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How We Rate Banks

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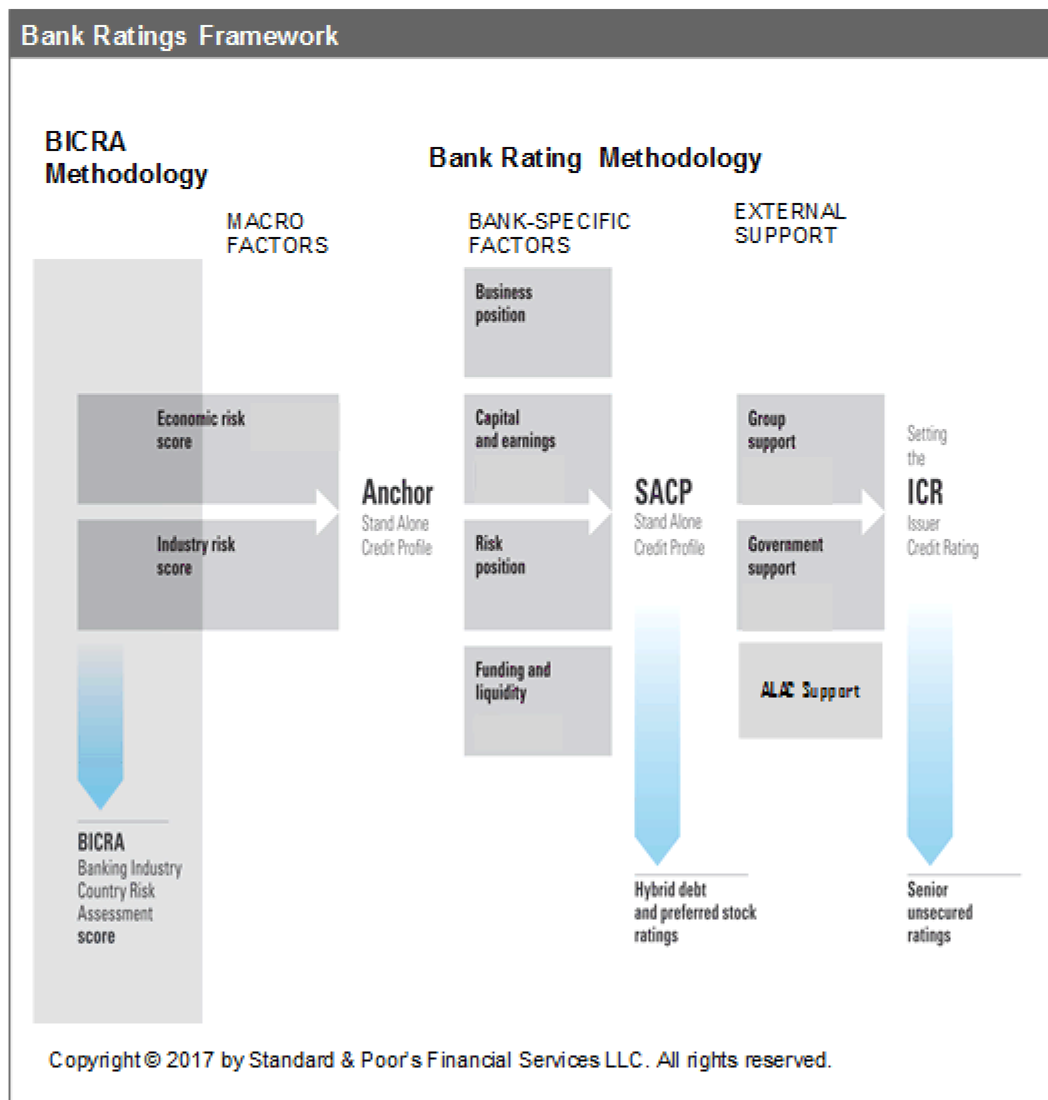
*(**Editor's Note:** We republished this article on Feb. 28, 2018, to update the contact list, website links, and references to related criteria articles. We also updated the chart to include references to additional loss-absorbing capacity (ALAC) as a form of potential external support.)*

This article provides in summary form a step-by-step guide to how our bank criteria work to produce an issuer credit rating. The process starts with our Banking Industry Country Risk Assessment (BICRA) methodology, a macro analysis of economic and industry risk. Next, we look at bank-specific characteristics: business position, capital and earnings, risk position, and funding and liquidity. Finally, we assess the likelihood of government and group support for the bank (see chart).

For a more comprehensive understanding of our approach, please read the following criteria documents, available on RatingsDirect:

- Banks: Rating Methodology And Assumptions, published Nov. 9, 2011
- Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
- Group Rating Methodology, May 7, 2013
- Bank Rating Methodology And Assumptions: Additional Loss-Absorbing Capacity, April 27, 2015
- Bank Hybrid Capital Methodology And Assumptions, Nov. 1, 2011
- Risk-Adjusted Capital Framework Methodology, July 20, 2017

The criteria apply to ratings on retail, commercial, and corporate and investment banks. The definition of a bank is broad and includes the larger broker-dealers, mortgage lenders, trust banks, credit unions, building societies, and custody banks. The criteria do not apply to ratings on finance companies, asset managers, exchanges, clearinghouses, and regional securities brokers.



BICRA Methodology: Macro Factors

Our BICRA methodology is designed to evaluate the strengths and weaknesses of the broader operating environment for banks by assessing economic and industry characteristics in a standardized framework. This allows for global comparison across all of the banks we rate.

The BICRA methodology scores two components: "economic risk" and "industry risk." Combined, these scores are then used to determine an anchor stand-alone credit profile (SACP), which acts as a starting point for determining a bank's SACP. The BICRA analysis rests on six "factors" that result in an economic and industry risk score for each country. Combined, these produce an overall BICRA score for a country. A factor that is assessed as high risk has greater weight in the assignment of a BICRA.

A BICRA is scored on a scale from '1' to '10', ranging from the lowest-risk banking systems (group 1) to the highest-risk

(group 10), with a time horizon of three to five years, similar to that of investment-grade ratings in the 'BBB' and higher categories.

The BICRA analysis incorporates the influence of government supervision and regulation of the banking system, including existing systemic support--such as emergency systemwide support programs. It excludes the potential for targeted government intervention and rescue of specific financial institutions.

The creditworthiness of a sovereign and its banking sector are in our view closely related. Many of the credit factors underlying a sovereign rating are important in determining a BICRA.

Economic risk

The BICRA economic risk score of the country (or countries) where a bank operates captures the economic risk it faces. BICRA economic risk scores range from '1' to '10', from lowest to highest risk.

Economic risk takes into account the stability and structure of a country's economy, its economic policy flexibility, actual or potential imbalances, and the credit risk of economic participants--mainly households and enterprises. The operating environment (economic, country, and industry) can have a strong influence on the credit dynamics of a bank.

When a bank is active in more than one country, we calculate a "weighted-average economic risk" for that bank. This is the average of the economic risk scores for the countries where the bank mainly operates, weighted by the proportion of its business (for lenders, of its loans) in each country.

Industry risk

A bank's industry risk is determined by the BICRA industry risk score for the country where it is domiciled and primarily regulated. The BICRA industry risk scores range from '1' to '10', from lowest to highest risk.

Industry risk assesses three structural features of a country's banking industry:

- The institutional framework, that is, the quality and effectiveness of bank regulation and the track record of authorities in managing financial sector turmoil;
- Competitive dynamics, that is, the competitive landscape and performance, financial products and practices, and the role of nonbank financial institutions; and
- Funding through the debt markets or government, including the role of the central bank and government.

Unlike economic risk, a bank's industry risk is not calculated as a weighted average when it operates in more than one country. The main reason for this is the importance and influence of the bank's home regulatory framework.

The Anchor SACP: Combining Economic Risk And Industry Risk

The rating methodology for banks uses the BICRA economic and industry risk scores to determine an anchor SACP. This essentially represents the baseline creditworthiness of a representative bank operating in that market.

The anchor SACP is a globally consistent, relative ranking of creditworthiness across national banking markets and ranges from 'a', the least risky, down to 'b-', the riskiest.

Table 1

Determining The Anchor SACP From Economic Risk And Industry Risk

	Economic risk*									
Industry risk*	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**
1	a	a	a-	bbb+	bbb+	bbb				
2	a	a-	a-	bbb+	bbb	bbb	bbb-			
3	a-	a-	bbb+	bbb+	bbb	bbb-	bbb-	bb+		
4	bbb+	bbb+	bbb+	bbb	bbb	bbb-	bb+	bb	bb	
5	bbb+	bbb	bbb	bbb	bbb-	bbb-	bb+	bb	bb-	b+
6	bbb	bbb	bbb-	bbb-	bbb-	bb+	bb	bb	bb-	b+
7		bbb-	bbb-	bb+	bb+	bb	bb	bb-	b+	b+
8			bb+	bb	bb	bb	bb-	bb-	b+	b
9				bb	bb-	bb-	b+	b+	b+	b
10					b+	b+	b+	b	b	b-

*On a scale from 1-10, lowest to highest risk where economic risk and industry risk scores are rounded to the nearest whole number prior to the application of the table. SACP--Stand-alone credit profile. From: "Banks: Rating Methodology And Assumptions," Nov. 9, 2011.

The SACP: The Result Of Bank-Specific Analysis

The SACP results from adding or subtracting a number of notches to the anchor SACP to take into account a bank's specific strengths and weaknesses. This is the case unless either of the following occurs: we expect an issue or issuer to receive extraordinary support in the very near term to prevent it from defaulting, and then the SACP is 'cc'; or when we assess a bank's "liquidity" as "moderate" or weaker, which caps its SACP. This analysis covers the following four areas:

- Business position,
- Capital and earnings,
- Risk position, and
- Funding and liquidity.

The assessment of each area (explained below) can raise or lower the SACP by one or more notches relative to the anchor SACP, or have no effect in some cases. The result is a bank's SACP, an interim step in assessing a bank's overall creditworthiness. The criteria typically place the SACP for an average bank in developed economies in the 'bbb' and 'a' categories, where the lowercase letters intentionally differentiate these credit profiles from issuer credit ratings. As a result, only banks with specific strengths in one or more of the four areas above may have higher SACPs.

Business position measures the strength of a bank's business operations. By strength, we mean specific operational features that add to or mitigate industry risk. The criteria group these features into three subfactors: business stability, concentration or diversity, and management and corporate strategy. Relative strength is assessed through a number of indicators. Where they are relevant and available, quantitative metrics are used, though much of the assessment is qualitative.

Capital and earnings measures a bank's ability to absorb losses. This ability provides protection to senior creditors while the bank remains a going concern. The analysis of capital and earnings comprises four steps:

- Assessment of regulatory requirements,
- Future risk-adjusted capital levels,
- Quality of capital and earnings, and
- Earnings capacity.

To assess capital and earnings, Standard & Poor's calculation of a projected risk-adjusted capital (RAC) ratio is the most important metric. The RAC ratio compares a bank's capital to its risk-weighted assets (RWAs). Specifically, the criteria use Standard & Poor's own globally consistent measure of capital, total adjusted capital (TAC), and its own calculation of RWAs. To arrive at the RWAs of a bank, we apply specific risk weights to the bank's various exposures.

The criteria for this factor measure the degree to which a bank's capital and earnings would cover estimated losses following a substantial economic stress for developed countries. The criteria make earnings a component of the capital analysis, rather than a separate rating factor, measuring a bank's capacity to absorb losses and build capital. In theory, a bank's product pricing includes a margin sufficient to cover the expected losses on its assets, which leaves capital to protect against unexpected losses.

Risk position serves to refine the view of a bank's actual and specific risks beyond the assumptions in the capital and earnings analysis. Those assumptions do not always fully capture the specific risk characteristics of a particular bank. The risk position analysis is similar to that traditionally applied to assess the asset quality of a bank.

Funding and liquidity combined are the final factor. How a bank funds its business, and the confidence-sensitive nature of its liabilities, directly affect its ability to maintain business volumes and to meet obligations in adverse circumstances.

The analysis of funding compares the strength and stability of a bank's funding mix, according to several metrics, with the domestic industry's average. The criteria use that average to remain consistent with the BICRA's assessment of systemwide funding.

The liquidity analysis centers on a bank's ability to manage its liquidity needs in adverse market and economic conditions, and its likelihood of survival over an extended period in such conditions. The analysis is both absolute and relative to peers.

The Indicative ICR: Considering The Relationship To The Parent Group Or Government

The support framework considers both the relationship between a bank and its parent group or government, and how this relationship affects a bank's overall creditworthiness. This focuses on extraordinary support and therefore goes beyond the system or direct support that we include in the SACP. The likelihood of extraordinary government support is based on the combination of a bank's systemic importance and a government's tendency to support banks. For a subsidiary, the likelihood of extraordinary group support is based on the bank's strategic importance to its parent group.

The SACP and support conclusions combine to produce the indicative ICR, a component of the ICR.

In practice, a bank's subsidiary normally receives support from either its parent group or its government. Accordingly, a bank that is a subsidiary typically is assigned the higher indicative ICR resulting from application of either the group support framework or the government support framework.

The indicative ICR will be the same as the SACP unless:

- The bank is likely to receive additional capital, liquidity, or risk relief from the government or the parent group in a crisis, or
- The bank is exposed to contagion risk in the form of calls from a distressed or less creditworthy parent group.

The Issuer Credit Rating: In Some Cases, A One Notch Adjustment To The Indicative ICR

In most cases, the ICR is at the same level as the indicative ICR. In some cases, the criteria allow for an ICR that is one notch higher or lower than the criteria for the SACP and extraordinary support imply. This adjustment of the bank's ICR considers its relative credit standing among all banks with a similar SACP, that is, the same or one notch higher or lower. In yet other cases, as in "Criteria For Assigning 'CCC+', 'CCC', 'CCC-', And 'CC' Ratings," published Oct. 1, 2012, an ICR of 'CCC+' or below is appropriate.

Hybrid Capital Issue Ratings: Generally Based On The SACP

The methodology for assigning an issue rating to a bank hybrid capital instrument is generally to notch down from the bank's SACP unless any of the following applies: near-term default risk suggests a rating of 'CCC+' or below; the issuer is a nonoperating holding company; we believe group or government support can accrue to the hybrid; or the issuer's ICR is lower than its SACP. The minimum notching for a bank hybrid capital instrument ranges from two notches below the SACP--if the bank's SACP is assessed at 'bbb-' or higher--to three notches below the SACP--if the bank's SACP is 'bb+' or lower. An issue rating is a forward-looking opinion that reflects the risk of nontimely or partial payment on a bank hybrid capital instrument and the subordination of the instrument. If an instrument shows a higher risk of nontimely or partial payment than the SACP assessment indicates, additional notching from the SACP applies.

Related Criteria And Research

- Risk-Adjusted Capital Framework Methodology, July 20, 2017
- Bank Rating Methodology And Assumptions: Additional Loss-Absorbing Capacity, April 27, 2015
- Group Rating Methodology, May 7, 2013
- Criteria For Assigning 'CCC+', 'CCC', 'CCC-', And 'CC' Ratings, Oct. 1, 2012
- Banks: Rating Methodology And Assumptions, Nov. 9, 2011
- Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
- Bank Hybrid Capital Methodology And Assumptions, Nov. 1, 2011
- Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010

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