the respective subsidiary higher. Typically, the difference would be one notch, but it could be wider if, for instance, a financially healthy subsidiary is ring-fenced by a regulator or benefits from other forms of credit enhancement such as external credit insurance for its assets.

Intra-group support mechanisms
If there are mutual support mechanisms or cross-guarantees within a group of entities, as in the case of certain cooperative or savings bank groups, an upward adjustment to the rating of a group member could be warranted, based on the ability and willingness of the members of the group to provide support.

For highly cohesive groups that also prepare consolidated financial statements and share significant functions, we may apply a group rating approach, in which we align the rating of core member institutions with the combined credit strength of the group. This would typically apply to the group’s local banks but could also apply to member institutions that perform key functions within the group. For highly integrated members, we would apply one downward notch from the group rating. Less integrated group members would be rated on a standalone basis but their final rating could benefit from support notches.

The regulator’s own view of the cohesiveness of such groups would be a key element informing our decision on which rating approach to pursue. For example, a group approach would typically apply for banks belonging to officially recognised European Institutional Protection Schemes.

State support
As resolution regimes have been implemented across Europe and North America, timely external state support for banks in distress (bail-out) has become less likely. We therefore believe that bank ratings cannot generally be boosted by the expectation of state support in those jurisdictions.

Our rating assessment may incorporate the possibility of state support for banks domiciled in jurisdictions without resolution regimes if the systemic importance of those entities indicates a significant likelihood of support.
3. Ratings of debt instruments

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

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

Subordinated debt is rated two notches below the issuer rating.

Banks’ capital structures typically also include capital instruments, such as Tier 2 and Additional Tier 1 securities.

For full details on the rating process for bank capital securities and the credit assessment underpinning it, please refer to our Bank Capital Instruments Rating Methodology.

<table>
<thead>
<tr>
<th>Typical notching structure for classes of bank debt securities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Issuer rating</td>
</tr>
<tr>
<td>Senior unsecured debt</td>
</tr>
<tr>
<td>Senior unsecured debt (subordinated)</td>
</tr>
<tr>
<td>Subordinated debt</td>
</tr>
<tr>
<td>Tier 2 debt</td>
</tr>
<tr>
<td>Additional Tier 1 debt</td>
</tr>
</tbody>
</table>

Bank holding companies/ non-operating holding companies

Although it is less widespread than in the US banking system, some European banking groups have a holding company structure – notably in the UK, Ireland, Switzerland and the Benelux countries. In line with the regulatory approach adopted in Europe, we consider the credit fundamentals of the entire banking group, i.e. on a consolidated group basis, when assigning an issuer rating to a holding company. Consequently, a holding company may be rated at the same level as an operating bank in a group. Meanwhile, the debt issued by the various entities in the group will be rated according to their ranking in the creditor hierarchy and within the context of the group.

Low issuer ratings

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

Banks under regulatory intervention

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

3.1. Covered bond ratings

We view covered bonds as part of the general on-balance sheet funding of a bank, a view further confirmed during the great financial crisis, when covered bonds managed to keep many banks afloat.
The introduction of resolution/bail-in regimes in several markets, e.g. the Bank Recovery and Resolution Directive in the EU, has had significant implications which are reflected in our separate methodology for covered bond ratings. The former base case for covered bond analysis – in which the cover pool becomes the sole source of repayment upon the insolvency of the issuer – has become unlikely in a resolution regime.

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

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

For more details, please see our rating methodology\(^1\) for covered bonds.

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Appendix: Financial ratios for banks

The financial ratios and metrics listed below are typically used in the analytical process for our bank ratings, in accordance with the present methodology. Not all ratios may be applicable to each rated bank, and bank rating reports typically do not include the entire range of these ratios. On occasion, we may use additional ad-hoc ratios for specific analytical aspects.

Figure 8: Financial ratios

<table>
<thead>
<tr>
<th>Earnings and risk exposures</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Net interest margin (%)</td>
<td></td>
</tr>
<tr>
<td>Net interest income/ average RWAs (%)</td>
<td></td>
</tr>
<tr>
<td>Net interest income/ operating income (%)</td>
<td></td>
</tr>
<tr>
<td>Net fees &amp; commissions/ operating income (%)</td>
<td></td>
</tr>
<tr>
<td>Cost/ income ratio (%)</td>
<td></td>
</tr>
<tr>
<td>Operating expenses/ average RWAs (%)</td>
<td></td>
</tr>
<tr>
<td>Pre-impairment operating profit/ average RWAs (%)</td>
<td></td>
</tr>
<tr>
<td>Impairment on financial assets/ pre-impairment income (%)</td>
<td></td>
</tr>
<tr>
<td>Loan loss provision/ average gross loans (%)</td>
<td></td>
</tr>
<tr>
<td>Pre-tax profit/ average RWAs (%)</td>
<td></td>
</tr>
<tr>
<td>Return on average assets (%)</td>
<td></td>
</tr>
<tr>
<td>Return on average RWAs (%)</td>
<td></td>
</tr>
<tr>
<td>Return on average equity (%)</td>
<td></td>
</tr>
<tr>
<td>Net loans/ assets (%)</td>
<td></td>
</tr>
<tr>
<td>Problem loans/ gross customer loans (%)</td>
<td></td>
</tr>
<tr>
<td>Loan loss reserves/ problem loans (%)</td>
<td></td>
</tr>
<tr>
<td>Net loan growth (%)</td>
<td></td>
</tr>
<tr>
<td>Problem loans/ tangible equity &amp; reserves (%)</td>
<td></td>
</tr>
<tr>
<td>Asset growth (%)</td>
<td></td>
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</tbody>
</table>

<table>
<thead>
<tr>
<th>Financial viability management</th>
<th></th>
</tr>
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<tbody>
<tr>
<td>Net loans/ deposits (%)</td>
<td></td>
</tr>
<tr>
<td>Liquidity coverage ratio (%)</td>
<td></td>
</tr>
<tr>
<td>Net stable funding ratio (%)</td>
<td></td>
</tr>
<tr>
<td>Common equity tier 1 ratio (%)</td>
<td></td>
</tr>
<tr>
<td>Tier 1 capital ratio (%)</td>
<td></td>
</tr>
<tr>
<td>Total capital ratio (%)</td>
<td></td>
</tr>
<tr>
<td>Leverage ratio (%)</td>
<td></td>
</tr>
<tr>
<td>Asset risk intensity (RWAs/ total assets, %)</td>
<td></td>
</tr>
<tr>
<td>Dividend payout ratio (%)</td>
<td></td>
</tr>
</tbody>
</table>