Financial Institutions' Rating Methodology

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ARC's Criteria for Rating Banks and Similar Financial Institutions

This is an update to the methodology previously published in March 2019.
There are no material changes and as such no rating impact.

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I. CRITERIA SUMMARY

This criteria report is an update to the version published in March 2019 and has no material changes in respect of ARC's approach to rating Financial Institutions and therefore no rating impact. Please note that ARC has introduced a new section on Environmental, Social and Governance (ESG) factors with the aim of making ARC's approach to these factors clearer. The addition of these factors will not materially change our approach and thus no rating actions are expected.

II. INTRODUCTION

Incorporating both quantitative and qualitative factors, ARC's ratings reflect an evaluation of the financial institution's current financial position, as well as how the financial position may change in the future. In its quantitative analysis, ARC focuses on fundamentals, analysing an institution's historical and current financial performance. This is used as a foundation for developing expectations regarding the institution's future financial performance and risk profile, under both normal and stressed operating scenarios. Emphasis is also placed on assessing the operating environment (including both economic and industry risk), strategy, market position, diversification, depth of management, as well as risk management policies and procedures.

While ARC's methodology for rating banks and other financial institutions focuses largely on rating a financial institution's ability to honour its general obligations (i.e. deposits, borrowings and other liabilities) in a timely manner, it is also relevant to specific debt issues. ARC's methodology for rating banks and other financial institutions is relevant in the analysis of various types of entities, including, but not limited to, commercial and merchant banks, building societies, discount houses, finance and leasing companies, and other similar financial institutions. Moreover, this methodology is intended to be applied universally, and covers institutions with solely domestic or regional operations in a single market, as well as those with a broad franchise operating in multiple countries.

III. RATING METHODOLOGY

The following guidelines provide a general overview of the quantitative and qualitative factors that ARC considers when analysing a financial institution. For the sake of simplicity, this criteria report refers primarily to banks, although this term may, in most cases, be used interchangeably with building societies, discount houses, finance and leasing companies and other financial institutions.

ARC's opinions are based on a clear understanding of the fundamentals of the rated organisation and the industry in which it operates. These guidelines are intentionally broad in scope, recognising that the process of assigning credit ratings is a dynamic one, and that each specific entity possesses unique characteristics and assumes varying levels of risk.

ARC's analytical process focuses on the following eight fundamental factors:

1. Economic risk
2. Industry risk (including regulatory considerations)
3. Market position (including strategy)
4. Asset quality
5. Financial analysis
6. Management quality
7. Risk management
8. Environmental, Social and Governance factors

ARC also considers the likelihood of support from potential providers, typically shareholders, or (in the case of regulated banks), national government authorities.

In order to issue an opinion on a financial institution's ability and willingness to pay, ARC typically analyses the last five years of audited financial statements and most recent interim financial statements.

ECONOMIC RISK

Clearly understanding the fundamentals of the environment in which the bank operates is of foremost importance. This is especially the case in emerging markets, where the political and economic environments tend to be significantly more volatile. ARC focuses on the strengths and weaknesses of the country's economic and political situation, always bearing in mind the effects this could have on the banking industry, and accordingly, a rated institution.

Some of the most important aspects in examining the direct effects of the economy on the performance of the banking sector are the size of the economy, its composition and its growth prospects. The latter is especially important when considering the rate of monetary and credit growth in relation to economic growth, as well as the trends in savings and investment in the economy. ARC also places emphasis on understanding the potential structural problems facing the economy, correction of which may require policies that depress economic growth (e.g. structurally high inflation). These factors determine interest rates and demand for credit, and they significantly influence the bank's operating environment and accordingly its strategy, growth, liquidity and profitability.

Apart from this, ARC analyses the fundamentals of various other industrial sectors within the economy, concentrating on the structure and financial strength of the public and private sectors. In this process, the sectors that are most likely to be affected by an adverse movement in the economy are identified, as high exposure to such sectors could result on deterioration of the bank's asset quality.

INDUSTRY RISK

In understanding the risks inherent in the banking industry, ARC places great emphasis on analysing the basic structure of the banking system (including its relative size, regulatory environment, number of participants and transparency). It also assesses the disruptive potential of fintech start-ups on the established banking system.

Firstly, the percentage of funds in the economy that flow through the banking system, as well as the relative depth of capital markets, is considered. Cognisance is then taken of the dynamics of competition within the industry, including both bank and non-bank institutions. ARC examines the barriers to entry, consolidation trends, number of banks and bank branches relative to population, foreign participation, level of price sensitivity and market sophistication.

Significant emphasis is placed on the regulatory environment in which the bank operates. In this respect, the quality of the banking supervision framework is closely examined. Apart from an in depth understanding of the legislation governing the industry, ARC considers the instruments used to monitor the banking system, which includes the form and quality of reporting of banks to the regulatory authorities, as well as the frequency and quality of on-site examination and off-site surveillance conducted by the banking supervision authorities. The actions and measures that regulatory authorities are empowered to use in avoiding problems and potential failures of banks within the system are identified. To this end, ARC considers the level of solvency and liquidity support to banks from the relevant authorities.

MARKET POSITION

Once the operating environment of a rated institution has been analysed, ARC determines the market position of the bank based on its market share and core competences. Advantages and vulnerabilities arising from its market position are examined, with emphasis on diversification, strategy, management and systems.

As the success of a bank is reliant on its strategy and, to an extent, its ability to differentiate itself from other players in the industry, the bank's chosen target market and its position/ability to service this segment is scrutinised. To this end, diversity of products offered, as well as diversity of the bank's customer base is examined. This is important in establishing diversification of the bank's revenue streams and potential vulnerability with regards to dependency on a single product, market segment, geographical area and/or product type.

ASSET QUALITY

Asset quality reflects the quantum of existing and potential risks associated with the loan and investment portfolios, other real estate owned, and other relevant assets, as well as off-balance sheet transactions. The ability of management to identify, measure, monitor and control credit risk is also reflected here. The evaluation of asset

quality considers the adequacy of the impairment provision and weighs the exposure to counterparty, issuer, or borrower default under actual or implied contractual agreements. All other risks that may affect the value or marketability of an institution's assets, including, but not limited to, operating, market, reputation, strategic, or compliance risks, are also considered.

ARC's review of asset quality of a financial institution is based upon, but not limited to, an assessment of a wide range of evaluation factors. ARC forms an opinion on the adequacy of the institution's underwriting standards, the soundness of its credit practices, and the appropriateness of its risk identification practices. Particular attention is placed upon identifying the level, distribution, severity and trend of any non-performing assets, along with assessing the adequacy of the impairment reserve and other provisions. Off-balance sheet risks are carefully reviewed. An analysis of the bank's loan and investment book is carried out to identify the level of risk arising from any concentration, and the level of diversification present. The accumulation of excess counterparty risk in its trading activities is also considered. Finally, ARC assesses the adequacy of the bank's policies, procedures and practices in managing its assets and maintaining efficient controls and management information systems.

Therefore, it is important to understand the institution's credit culture. How loans or investments are made and underwritten, what approval processes exist and how they are complied with. The appraisal process, legal documentation and disbursement of funds are part of the broader transaction management. Portfolio management, including workout procedures, is also important as is the way in which a financial institution classifies its assets.

In some instances, lending to related parties or lending to high net-worth individuals may bear specific risks. Of course, the level of loan loss reserves, provisioning and write-off procedures are important as are reschedulings, their terms and frequency. For securities in a financial institution's portfolio, it is important to understand the composition. A large portion of government securities held by a financial institution may be a "safe" investment, but also impede its ability to lend to other sectors and enhance its profitability.

Market risk is an important aspect in reviewing the securities portfolio. Depending on regulatory provisions, an institution may have to mark-to-market certain securities in its portfolio. Depending on the weight that such securities have in the overall portfolio this may significantly impact day-to-day valuation of its assets and may cause credit impairment. Value at Risk (VaR) is applied by financial institutions to give them a snapshot of their trading portfolio. As many quantitative measures, it is constrained by lack of assessing future risks. Such mathematical factors as confidence levels and standard deviations with which VaR is calculated will influence its meaning to the rated institution and to ARC.

Key Quantitative Indicators:

- Non-Performing Assets (NPAs), net and gross;
- NPAs / total assets;
- Five-year annual growth of NPAs and total assets;
- Sectorial, product and currency composition of assets;
- Securitized assets/total assets;

- Concentration of assets;
- Securities / total assets;
- Government securities/total assets; and
- VaR.

ASSET COMPOSITION

ARC examines the composition of the bank's assets, including relative proportions in different asset classes exposed to credit risk (e.g. liquid assets, investment securities, loans and advances, etc). It is important to note that in examining the bank's asset composition, certain off-balance sheet exposures (e.g. contingent liabilities) are brought on balance sheet, whilst certain intangible items (e.g. goodwill) are subtracted from assets and, correspondingly, capital. Whilst cognisance is taken of the annual growth and year-on-year change in asset composition, particular scrutiny is placed on the bank's loan book.

CONCENTRATIONS

ARC focuses on identifying concentrations in the loan book by the type of loan, client, collateral, industry sector, geography and maturity. High exposures to individual clients (measured as a percentage of the bank's capital base) are also reviewed.

Some financial institutions offer only a single line of business (such as consumer or mortgage finance). Although the loan portfolios of such institutions are usually granular, i.e. well-diversified from a single-borrower perspective, concentration risk remains in the form of undiversified exposure to particular economic/industry variables (such as consumer health, or residential property prices). In such cases, an assessment of concentration risk is more explicitly linked with economic and industry risk assessments.

NPLS AND PROVISIONING

Any improvement or deterioration in asset quality can significantly influence the bank's profitability and its capitalisation. In assessing asset quality, ARC focuses on the breakdown of all credit exposures in arrears, as well as large individual non-performing loans ("NPLs"). Here changes in levels relative to past performance, as well as industry trends, are monitored. One of the most important aspects of the bank's asset quality is the level of provisions (impairments under IFRS) raised against NPLs, including both general and specific provisions (collective and individual impairments under IFRS), as well as interest suspended (which is not allowed under IFRS). Although cognisance is taken of the level and nature of the collateral held against NPLs, this is excluded from ARC's asset quality ratios. There are three main ratios measuring the level of asset quality, namely:

- Gross NPL ratio (gross NPLs excluding suspended interest as a percentage of gross advances excluding suspended interest), which calculates the general level of asset quality, trends in which indicate deterioration/improvement in asset quality;
- Net NPL ratio (net NPLs after suspended interest and provisions as a percentage of net advances after

suspended interest and provisions), which assesses the effect of provisions raised and determines the uncovered portion of NPLs; and

- Net NPLs/Capital, measuring the ability of the capital base to absorb potential bad debts.

Charge-offs (write-offs), the sale of NPLs, and recoveries are an important component of the asset quality analysis and can distort trends in asset quality ratios. As such, these aspects require specific assessment. For instance, a bank demonstrating an aggressive write-off policy could display a reasonable NPL position, when asset quality (in terms of loans granted) is in fact worse than its peers. Recoveries are an important indicator of the effectiveness of the risk management department.

ARC acknowledges that financial institutions with high-volume, granular loan portfolios, particularly when assets are of short duration, require a more dynamic assessment of NPL formation, arrears roll-rates and net write-off and provisioning metrics. This is because such lending (and related provisioning) is highly systems-driven, and underwriting may require intra-reporting period adjustment in response to changing market/economic conditions.

It is important to note that ARC does not consider collateral in calculating the key asset quality indicators, although the significance placed on security would differ from country to country.

FINANCIAL ANALYSIS

FUNDING AND LIQUIDITY

In evaluating the adequacy of a financial institution's liquidity position, consideration is given to the current level and prospective sources of liquidity compared to funding needs, as well as to the adequacy of funds management practices relative to the institution's size, complexity, and risk profile. In general, funds management practices should ensure that an institution is able to maintain a level of liquidity sufficient to meet its financial obligations in a timely manner. Practices should reflect the ability of the institution to manage unplanned changes in funding sources, as well as react to changes in market conditions that affect the ability to quickly liquidate assets with minimal loss. In addition, funds management practices should ensure that liquidity is not maintained at a high cost, or through undue reliance on funding sources that may not be available in times of financial stress or adverse changes in market conditions.

One of the main factors determining the bank's ability to continue meeting its obligations in a timely manner is the stability of its funding. Whilst the strength of the bank's funding base determines its ability to weather bad times, it also provides financial flexibility for growth during periods of stable financial performance. ARC examines the bank's funding strategy in establishing the main sources of funding (e.g. retail and wholesale markets) and the bank's presence and competitiveness in sourcing funding from these markets. Assessing the bank's funding capability requires an understanding of the local deposit market and the history of the franchise. The nature of the bank's deposit base determines the relative stability and influences its cost of funding.

In determining the strength of the bank's funding base, ARC focuses on the diversity of funding sources, examining concentrations in the deposit book by client, industry sector, geography and size. In addition, it is important to understand the flow of funds within the institution and, to this end, deposit flows and maturities are examined. Potential maturity mismatches between the bank's assets and liabilities are identified.

Cognisance is taken of management's philosophy and planning with regards to liquidity. ARC takes cognisance of an institution's ability to access debt in the capital markets, as well as the possession of assets that can be liquidated without a significant impairment to its value. In this respect, liquidity of assets is closely examined, and includes an assessment of the ability to liquidate short-term deposits and marketable securities, ability to sell or securitise loans, and any liquidity facilities with the central bank or other sources of asset liquidity. The liquidity ratios focused on, include:

- Total cash and liquid assets as a percentage of total assets;
- Total cash and liquid assets as a percentage of total deposits; and
- Total cash and liquid assets as a percentage of total short-term liabilities.

CAPITAL ADEQUACY

A financial institution is expected to maintain capital commensurate with the nature and extent of the risks to the institution. ARC begins its review of capital adequacy by looking at local regulatory requirements and understanding the basis for capital measurement.

The focus is on tangible capital, as well as a bank's ability to grow its capital base through the retention of its earnings. In this process, the composition and quality of the bank's capital are examined, including levels of common equity, preferred stock, convertible and subordinated debt, minority interests, asset revaluation and unrealised capital gains, as well as loan loss reserves. In order to take a more conservative stance in assessing the level of the bank's capital adequacy, certain intangibles and goodwill are excluded from the capital base in ARC's analysis.

The types and quantum of risks inherent in an institution's activities will determine the extent to which it may be necessary to maintain capital at levels above the minimum capital requirements ("MCR"), as dictated by local regulations or the Basel Committee.

The nature, trend and volume of problem assets (including off-balance sheet activity) and the adequacy of impairment provisions are vital factors in determining capital adequacy.

The risk exposure from off-balance sheet activities varies between institutions but must be considered in the capital evaluation. The volume and nature of business transacted in a fiduciary capacity can be significant in the assessment of capital needs.

Contingencies where the bank is acting in a fiduciary or non-traditional banking capacity can expose the bank to surcharges, and therefore operations, controls, and potential exposures must be carefully appraised. Similarly, lawsuits involving the bank as defendant or any other contingent liability, such as off-balance sheet lending, may

indicate a need for a greater level of capital protection.

A bank's current and historical earnings record is one of the key elements to consider when assessing capital adequacy. Good earnings performance enables a bank to fund asset growth and remain competitive in the marketplace, while at the same time retaining sufficient equity to maintain a strong capital position. The institution's dividend policy is also of importance. Excessive dividends can negate even exceptional earnings performance and result in a weakened capital position, while an excessively low dividend return lowers the attractiveness of the stock to investors, which could compromise investor participation should the bank need to raise additional equity. Generally, earnings should first be applied to the elimination of losses and the establishment of necessary reserves and prudent capital levels. Thereafter, dividends can be disbursed in reasonable amounts.

The continued adequacy of capital as reflected in the growth in equity in relation to the growth in assets is of critical significance to ratings as a reflection of risk. A bank's ability to grow its capital base through the retention of its earnings is paramount. In general, a solid capital base provides a basis for growth, finding funding alternatives and creating loan loss provisions. Management's ability to adequately plan for and manage growth is important with respect to assessing capital adequacy. A review of past performance and future prospects is a starting point for this review. ARC compares asset growth to capital formation during recent periods, and also reviews current budgets and strategic plans to evaluate growth plans. Through this analysis, management's ability to both forecast and manage growth is assessed.

Management's ability to address emerging needs for additional capital depends on many factors. A few of these factors include earnings performance and growth prospects, the financial capacity of the directorate, and the strength of the parent company, if any. A combination of ratio analysis and judgement is utilized to address this evaluation factor.

Whilst ARC focuses on the absolute quantum of the bank's capital base in order to assess its ability to weather extraordinary and unexpected losses that could arise, the bank's access to external sources of capital and long-term funding is taken into consideration as well. Subordinated shareholder loans, where evidence of the subordinated nature exists, are typically included under shareholders' equity by ARC.

In general, a solid capital base provides a basis for growth, finding funding alternatives and creating loan loss provisions. The bank's capital ratios are to a great extent determined by the regulatory requirements and ARC compares the bank's capital adequacy position with domestic capital requirements. Qualifying primary and secondary capital is compared with the perceived level of risk in a rated institution's business. Here, the Risk Weighted Capital Adequacy Ratio (RWCAR) is considered to be amongst the most important parameters of the bank's capital adequacy. In addition to the RWCAR, ARC focuses on a number of other ratios, including:

- Internal rate of capital generation;
- Dividend payout ratio (and conversely earnings retention ratio);
- Total capital as a percentage of total assets;
- Total capital as a percentage of total advances; and

- The ratios of Tier 1 and Tier 2 (primary and secondary) capital to risk weighted assets.

RATIO ANALYSIS

The rating reflects not only the value and trend of earnings, but also factors that may affect the sustainability or quality of earnings. The value, as well as the quality of earnings can be affected by excessive or inadequately managed credit risk that may result in loan losses and require additions to provisions, or by high levels of market risk that may unduly expose an institution's earnings to volatility in interest rates. The quality of earnings may also be diminished by undue reliance on extraordinary gains, non-recurring events or favourable tax effects. Future earnings may be adversely affected by an inability to forecast or control funding and operating expenses, and the exposure to other risks improperly controlled. The rating of an institution's earnings is based upon, but not limited to, an assessment of the following evaluation factors:

- The level of earnings, including trends and stability;
- The ability to provide for adequate capital through retained earnings;
- The quality and sources of earnings;
- The level of expenses in relation to operations;
- The adequacy of budgeting systems, forecasting processes and management information systems in general;
- The adequacy of provisions to maintain acceptable levels of loan loss reserves; and
- The exposure of earnings to market risks such as interest rate, foreign exchange and other price risks.

One of the key factors in assessing the long-term viability of any organisation is profitability. The first step is to examine the split between interest and non-interest income and the bank's relative dependency on certain types of income. Here, ARC analyses how successful the bank has been in optimising the risk/return trade-offs in each of its key businesses. Every significant item on the income statement is examined in detail, determining year-on-year movements in various types of income and expenses. In measuring the bank's relative profitability, some of the most important ratios considered are:

- Interest margin (net interest income as a percentage of gross interest income), which identifies the profitability with respect to interest earned and interest paid (i.e. cost of funding);
- Net interest margin (net interest income as a percentage of total interest earning assets), measuring the interest earned relative to the asset base;
- Non-interest income as a percentage of total operating income;
- Cost ratio (total operating expenses as a percentage of total operating income), measuring the bank's cost efficiency;
- Bad debt charge as a percentage of total operating income; and
- Return on average equity ("ROaE") and return on average assets ("ROaA"), assessing the level of overall

profitability.

For certain types of financial institutions, in particular, single-product businesses, or those with high-volume, granular portfolios, additional measures of relative profitability may include portfolio yield and cost (operational, financial and credit loss) coverage considerations, as well as "per client" profitability measures. ARC determines the appropriateness of profitability measures on a case-by-case basis, with reference to the specific nature of the financial institution's business.

The quality of the bank's profitability and efficiency ratios to a large extent determine the bank's long-term prospects. In addition to this, based on the comparison between historical financial performance and the original budgets, ARC assesses the accuracy of the new budgets in determining future prospects.

CORPORATE GOVERNANCE AND MANAGEMENT QUALITY

ARC expects that all financial institutions it rates have a strong corporate governance framework, including high levels of financial transparency. Corporate governance principles are not always legally enforceable and are very often implemented through recommendations and best practices. Thus, it is as important to understand the corporate culture within an organisation and to take note of more subjective measures of strong corporate governance. ARC will review the issuer corporate governance principles, guidelines and application and will highlight any material concerns or faults.

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

The experience and depth of management, including its track record, ability to manage through stressful periods, ability to manage new business lines, and the presence of clear and established management succession plans, is also evaluated. One of the focal areas in the analysis of the bank's performance is an evaluation of the quality of the strategic and financial planning. For this purpose, ARC uses a comparison of the bank's financial results with management's plans and budgets.

Another of the focus areas that ARC evaluates is the level of sophistication and quality of the bank's information technology systems. Here, emphasis is placed on storing and retrieval of data, both in individual branches and in

the entire network. As it affects both the quality of operations and services delivered, ARC examines the type of network, as well as the communication systems in place. A bank's position relative to its peers in available technological advances can affect the bank's market position. In addition, risk management procedures enhanced by high quality information systems provide for better monitoring and lower risk.

RISK MANAGEMENT

The ability of management to identify, measure, monitor and control the risks in its operations carries an inordinate amount of weight when assigning a rating. The adequacies of, and conformance with, appropriate internal policies and controls addressing the operations and risks of significant activities through effective risk management systems and procedures, is carefully evaluated. It is recognised, however, that appropriate management practices vary considerably between financial institutions, depending on their size, complexity and risk profile. For less complex institutions engaged solely in traditional banking activities and whose directors and senior managers, in their respective roles, are actively involved in the oversight and management of day-to-day operations, relatively basic management systems and controls may be adequate. At more complex institutions, on the other hand, detailed and formal management systems and controls are needed to address their broader range of financial activities and to provide senior managers and directors, in their respective roles, with the information they need to monitor and direct day-to-day activities. All institutions are expected to properly manage their risks.

It is important that ARC gains an in-depth understanding of the institution's risk management policies and procedures. The risk management structures (including the structure and authority of various risk committees and subcommittees) and policies with regards to credit and market risk, as well as asset and liability management, are particularly scrutinised.

ARC examines the bank's underwriting criteria, the credit approval process, levels of credit approval authority (including the delegation of such authority within the organisation) and collateral valuation. The level of sophistication and stringency of the bank's monitoring of credit exposures, once a facility has been approved and credit extended, is also very important. The monitoring of credit exposures determines the bank's ability to identify potential problems and proactively manage its asset quality. Here, ARC focuses on the credit review function, internal credit rating system and the role of the audit department. With regards to problem assets, the bank's policy concerning classification of advances in arrears and the level of bad debt provisions (specific including suspended interest and general provision), as well as the manner in which problem credits are handled, are considered. Recovery procedures and collateral foreclosure policies are also reviewed.

Market risk reflects the degree to which changes in interest rates, foreign exchange rates, commodity prices, or equity prices can adversely affect a financial institution's earnings or economic capital. When evaluating this factor, consideration is given to: management's ability to identify, measure, monitor and control market risk; the institution's size; the nature and complexity of its activities; and the adequacy of its capital and earnings in relation to its level of market risk exposure. For many institutions, the primary source of market risk arises from non-trading

positions and their sensitivity to changes in interest rates; for others, trading activities and foreign operations are a major source of market risk.

The level of liquidity, interest rate and other market risk is to a great extent determined by the bank's Asset Liability Management (ALM) policies and acceptable risk guidelines. In examining these, the structure and authority of the bank's Asset and Liability Management Committee ('ALCO') is considered. ARC examines the policies of the ALCO, as well as the various limits ALCO sets with respect to relevant risks, and the impact of its decisions on the bank's daily risk management.

The balance between the bank's interest rate sensitive assets and liabilities is analysed using traditional gap measures. Finally, the institution's use of derivative instruments and other off-balance sheet instruments are reviewed, in order to understand the nature of these exposures, and in the case of hedges, the risks being managed and the effectiveness of methodologies employed.

LIKELIHOOD OF SUPPORT

In the case of need, financial institutions often have access to extraordinary support from shareholders (institutional support) and/or national government authorities (sovereign support). This typically takes the form of financial support. While the potential for institutional support applies to all financial institutions, sovereign support is usually limited to regulated banks/other deposit-taking institutions and is typically undertaken (on a contingent basis) only when a potential bank failure represents a significant systemic risk, and with the ultimate aim of maintaining financial market stability.

Accordingly, the likelihood of support (which encompasses both willingness and ability to support) from either shareholders or government authorities is an important consideration in determining a bank's credit rating.

When assessing the likelihood of support from shareholders (which is explicitly taken into account in the rating process, often using a notching approach), ARC considers the following factors to determine the ability and willingness of shareholders to extend support:

- Shareholders' financial strength/credit ratings;
- The presence or absence of a controlling shareholder;
- Parent / group regulation that might impede the flow of support (in particular, where parents / shareholders are foreign domiciled); and
- The relative size and importance of a bank subsidiary relative to the consolidated group.

When analysing the likelihood of support from government authorities (which implicitly forms part of the assessment of, for example, industry risk and market position), ARC considers the following factors:

- The existence of a "lender of last resort" – typically the central bank – and accessibility of the discount window;

- The existence of clear legislation detailing troubled bank resolution;
- The track record of banking sector support;
- The bank's eligibility for support, and the regulatory construct of the bank being analysed;
- The systemic importance of the bank;
- The ownership structure of the bank (whether government, local or foreign-owned); and
- The liability structure of bank (domestic/foreign, wholesale/retail).

While the foregoing discussion of financial support highlights capital support, and mainly contemplates a single bank in financial difficulty, it should be noted that sovereign support could take other forms, including liquidity support and relaxation of regulatory norms, and may also be provided to several banks at once, in the event of market shocks.

ENVIRONMENTAL, SOCIAL AND GOVERNANCE FACTORS

ARC's rating actions are always based on a holistic analysis of the issuer and issue to be rated with the goal of identifying all relevant aspects, including environmental, social and governance factors, that might impact the issuer's capacity and willingness to pay in due time and in full its obligations. Furthermore, ARC always takes the most forward-looking perspective that the current knowledge about these risks permits, acknowledging that in the case of some ESG factors (climate change or demographics are examples) the credit impact of such factors will only be known over a very long time horizon, making an accurate quantification of its potential impact impossible. Therefore, ARC will try to incorporate these into its ratings mostly through qualitative analysis. Within this broad context ARC must highlight that governance factors are usually the most relevant factors to impact creditworthiness and therefore these are covered in the Corporate Governance and Management Quality section of this methodology (see above). Environmental and social factors are also captured and highlighted in ARC's analysis whenever it is considered that these might have a material impact on credit quality.

For financial institutions ratings, usually the most relevant environmental factors are contained with the environmental policy of the financial institutions, specific areas of focus would be:

- Air pollution.
- Energy management.
- Water and wastewater management.
- Exposure to climate change and extreme natural disasters / events.

We assess both the consequences (effective or potential) from the environmental factors, as well as the impact of regulatory or policy initiatives aimed at minimizing or preventing the deterioration of these environmental factors.

And the most relevant social factors are:

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

ESG factors typically may differentiate ratings between different sectors, but generally will only differentiate ratings from issuers within the same sector when an issuer is unusually strong or weak in a specific ESG factor.

Where ESG factors are a key driver behind the assignment or change of a credit rating or rating outlook this will be outlined, the ESG factor that was considered a key driver identified and its materiality will be explained in the accompanying press release or report.

CONCLUSION

While thorough quantitative analysis is important, the qualitative characteristics of ARC's analysis cannot be overemphasised. It is critically important to look "beyond the numbers" and to evaluate the intangible strengths and weaknesses of an entity. At the core of ARC's analysis is the understanding of the strategic characteristics of an organisation and the quality of management. Our emphasis is on determining how these strategic aspects will affect the organisation's flexibility and capacity to weather adverse market circumstances.

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