Criteria Report

Launch of Fitch's Bank Support Rating Methodology

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Summary

On 16th April 2003 Fitch Ratings issued a "Comment" titled "Fitch announces new Support rating methodology". This included the undertaking that: "as regards the reformulated Support ratings, which will result from the adoption of the new methodology, Fitch intends to test these in presentations to investors and to allow those institutions, which have the existing ratings built into their information systems, time to adapt before they are introduced. Fitch, therefore, expects that the new methodology will not be formally launched until mid-July of this year. The agency intends to publish an announcement of the details of this in mid-July."

The process of assigning new Support ratings to all banks that currently have such ratings from Fitch is now complete. We have today posted to the Fitch Ratings website a list of all the banks (also sortable by country), showing their Support ratings under the new and the old methodologies. It is available free of charge on www.fitchratings.com by selecting 'Sectors'/'Banks and Securities Firms'/'New Support Ratings List'.

It should be stressed that, although both the old and the new ratings are designated in terms of the same numeric scale (1-5), the new support ratings are based on a revised methodology and new rating definitions. It would, therefore, be incorrect to refer to Support ratings having been raised or lowered as a result of the change in methodologies. It is, nevertheless, interesting to note how banks in aggregate have migrated from the old scale to the new, and we attach such a migration analysis (**Annex 1)**.

In the interest of completeness we also attach as **Annex 2** the appendix to the 16th April announcement, which provided definitions of Individual and Support ratings. The only modifications we have made to this are that the "preliminary" Individual ratings definitions are unchanged but have become final and the Support ratings definitions have been slightly modified. In regard to the Individual ratings the 16th April announcement stated: "Publication of finalized, revised ratings definitions will coincide with the introduction of the new Support ratings at the end of the consultation period." As indicated, it proved not to be necessary to revise the "preliminary" definitions, and we are currently engaged in adjusting banks' Individual ratings to conform with the attached definitions. We hope to have completed this exercise by the end of this year and do not consider that it will have any appreciable effect on banks' existing Individual ratings.

As those who have perforce followed the progress of the reform of Fitch's Support rating methodology must have appreciated, it has proved to be a long and laborious process. Nevertheless, we trust that investors and subscribers will agree with us that the changes result in a considerable improvement in the value added by the full range of Fitch Ratings' bank ratings.

Annex 1

Migration of Support Ratings

Old		New				
Rating	Total	1	2	3	4	5
1	41	37	4	0	0	0
2	221	55	154	12	0	0
2T	16	0	0	16	0	0
3	171	104	61	6	0	0
3T	13	0	0	12	1	0
4	245	4	15	135	84	7
4T	132	0	0	17	69	46
5	329	3	1	5	8	312
5T	95	0	0	0	3	92
Total	**1,263**	**203**	**235**	**203**	**165**	**457**

The analysis above shows that there is now a more even distribution of banks across the whole Support rating scale. There is a variety of explanations for this. First, the majority of former 3s have migrated to 1 or 2, reflecting the strength of their potential institutional support. Ratings assigned under the new methodology no longer distinguish the source of support (sovereign versus institutional), rather they now indicate the relative probability of support from whatever source. Partly for the same reason, the majority of former 4s have moved to the 3 category; the few that have migrated to 1 reflect our decision to revisit our judgement of the probability of support attributable to them, largely because of our methodology's new emphasis on systemic risk, and particularly international systemic risk. The new 5 rating now accounts for the greatest part of the distribution, reflecting more clearly our previously somewhat obscured view of the low probability of support for a sizeable proportion of the banks we rate. A contributory factor here is that the new 5s also include a number of former 4Ts and 5Ts. This is the result of the replacement of the T suffix by the concept of a country ceiling cap in the case of banks in "emerging markets". This follows from the decision to assess support in terms of foreign rather than local currency, which prevents these banks from attaining the higher Support ratings.

Annex 2: Definitions

Bank Individual and Support Ratings

Fitch Ratings' Bank Individual and Support ratings are assigned to banks that are legal entities. The term "banks" here includes bank holding companies and bancassurance holding companies, bancassurance companies operating as single legal entities, investment banks and private banks. These ratings may also be assigned to leasing companies, instalment credit companies, credit card companies, brokerage houses, investment management companies and securities dealing companies, as circumstances demand. They are not assigned to insurance companies even if these form part of a bancassurance group. For ease of exposition the definitions that follow usually refer only to "banks".

Fitch assigns separate ratings to the principal legal entities within a consolidated group rather than to the group as a whole. We may assign an Individual and a Support rating to any holding company in a group, to any "parent" bank, to its lead banking subsidiary, if any, and to its other core domestic and foreign banking and bancassurance subsidiaries, if any.

Individual Ratings

Individual Ratings, which are internationally comparable, attempt to assess how a bank would be viewed if it were entirely independent and could not rely on external support. These ratings are designed to assess a bank's exposure to, appetite for, management of and capacity to absorb risk and thus represent Fitch's view on the likelihood that it would run into significant difficulties such that it would require support. The principal factors we analyse to evaluate the bank and thus to determine these ratings take into account profitability and balance sheet integrity (including capitalisation), franchise, management, operating environment and prospects. Consistency is an important consideration. Others include a bank's size (in terms of equity capital) and diversification (in terms of involvement in a variety of activities in different economic and/or geographical sectors).

Individual Ratings Definitions

A denotes:
A very strong bank. Characteristics may include outstanding profitability and balance sheet integrity, franchise, management, operating environment or prospects.

B denotes:
A strong bank. There are no major concerns regarding the bank. Characteristics may include strong profitability and balance sheet integrity, franchise, management, operating environment or prospects.

C denotes:
An adequate bank, which, however, possesses one or more troublesome aspects. There may be some concerns regarding its profitability and balance sheet integrity, franchise, management, operating environment or prospects.

D denotes:
A bank, which has weaknesses of internal and/or external origin. There are concerns regarding its profitability, substance and resilience, balance sheet integrity, franchise, management, operating environment or prospects. Banks in emerging markets are necessarily faced with a greater number of potential deficiencies of external origin.

E denotes:
A bank with very serious problems, which either requires or is likely to require external support.

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

Note: In addition, we use gradations among these five ratings, i.e. A/B, B/C, C/D, and D/E.

Support Ratings

General

The Purpose and Function of Support Ratings
Support ratings are the product of Fitch's assessment of a potential supporter's (either a sovereign state's or an institutional owner's) propensity to support a bank and of its ability to support it. Its propensity to support is a judgement made by Fitch Ratings. Its ability to support is set by the potential supporter's own Fitch Long-term debt rating, both in foreign currency and, where appropriate, in local currency. Support ratings have a direct link to Long-term debt ratings, but they do not, nevertheless, assess the intrinsic credit quality of a bank. Rather they communicate Fitch Ratings' judgement on whether the bank would receive support should this become necessary. It is emphasised that these ratings are exclusively the expression of Fitch's opinion even though the principles underlying them may have been discussed with the relevant supervisory authorities and/or owners.

Timeliness and Effectiveness Requirements
Fitch's Support rating definitions are predicated on the assumption that any necessary "support", either in foreign currency, or where appropriate, local currency, is provided on a timely basis. The definitions are also predicated on the assumption that any necessary support will be sufficiently sustained so that the bank being supported is able to continue meeting its financial commitments until the crisis is over.

Local Currency vs Foreign Currency and Obligations and Financial Instruments Covered
In terms of these definitions, unless otherwise specified, "support" is deemed to be in terms of foreign currency.

It is assumed that typically the following obligations will be supported: senior debt (secured and unsecured), including insured and uninsured deposits (retail, wholesale and interbank); obligations arising from derivatives transactions and from legally enforceable guarantees and indemnities, letters of credit, acceptances and avals; trade receivables and obligations arising from court judgements.

Likewise, it is assumed that typically the following capital instruments will not be supported when sovereign support is involved: preference/preferred shares or stock; hybrid capital (tier 1 and "upper" tier 2), including Reserve Capital Instruments (RCIs) and variations upon RCIs; and common/ordinary equity capital. It is also assumed that there will be no support for any moral obligation on securitizations.

The sovereign support status of subordinated debt is difficult to categorize in advance; it is assessed on a case by case basis, distinguishing among different jurisdictions.

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

Criteria and Method

As already indicated, two types of potential supporter are predicated: sovereign states and institutional owners. Individuals and families, who own banks, are not taken into account: their motivation is likely to be ruled by sentiment and by the instinct of self-preservation, and therefore their propensity to support is impossible to predict. Also, their ability to support cannot usually be assessed. The following are taken into account as determinants of the propensity of sovereigns and institutions to support banks:

Sovereign unitary or federal state support: there are three broad categories of criteria: state guarantees and commitments; relationship with the state; and importance of the bank to the state.

Institutional owner or owners: there are four broad categories of criteria: guarantees and commitments; percentage control; nature of the owner; and importance of the bank to the owning institution(s).

Support Ratings Definitions

1 denotes:
A bank for which there is an extremely high probability of external support. The potential provider of support is very highly rated in its own right and has a very high propensity to support the bank in question. This probability of support indicates a minimum Long-term rating floor of ‘A-’.

2 denotes:
A bank for which there is a high probability of external support. The potential provider of support is highly rated in its own right and has a high propensity to provide support to the bank in question. This probability of support indicates a minimum Long-term rating floor of ‘BBB-’.

3 denotes:
A bank for which there is a moderate probability of support because of uncertainties about the ability or propensity of the potential provider of support to do so. This probability of support indicates a minimum Long-term rating floor of ‘BB-‘.

4 denotes:
A bank for which there is a limited probability of support because of significant uncertainties about the ability or propensity of any possible provider of support to do so. This probability of support indicates a minimum Long-term rating floor of ‘B’.

5 denotes:
A bank for which external support, although possible, cannot be relied upon. This may be due to a lack of propensity to provide support or to very weak financial ability to do so. This probability of support indicates a Long-term rating floor no higher than ‘B-’ and in many cases no floor at all.