Banking Criteria

Rating Criteria

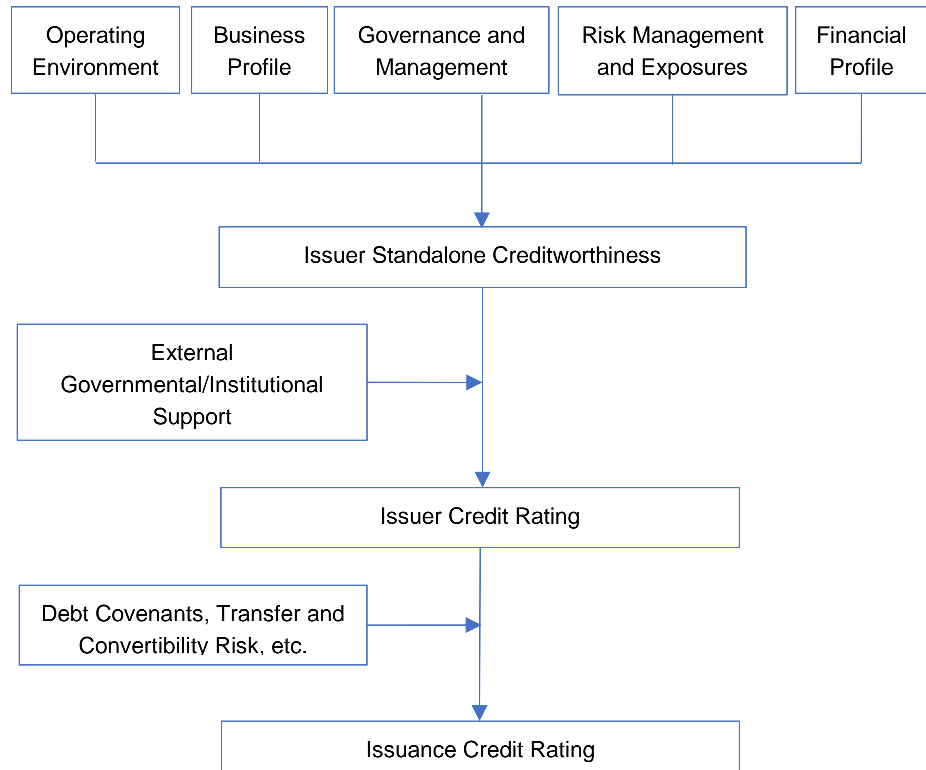
Scope of the Criteria

Lianhe Ratings Global Limited (“Lianhe Global”) applies the banking criteria to banks globally, including commercial and policy banks. Banks are financial institutions that take deposits, grant loans, and offer financial products and services to individuals and businesses and are subject to prudential regulation. We may apply the criteria to the other types of financial institutions (such as credit unions), with borrowing and lending as their core business activities. Furthermore, the criteria do not represent a comprehensive coverage but only address key rating factors.

Overview

The criteria report explains Lianhe Global’s general approach to assessing a bank’s standalone credit profile and the likelihood of external support that the entity will receive in case of need, i.e. to sustain a bank’s viability. We incorporate the availability of external support into the assessment of the bank’s standalone credit strength to assign a credit rating to the bank.

The diagram below illustrates the topology of the criteria:



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Standalone Creditworthiness Analysis

The assess analysis of a bank's standalone creditworthiness is assessing the probability of the bank that will default or need to receive external support to avoid a default. We use a combination of qualitative and quantitative analysis to assess five key credit factors: the operating environment, business profile, governance and management, risk management and exposures, and financial profile.

The standalone assessment considers operational support, from which a bank benefits in the usual course of business, including the access to central bank liquidity and supports (such as complementary product offerings, funding facilities and knowledge and information sharing) from its parent and affiliates, if any. In addition, ratings assigned are based on our forward-looking expectations. We assess a bank's financial history as well as its strategy and business model to arrive at a forward-looking view of its credit profile.

Key Credit Factor	Sub Factor
Operating Environment	Sovereign Rating
	Macroeconomy
	Legal and Regulatory Environment
	Banking Sector Profile
Business Profile	Franchise and Market Position
	Business Mix and Diversification
Governance and Management	Corporate Structure and Governance
	Management Quality
	Business Strategy and Execution
Risk Management and Exposures	Risk Policy and Framework
	Credit Risk Profile
	Market Risk Exposure
Financial Profile	Capital Adequacy
	Asset Quality
	Profitability
	Liquidity and Funding

Operating Environment

The operating environment often has a significant influence on the other aspects of a bank's credit profile. Weakening sovereign strength can affect the credit quality of a bank operating in that jurisdiction as the deterioration usually relates to economic weaknesses or system-wide issues. A volatile economic environment may impair a bank's earnings stability and asset quality. Competition tends to be intense in a fragmented banking sector, while concerns over corporate governance and transparency are usually more pronounced within an underdeveloped legal system and regulatory framework.

Sovereign Rating

Sovereign strength often has a significant impact on a bank's credit profile domiciled in that country. In limited circumstances (such as with a strong overseas presence), a bank's rating may exceed the sovereign rating.

We use an internal assessment to gauge sovereign ratings and believe our internal assessments on sovereign nations are not expected to be materially different from the market consensus. We apply both commonly accepted quantitative and qualitative metrics to conduct the sovereign analysis. In addition, we apply elements from recognised third-party indexes such as World Bank's Worldwide Governance Index, Human Development

Index, Easy of Doing Business Index to maintain neutrality and objectivity in our analysis. We believe these indexes provide us with a platform to conduct our analysis in a non-ideologically biased setting.

Macroeconomy

A country's economy usually affects a bank's operation through its impact on the business and financial environment. Factors taken into consideration include the stage of economic development, and the economic growth pace and expectations. We also consider other attributes that may affect the healthiness of the economic environment. This may include the aggregate indebtedness of the country and growth, the stability of interest rates and exchange rates, inflation rates and employment and demographic prospects.

Legal and Regulatory Environment

A well-established legal system and regulatory framework contribute to the stability of the banking sector. We consider that a comprehensive and effective legal system should provide adequate protection to property and creditor rights, and have a reliable, efficient and independent justice system. A prudent regulatory banking system often requires a market-based regulatory and supervisory framework with an independent authority. The regulator has willingness and capability to intervene and enforce laws and regulations, including dealing with problematic banks and potential contagion risk. Internationally comparable accounting standards and proper auditing procedures are also important to ensure the reliability and integrity of financial information.

Banking Sector Profile

The market structure and competitiveness affect a bank's business strategy and development. An oligopolistic market may create an obstacle for new participants and protect existing banks' franchise and market position. However, deregulation may encourage banks to focus on capital adequacy and operating efficiency and to put emphasis on shareholder value. We analyse the banking sector profile by looking at the size and number of market participants, products and services provided, business growth, deregulation of financial services and opening up to international competition.

Business Profile

A bank's business profile, franchise and competitive position influence its current financial performance and creditworthiness and the sustainability for a long run.

Franchise and Market Position

A bank's franchise value is usually reflected in its resilient and sustainable market position, comprehensive product and service offerings, and wide market coverage. Large banks generally have a competitive advantage with business leadership and pricing power as well as the benefit of economies of scales. However, small market presences may be offset by a sustainable business model in a specific region or in niche product or client segments.

Being part of a larger (typically financial) group can be beneficial to a bank's franchise with the access to a larger clientele base and business synergies from non-banking businesses. Conversely, reputational and contagion risks may arise should its affiliates have weaker credit profile.

Business Mix and Diversification

Diversified revenue streams from various business lines and regions can support a bank's earnings stability through economic and credit cycles. On the other hand, a concentrated business profile (e.g., a high reliance on volatile activities, such as securities trading) can cause high earnings volatility and risk concentrations.

Governance and Management

Prudent governance and professional management is essential for the achievement of a bank's business and financial objectives and ensuring good internal control and in compliance with regulatory requirements.

Corporate Structure and Governance

Prudent governance practices support a bank to achieve long-term business success and financial stability. The board members (directors) are elected by the shareholders to oversee the bank's interest in the long-term health and the overall success of the business and financial strength. We examine features (including but not limited to) such as the ownership and organisational structure, reporting hierarchy, board composition and independence, board committees, related party transactions, material litigations, and prior regulatory sanctions, etc.

A complex and opaque organisational structure, including layers of intermediate holding companies, may raise concerns over effective management, corporate governance and inappropriate intra-group transactions. Publicly listed entities usually have better disclosures and governance practices as they must abide by both listing and regulatory rules. However, private-owned institutions are not necessarily calls for concern.

Management Quality

Professionalism and integrity are two important features in quality management. A solid management team shows good credibility and competence. It manages business in a professional and ethical manner and has a proven record of achieving an institution's business and financial goals. The remuneration scheme is established to ensure the alignment of the management's interests and risk preferences with those of the organisation and its stakeholders. Mitigations of key man risk (such as an established succession plan) are also essential especially for an institution with a reliance on a specific individual or a few individuals.

Business Strategy and Execution

Business objectives give a bank a guideline and direction from where to start and where the organisation is going, while successful execution turns strategic objectives into performance. The objective setting should be clearly-defined, measurable, and achievable. It takes into account the bank's operating environment, business model, management expertise, and competitive position, and balances risks and rewards.

Risk Management and Exposures

Risk control is an integral part to support a bank's credit strength and resilience throughout an economic cycle. An effective risk management can help the bank identify, measure, monitor, and control or mitigate risks and protect the institution's capital base and earnings without hindering growth.

Risk Management Framework

A sound risk management framework should be able to identify the risk universe and quantify specific and aggregate risk exposure, as well as potential loss. Risk mitigation mechanisms are well established to ensure the risk levels remain at an optimal threshold. Risk policies and governance clearly define and segregate duties and assign authority to employees, committees and the board for approval and execution of various risk limits and exceptions to limits.

Credit Policy and Profile

Credit risk is the risk that a customer or counterparty in a transaction may default. It arises from the lending, trade finance, treasury and other activities undertaken by a bank. We examine a bank's credit policy and underwriting standards, including its lending criteria, collateral requirements, concentration limits and impairment and provisioning policies, as well as the soundness of its internal credit rating system, scorecards, or third-party databases such as credit bureaus. Quantitative aspects mainly focus on the degree of borrower, sector and geographic concentrations of its lending business, loan-to-value ratios, provision coverage, and off-balance-sheet exposure.

Liquidity and Capital Management

Liquidity is generally defined as the ability of a bank to meet its debt obligations without incurring unacceptably large losses. A healthy liquidity profile often requires effective liquidity analysis and projections to identify potential funding issues, diversified funding sources with a broad depositor base, sufficient liquidity cushion, and contingency funding plans in place. Liquidity projections should be made under both normal conditions and a range of stress scenarios. Early warning indicators for liquidity shortages also help the bank take pre-emptive actions.

Effective capital management identifies a bank's capital needs for various business activities depending on the risks taken by each business division and in accordance with the requirements of relevant regulatory authorities. It helps ensure the bank's capital adequacy is commensurate with the risk involved and in compliance with relevant statutory limits, taking into account business growth, dividend pay-outs, potential capital market volatility and other relevant factors.

Market Risk

Market risk refers to the risk of incurring losses due to fluctuations in the value of a bank's assets and liabilities caused by market movements, including the changes in interest rates, prices of securities and exchange rates. We assess the scale of the risks relative to the bank's ability to absorb the impacts of sudden and substantial market movements and the bank's control mechanisms and hedging practices to monitor and mitigate the risks. Quantitative measures usually include value at risk (VaR), stop-loss limits, concentration limits (by product, counterparty, industry and region), sensitivity analysis and stress testing.

Operational Risk

Operation risk arises from employee misconduct, inadequate or failed internal procedures and processes, inadequate management of information and other systems, as well as unforeseeable external events. A bank should implement monitoring systems for operational risk exposures and losses for major business lines and enforce control or mitigation mechanisms through regular internal auditing. Infrastructure investments should commensurate with the nature of the business.

Financial Profile

We examine a bank's financial profile by analysing key financial metrics, including their historical trends, stability and expectations. We may reclassify items derived from the bank's financial statements to fit our standard spreadsheets and ratio calculations for greater comparability across regions and/or for better measurements of the bank's financial position. Common treatments may involve excluding nonrecurring gains/losses from operating profits, deducting intangible assets from eligible capital, or including restructured loans in impaired loans.

Capital Adequacy

Capital serves as a buffer that absorbs losses and sustains a bank's viability. Stringent capital requirement prevents a bank from taking excessive risk and increases incentives for better risk management to safeguard shareholders' equity. Adequate capitalisation also helps maintain both public and regulatory confidence in a bank. The absolute size of a bank's capital, its composition (core and supplementary capital), and capital adequacy ratio are key financial metrics.

Asset Quality

Analysis of a bank's asset quality primarily focuses on the loan portfolio as it accounts for the largest portion of total assets and has a prominent influence on a bank's credit profile. Absolute and relative loan growth rates (compared with industry averages and the underlying economic growth) help assess a bank's risk appetite and asset quality trend. We also inspect other on- and off-balance sheet credit exposures to have a sound understanding of the overall asset quality. Key financial metrics include classification of loans according to their performance and provisions made against them, the ratio of impaired loans to gross loans, and loan impairment charges to gross loans.

Profitability

Internal earnings generation capability is important to support a bank's capital adequacy and future business expansion. We look at the level of profitability and earnings quality, diversification and stability. Key financial metrics include returns on assets/equity, net interest margins, contributions of fee-based income, impairment charges to pre-provision profits, and the cost-to-income ratio. We may exclude nonrecurring income/expenses in the ratio calculations if deemed necessary.

Liquidity and Funding

To remain viable, a bank must have enough liquid assets to meet its near-term obligations, such as withdrawals by depositors. Key financial metrics include loan-to-deposit and liquidity coverage ratios (the amount of high-quality liquidity assets against stressed cash outflows over a prospective 30 calendar-day period) to measure the margin of liquidity a bank has retained. We also analyse a bank's funding structure. Core deposits are typically funds of local customers left at a bank due to convenience or through loyalty. Non-core deposits/wholesale funding are sources that can be very sensitive to changes in the credit risk profile of the bank or to interest rate movements.

External Support Assessment

External support typically comes from the governmental authorities of the country/region where the bank is domiciled or from the bank's shareholders. Governmental authorities include the government of the nation, any political subdivision thereof, whether state or local,

and any agencies and regulatory bodies pertaining to the government. We assess both the capability and willingness of the potential supporter to provide assistance to sustain the bank's viability.

Government Support

We consider that the government's long-term rating best captures its capability to provide support to a bank. However, a very large banking system may constrain the authority's ability to provide sufficient support.

A bank's government ownership, systemic importance, and policy role are key considerations in assessing the public authority's willingness to provide support. The government statements on the intention to bail out failed banks and track record of support also help gauge the propensity.

A meaningful or long-term strategic government ownership or a private bank with strong government relations may indicate the authority's high tendency to provide support. Support for a systemic important or policy bank is more likely as their failure may cause substantial disruption to the financial system stability and the national economy. An important policy role is usually broad and difficult to be performed by another entity. A systemic important bank often represents a meaningful market share in deposits or loans in the banking system or owns a niche franchise in a region of the country or in a specific business segment.

Institutional Support

The institutional parent's credit strength as reflected in its issuer rating, its relative size to the banking subsidiary, and relevant regulations governing the group's operations (particularly the capital and liquidity flows within the group) affect the parent's ability to provide support. In cases where the parent's rating has factored in potential government support, we assess whether this support would flow through to the subsidiary.

The strategic importance of the bank to its parent is usually the key factor in assessing the parent's willingness to provide support. The likelihood tends to be high should the subsidiary bank represent an essential part of the group's operation, carry the same brand name, and its failure may bring reputational risk to the group.

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