

## Analyzing Commercial Banking Operations

**G**lobally, increasing numbers of banks and insurers have expanded operations into each other's industry, through start-up companies, acquisitions and/or merger activity. This report describes A.M. Best Co.'s methodology for evaluating the financial health of the banking operations of insurance-related enterprises, and, in certain instances, the ability of commercial banks to support insurance company subsidiaries, including direct writers, reinsurers and captive insurers. Such evaluations typically are performed in the course of assigning a Best's Financial Strength Rating (FSR) to insurance entities within an organization.

A Best's FSR and Issuer Credit Rating (ICR) are assigned to an operating company, based on a comprehensive quantitative and qualitative assessment of the entity's financial strength and operating characteristics. The assignment of an ICR to a holding company of an operating insurer or noninsurance entity reflects an analysis of the impact of the creditworthiness of the subsidiary on the parent's credit profile. This analysis includes consideration of the risks associated with the holding company being a discrete legal entity and reflects the subordination of the holding company's creditors to the operating company's policyholders.

The FSR/ICR of an operating entity also reflects A.M. Best's analysis of the extent to which the operating company is supporting debt or other obligations of a holding company, and vice versa. For noninsurance banking entities, A.M. Best performs a detailed internal analysis of their risk profiles and the resulting effects on the rated entities within the group, as detailed in the accompanying chart.

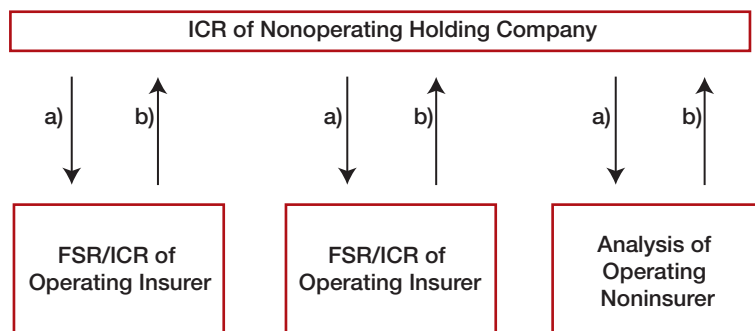
The analytical framework outlined for assessing banking institutions highlights special issues particular to the banking industry.

*Questions regarding A.M. Best Co.'s methodology for evaluating commercial banking operations can be directed to Khanh Vuong, senior financial analyst, in the capital markets group at A.M. Best Co.*

Unique factors include:

- The vital role banks play in a country's macroeconomic and monetary policies as vehicles through which currency and credit flow into a nation's stream of commerce and financial system. A bank's operations and activities depend on, or may be tied directly to, the economic policies of its sovereign state, ranging from access to the central bank funding system to being subject to regulatory mandates for sound operating standards.
- Bank earnings are derived from leveraging capital. Hence, banks tend to be highly leveraged and operate with relatively low capitalization. Operating in this manner heightens the need for banks to adroitly manage and control operating risks (credit, market and operational risks being the major areas).
- Banks also have to be adept at managing liquidity, since they usually rely on confidence- or reputation-sensitive funding sources, such as deposits, capital markets and interbank borrowings, as primary funding sources.
- Banking operations are subject to the credit business cycles of industries and to

### Summary of the Relationship Between Different Ratings for Complex Organizations



a) The ICR of the holding company is derived from the ICRs of the operating companies via A.M. Best's analysis of the degree of impact each operating company has on the holding company's creditworthiness and any benefits it gains from diversified sources of funds from operations.

b) The FSR/ICRs of the operating companies reflect A.M. Best's analysis of the extent to which each is supporting debt, or other obligations, of the holding company or of affiliated companies.



consumer credit trends, in addition to economic factors. It is, therefore, essential to conduct an analysis of banks over at least a full cycle of credit expansion and contraction.

Key bank-specific issues assessed include: the competitive and regulatory environment; management and strategy; funding and liquidity; financial and operating leverage; capital adequacy; earnings sources and stability; and risk management. Each element considered fits comfortably within the traditional A.M. Best insurer rating analysis framework of balance sheet strength, operating performance and business profile.

Taken together, these factors result in a determination as to whether the given banking activities add to, or potentially detract from, the financial strength and flexibility of the respective A.M. Best-rated companies.

### Balance Sheet Strength

Balance sheet strength indicates the absolute and relative degree of capital maintained by a company with respect to its operating and financing needs, on both a current and an expected basis. When applied to banking institutions, A.M. Best evaluates four general areas in determining balance sheet strength and flexibility:

- Credit Risk (Asset Quality)
- Market Risk
- Funding/Liquidity and Interest Rate Risk
- Capital Adequacy

#### Credit Risk (Asset Quality)

Banks' primary business activities are related to extending credit to borrowers (thereby generating loan and credit assets). A significant component of a bank's risk, therefore, lies in the quality of its assets. A review of a bank's credit risk examines the composition, diversification and quality of both its on-balance-sheet assets and off-balance-sheet assets in terms of repayment vs. loss potential. Examples of off-balance-sheet items primarily include unfunded extensions of credit, derivative products, and securitized assets. A.M. Best assesses both qualitative factors of management's strategy and operating constraints, and quantitative measures, in terms of the relation of credit costs (loss provision, reserve and charge-offs) to total loans and leases, level of income derived from these assets, portfolio growth and capital base.

Primary asset quality ratios considered include:

*Nonperforming loans and leases (consisting of nonaccruing assets and assets past due beyond 90 days and restructured loans) to total loan and lease assets.* This ratio provides an indication of the historical performance of a bank's credit portfolio, resulting from its credit underwriting criteria and market strategy. The actual level of this ratio for a bank should be viewed in the context of its market base and corresponding peer group, as nonperforming assets are an inevitable cost of doing business for credit-extending institutions.

*Charge-offs to total loans and leases.* Because some portion of nonperforming loans eventually becomes actual charge-offs, this ratio can be a good indicator of trends in the credit quality of a bank. The recovery rate of charge-offs also is considered in conjunction with the impact of any cyclical factors in order to gain a better perspective on these ratios.

*Provision for loan and lease losses (PLLL) to nonperforming loans, and allowance for loan and lease losses (ALLL)*

## A.M. Best Co. Methodology

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**The Insurance Information Source**

to *nonperforming loans*. These ratios measure the set-aside of capital by management of a bank for actual charge-offs. As such, the annual loan loss provision and cumulative loan loss reserve should closely track the actual charge-offs of loans. Any significant deviation in historical trends of the PLLL and ALLL to loan charge-offs is reviewed with further details on loan growth strategy and reserve policies. Peer group comparison also is important since there is some latitude in a bank's management in setting the levels of loan loss provisions and reserves. Possible reasons for a bank to set its PLLL higher than necessary include the desire to reserve more when earnings are good, or to report lower earnings for tax reasons.

*Nonperforming loans and leases to tangible common equity and loan loss reserve.* Supplementing the historical view of asset quality provided by the above ratios, this ratio gives an indication of current capital coverage of potential loan losses. More specifically, it is a conservative ratio that measures the extent of capital erosion in the event that a bank has to charge off all of its nonperforming loans and leases.

*Nonperforming loans to core earnings (also referred to as the earn-out ratio).* This ratio illustrates the relationship of nonperforming loans to preprovision loan loss earnings, measuring the payout ratio of future loan losses from internally generated cash flow. Core earnings consist of preprovision income and are the first line of protection for banks against loan losses before capital is affected.

### **Market Risk**

In addition to credit extension, banks also may engage in trading activities and other capital market lines of business. Securities underwriting, for example, is undertaken in a limited manner by U.S. banks, but it is much more common among non-U.S. banks. A banking institution's exposure to market risks contributes to the market price volatility of the bank's asset portfolio and earnings and ultimately its capital base. The risk exposure comes primarily from three sources: asset/liability structure, trading activities and securities underwriting.

International standards for reporting market risks by banks have been set by the Bank for International Settlements Committee (BIS) and adopted by most banks worldwide. These rules

require some disclosure, and they mandate, in or around 2006, even greater disclosure of internal risk measurements. Banks must detail four areas of market risk: interest rate, foreign exchange, equity products and commodity products.

Analysts review management's market risk control systems and policies for various internal limits of market risk, as disclosed in a bank's annual reports. Additionally, the following quantitative indicators are considered:

*Noninterest income as a percentage of gross operating income (including the component ratios of trading income to gross operating income, investment banking income to gross operating income, etc.).* To the extent that a bank's earnings sources include income from trading activities, the market price volatility risk present in these earning streams make them less stable than credit-related earnings. Trend analysis of a bank's trading earnings over a period of 5-to-10 years or more should indicate not only the reliability of this earnings stream, but also management's view and strategy for trading activities as a source of earnings. Most banks take limited and measured market risk in their own trading book (trading for client accounts is done more regularly by banks and presents significantly lower market risk).

The market risks inherent in securities underwriting are high and dependent on a bank's ability to make a market for its inventory. Outside of the United States, banks are much less constrained from securities underwriting as a source of earnings. A.M. Best considers the historical track record of the bank as an underwriter of certain assets, and how much volatility in earnings has resulted from this line of business. Any recent entry into this activity by a bank is viewed negatively.

*Value-at-Risk (VaR) index for the trading portfolio.* This measurement provides a more robust indication of a trading portfolio's market risk and potential impact on earnings. As disclosed in most major banks' financial statements, the VaR index is a statistical probability of potential losses to a bank's trading portfolio, within a certain defined confidence interval. The BIS standard currently requires that banks calculate and publish a 99th percentile, one-tailed confidence interval with a minimum holding period of 10 trading days. Observing this index of a

bank against its peers' over a period of at least four quarters provides an indication of any significant increases in market risk undertaken by a bank. It is important to note that the assumptions and calculations for VaR can vary from bank to bank. Any significant differences from the norm in a bank's calculation of VaR warrant a more in-depth assessment of the bank's market risk level. A useful related ratio is the multiple of trading income to VaR, which indicates the level of earnings generated by trading activity as compared with the risk level assumed by a bank.

#### **Funding/Liquidity and Interest Rate Risk**

A bank's liquidity represents its ability to accommodate decreases in deposits and other liabilities efficiently and economically, as well as to fund increases in assets. Liquidity may be thought of as a defense mechanism that protects capital from losses on unscheduled asset sales. Unscheduled (distress) asset sales may be required by deposit runoffs.

The composition of the funding structure of a bank is assessed in terms of retail vs. wholesale funding sources. Retail banks, which often act as small business and consumer lenders, typically have large core deposit bases made up of numerous individual accounts within a branch network. Although these small deposit accounts are costly to administer (higher noninterest expense), they generally are very stable and have a low (interest) cost of funding. Large wholesale banks, which have access to capital markets, frequently rely more on volatile liabilities such as large certificates of deposit, federal funds purchased and repurchase agreements. These funding sources usually are more costly and far more sensitive to changes in interest rates. Consequently, they represent a less stable source of funding than core deposits.

Primary liquidity ratios considered include:

*Funding composition ratios and respective cost of funds (deposits as a percentage of total funding, federal funds as a percentage of total funding, market funds as a percentage of funding, and their respective costs).* These ratios show how dependent or diversified, a bank is with respect to its funding sources and their respective costs. Whether operating as a retail-funded or wholesale-funded operation, a bank that

commands a consistently lower cost-of-funds structure is better positioned relative to its peers.

*Total loans to core deposits.* This ratio indicates the extent to which a bank funds its loan book with low-cost deposits. Loan assets are the core assets of a bank and also are generally the most illiquid asset class of a bank. Accordingly, they require a stable source of funding, such as deposits. The growth rate of loans ideally should be proportionate to the growth rate of core deposits, from a liquidity standpoint.

*Average liquid assets as a percentage of average total assets.* Liquid assets provide an important internal source of liquidity for banks through the securities repurchase market. As a general rule, the greater the liquid asset level of a bank, the more flexibility it has and the more positively it is viewed. This also is dependent on the business strategy of the bank and the resulting funding needs.

*Volatile liabilities net of temporary investments, to net loans and leases plus investments due in more than one year.* Banks that have a substantial amount of volatile funding in their liability structure should use it primarily to fund temporary investments. This ratio provides a useful measure of the existence and the degree of longer-term asset funding based on volatile liabilities. If the ratio is positive, then volatile liabilities exceed temporary investments, and some longer-term assets are being funded by volatile liabilities. If the ratio is negative, then all volatile liabilities are funding temporary investments.

*Interest rate VaR.* A bank's exposure to interest rate volatility can be captured by a Value-at-Risk measurement provided by the bank. Taken as a percentage of total assets, this figure indicates the extent of a bank's exposure to interest-rate volatility.

*Asset-liability funding gap schedule.* This information as provided by a bank indicates a bank's sensitivity to interest rate changes across various maturity ranges as well as within each maturity segment. Both the degree and direction of a bank's gaps relative to forecasted or expected interest-rate movements are an important part of the bank's asset-liability management and business strategy.

#### **Capital Adequacy**

The analysis of capital adequacy should

reveal whether a bank has enough equity to support the risk on its balance sheet; whether asset growth can be supported by proportionate equity growth; whether a bank has the capacity to market long-term debt; and whether capital is being eroded by excessive dividends. A key determinant of capital adequacy is asset quality, because asset portfolios ultimately generate future retained earnings. Off-balance-sheet activity also has an impact on capital adequacy. Off-balance-sheet items can impact credit risk, growth, funding risk and risk-based capital requirements.

The following primary capital adequacy ratios are considered:

*Tangible net worth.* A simple measurement of capital is the level of tangible net worth of a bank as compared with its peers. Tangible net worth is calculated as the shareholders' equity of a bank reduced by certain intangible items (goodwill, unrealized gains, revaluation reserves, underprovided nonperforming assets and overvalued assets). The quality of capital also is assessed by the composition of the capital, whether made up largely of equity or of more hybrid and quasi-equity elements such as subordinated debt. The level and historical trends of retained earnings as a component of tangible net worth also are considered.

*Tier 1, total BIS capital and other regulatory ratios.* Regulatory capital adequacy ratios are reviewed for compliance with the minimum capital standards required of prudent banking operations. As in other areas, levels, trends and changes in capital structure are assessed, with compliance to national standards noted as a minimum requirement. For those banks adhering to the BIS standards, which adjust capital for risk factors inherent in different asset types, the assessment of capital adequacy is evaluated in light of earnings (the ability to generate capital internally to buffer asset losses); asset quality, as the driver of earnings; and the adequacy of the loan loss reserve. It is important to note that the assumptions and calculations of these capital figures can vary from country to country and may be readjusted by the analyst for greater consistency and integrity of computation of capital levels.

*Tangible net worth to total assets plus securitized assets.* This is a measure of the extent of a bank's leveraging of its capital to

generate assets on its balance sheet. Loans, investments and other earning assets not only should have, as a matter of prudence, certain capital to be reserved against, but also actually require regulatory capital reserves for the majority of banks. Total assets include both on-balance-sheet and off-balance-sheet assets. Securitized assets also are added back to total assets since most banks retain the first loss exposure on securitization transactions. In addition to this ratio, it is also appropriate to examine the relation of tangible net worth to risk-weighted assets (including risk-weighted securitized assets) to obtain a better measure of capital to asset risk. The ability to achieve consistent earnings with efficient levels of risk-weighted assets is a desired business strategy for banks.

*Retained net income to average equity.* The relation of retained net income to average equity is a good indication of the rate of capital growth from internally generated earnings, as opposed to equity issuance. Banks that plow back more of their earnings to their capital base, and ultimately to their operations, are viewed more positively from a balance sheet strength perspective than banks that adhere to a policy of distributing more of their earnings as dividends to shareholders.

*Double leverage at the bank holding company.* This ratio is calculated as equity investments in subsidiaries as a percentage of common equity at the holding company. This ratio not only shows the degree of debt burden across the operating and parent levels, but also can reveal the extent to which a holding company is dependent on the operating bank for dividends in servicing its debt. To obtain a more direct indication of the holding company's self-sufficiency in funding, another holding company ratio is considered: liquid assets to short-term debt.

## Operating Performance

The absolute size of a company's capital base, while important, can be eroded if the bank lacks solid operating performance. Operating performance is assessed on an absolute and relative basis to peers, with an emphasis on the profitability of operations, structure and composition of revenues and expenses. There are three main areas of analysis:

- Core Earnings Trends and Quality
- Individual Business Line Profitability
- Overall Return and Profitability

#### **Core Earnings Trends and Quality**

The long-term viability of a commercial bank is determined by its profitability. Healthy commercial banks usually have solid, sustainable earnings generated from normal banking activities, or core earnings. Sources of core earnings consist primarily (but not exclusively) of interest income, fee income and core trading income from its main lines of business operation (commercial, retail, etc.) Noncore earnings consist primarily (but not exclusively) of other trading income, investment income and nonrecurrent income such as those generated by asset sales.

If a bank has poor core earnings, then it is vulnerable to many adverse situations that could be weathered by a bank with good core earnings. Sustainable earnings are a source of capital to fund growth, to help maintain an adequate source of liquidity generation and to protect against a reasonable level of asset losses.

The following ratios are considered:

*Net operating income (NOI) growth rate.* The annual growth of NOI over a 5-to-10 year period should reveal the trends of a bank's profitability over a credit cycle and include any changes in its operating environment. Peer comparisons also reveal a bank's competitive performance. The components contributing to NOI are analyzed individually in the same manner. Management's discussion of results in its financial statements helps relate the bank's profitability to its business strategy and core business lines.

*Preprovision profits as a percentage of average assets plus securitized assets.* Core earnings are represented as profits before provision for loan losses, taxes and other "below-the-line" items (minority interest adjustments and other nonrecurrent accounting items). More precise calculations for core earnings can be done to the extent of available information from the bank. Defining core earnings considers management's identification of its core business lines in annual reports. Additionally, the historical comparison of the composition of the revenue base indicates stable sources of revenue for the bank. Preferred dividends are sometimes subtracted because they repre-

sent fixed charges, as banks generally rely on confidence-sensitive funding. Securitized assets are added back for the reasons discussed earlier. This ratio also is calculated on the basis of risk-weighted assets.

*Dividend payout ratio (declared common stock dividends to net income).* Taken over a period of 5-to-10 years, this ratio provides information on the rate of dividends paid by a bank to its owners (and may be committed to in a moral sense). Naturally, the lower the ratio, the more positively the bank is viewed.

*Effective tax rate.* The tax burden of a bank can depend on whether it invests mainly in tax-free assets, makes use of tax-advantageous offshore banking, or seizes other tax-management opportunities. A.M. Best attempts to quantify the sustainability of any tax advantages to determine whether to factor this into the bank's profitability analysis, or to apply a discount on the historical profitability of the bank.

#### **Individual Business Line Profitability**

To take advantage of cross-selling opportunities as well as diversify from the effects of credit cycles, banks engage in many types of banking activities (retail, wholesale, international finance and investment banking, among others) and other related activities (investment management, trading, etc.). A review of the composition of the revenue base is conducted to understand the bank's principal type(s) of markets and operations. This determines the banking and bank-related sector business dynamics affecting the bank, in terms of competitive factors, operating challenges and opportunities, and risks.

A similar analysis of the composition of a bank's expenses provides an indication of its cost structure. Interest expense and credit costs relate directly to the lending operation of a bank. A significant expense item is the provision for loan and lease losses (PLLL). In most cases, the annual provision a bank takes will exceed net loan and lease losses. This is done to keep the allowance for loan and lease losses (ALLL) in line with loan growth. If a bank does not take a larger provision, then the ALLL may become materially understated or depleted. Cost of operations constitutes another significant component of a bank's cost structure. Noninterest expenses, such as operating expenses, overhead costs and other expenses, relate to the

personnel compensation, cost of administration and operation of a branch network, among other categories.

The following ratios examine the profitability of the various lines of business of a bank:

*Noninterest expense (or overhead expense) as a percentage of net interest income.* This overhead expense ratio provides an indication of a bank's operating efficiency. A bank with low overhead costs can enjoy greater margins and flexibility in dealing with any decline in revenues relative to its peers. Conversely, an unfavorable efficiency ratio can force a bank into a defensive position of cost cutting and internal realignments to become more competitive.

*Yields on average loans, investments, trading assets and total earning assets.* The relative performance of certain assets within a bank depends on cyclical factors, market position of the bank in each line of business, and respective business strategies for those lines of business. Management's emphasis on some lines of business or strength in market position usually will translate into certain yield performance for specific asset categories. The differences in asset yields determine the optimal asset mix for a bank, which in turn drives many aspects of the rest of its operations, such as capital allocation, strategies for growth, etc.

*Net interest margin.* The net interest margin (the ratio of net interest income to average interest-earning assets) frequently is used as a measure of a bank's performance on its loan portfolio. This ratio is for most banks a key driver of performance and profitability.

Fee income can be another significant source of earnings for many banks through financial advisory services or asset-management functions. The ratio of fee income to total operating earnings as compared with various other earnings component percentages provides information about a bank's earning sources.

*Various cost of funds.* Cost of funds on deposits, federal funds and repurchase agreements, market funds and trading liabilities, and interest-bearing funds is the opposite or expense side of asset yields. At the minimum, these costs of funds indicate the funding sources, and relative cost of access to them of a particular banking institution. At times, because these funding sources are based on market confidence, they also can

indicate the credit strength of a bank as perceived in the marketplace for bank funds. This is especially true during certain events of crisis or disruptions in financial markets when credit spreads can widen dramatically for weak institutions, which can limit funding options very quickly.

Broader gauges of profitability for banks include ratios for measuring performance returns on utilized assets and capital:

*Return on average assets (ROA).* Net income to average assets indicates the earnings performance of a bank on its assets relative to its peers. This ratio can be adjusted for pretax income or pretax recurring income. It also is useful to determine the ratio in terms of risk-weighted assets plus securitized assets to arrive at a risk-adjusted ratio. All of these ratios are reviewed and highlighted as appropriate, depending on the type and level of different activities undertaken by a bank.

*Return on average equity (ROE).* Net income to average shareholder's equity indicates the earnings performance of a bank from the perspective of shareholders and the equity market.

Both the ROA and ROE ratios are assessed over a sufficient period of time to establish historical contexts as well as to cover the entire cycle of credit risk and competitive forces.

## Business Profile

A company's business profile is equated with its ability to maintain a distinct competitive advantage. Business profile drives current and future operating performance, which determines long-term balance sheet strength and ultimately financial security. Business profile encompasses issues that are not obvious from the balance sheet strength or operating performance analyses and includes:

- Country and Sovereign Risk
- Economic and Business Risk
- Regulation and Regulatory Risk
- Corporate Structure
- Management and Strategy

### Country and Sovereign Risk

The key point of analysis of any issuer institution, especially a banking institution, is the local environment in which it operates. For banks outside the United States, these factors are assessed and analyzed as part of

A.M. Best Country Risk Methodology, available at [www.ambest.com](http://www.ambest.com).

Factors studied include: the organization and make-up of the local banking system; legal infrastructure; accounting system; and regulatory bodies governing the banking operations in a particular country. Additionally, the local economic and financial-market conditions and cross-border risks directly impact the operating performance of the locally operating banking institution and potentially its parent holding company, in terms foreign-exchange and transfer risks.

Transparency of local accounting and reporting standards is a significant factor in assessing the country risk of a banking operation. Among the developed countries, the different accounting standards have to be addressed in order to arrive at some comparability standards and a meaningful analysis of a banking operation in a particular country. The analysis of a bank within the emergent countries of the world is rendered more challenging, and may have to rely to a greater extent on historical trends of the local governments or banking authorities in providing support to a local bank.

#### **Economic and Business Risk**

In understanding local economic conditions, which drive operating performance and the financial health of a bank, a study of the local economic indicators is conducted with the following as a beginning: GDP activity, inflation, employment rate, interest rates, the yield curve, the equity markets, trends in corporate and personal bankruptcies, and trends in commercial and residential real estate values, occupancy rates and rental rates.

Additionally, local business and market conditions are assessed in terms of competitive forces and structural dynamics of a local business environment.

#### **Regulation and Regulatory Risk**

Government regulatory policies vary by country and banking system. Not only does the regulatory framework vary from country to country among developed countries, but, more important, it presents critical structural and systemic issues for operating banks in emergent countries.

In addition to local regulatory bodies, the larger banking institutions in major developed countries have adopted the capital standards and supervision guidelines put forth by The Basel Committee on Banking

Supervision. Besides the Basel Accord, where relevant, some banks are also under the EU capital adequacy regulations in an effort to self-regulate and adhere to a common standard of prudent capital maintenance.

Analysts consider the nature of the local banking system and changes in regulatory requirements, as well as peer analysis produced by the various regulatory bodies. Also reviewed are the role and power of regulatory bodies in various countries and banking systems; reserve requirements that impact capital employment by banks; any other dynamics affecting banking products; and/or solvency requirements.

#### **Corporate Structure**

When analyzing a commercial bank, the analyst studies its entire organization, including: the parent company's balance sheet strength; diversity of operations (earnings and cash flow, sources and uses of capital); and geographic spread of business. Other nonbank and noninsurer members of the organization also are examined as to the level of risk or support they contribute to the overall entity, as are any legal/tax/regulatory-driven structures. The willingness and legal ability of the parent company to provide financial support for the bank is considered. In addition, the existence of less-profitable organization members that could divert earnings away from the bank, or of obligations by the bank to provide loans at less than market rates to such group members, are examined.

Certain banks may be privately held or operated by a state entity. In these situations, there may exist some type of explicit or implicit support arrangement (a private owner's external resources or a government body's intrinsic support). While these situations are more prevalent among countries other than the United States and the major European countries, they also exist in the United States and major economies to some extent, with banking authorities in the United States, Japan and Germany having arranged support or bailouts for a number of troubled banks.

When possible, analysts address the exact mechanism for a bank's receiving support from a third party and in what form. Factors of consideration include historical trends as well as economic interest in supporting the bank; capability of support; nature of commitment by the supporting source; funding

or appropriation approval process; and legal processes involved, if any. The degree and circumstances predicated the actual extension of support to a bank will determine how much of the underlying risk profile of the bank's operation should be relied on in the analysis. The greater the ease and efficacy of the extension of support historically and prospectively, the more the dependence of the assessment will be on the third-party source.

#### **Management and Strategy**

Assessing a bank's management possibly is the most subjective aspect of analyzing a bank. Notwithstanding the subjectivity, it is still a useful step in bank analysis to consider

the make-up of the senior management and board members of a banking institution. The strategic direction of a bank also can be assessed from its historical activities and operations, which should be considered as the broader context and underlying influences for the financial performance of a bank. Finally, the history of a bank's moral and litigation standing is reviewed for any outstanding cases and the frequency of penalties levied against the bank, litigation, and investigations by any authorities. These aspects would be especially significant if a bank is subject a greater burden of these issues as compared with its peers.

## GUIDE TO BEST'S RATINGS

A Best's Rating is an independent opinion, based on a comprehensive quantitative and qualitative evaluation, of a company's balance sheet strength, operating performance and business profile. Best's Ratings are not a warranty of a company's financial strength and ability to meet its financial obligations.

### Financial Strength Ratings

A **Best's Financial Strength Rating (FSR)** is an opinion of an insurer's financial strength and ability to meet ongoing obligations to policyholders.

	Rating	Descriptor
<b>Secure</b>	A++, A+	Superior
	A, A-	Excellent
	B++, B+	Very Good
<b>Vulnerable</b>	B, B-	Fair
	C++, C+	Marginal
	C, C-	Weak
	D	Poor
	E	Under Regulatory Supervision
	F	In Liquidation
	S	Suspended

A **Best's Long-Term Issuer Credit Rating (ICR)** is an opinion as to the ability of the rated entity to meet its senior obligations. In certain markets or product lines, particularly where the credit market scale is widely recognized, A.M. Best also assigns Issuer Credit Ratings to insurance companies using its Long-Term Credit Rating Scale. The definitions applied to insurance companies that are assigned a long-term Issuer Credit Rating are as follows: (aaa) - Exceptional; (aa) - Superior; (a) - Excellent; (bbb) - Very Good; (bb) - Fair; (b) - Marginal; (ccc-cc) - Weak; (c) - Poor.

A.M. Best may also assign Short-Term Issuer Credit Ratings to certain insurance companies using its Short-Term Credit Rating scale.

Rating Modifiers		Affiliation Codes	
"u"	Under Review	"g"	Group
"pd"	Public Data	"p"	Pooled
"s"	Syndicate	"r"	Reinsured

### Not Rated Categories (NR)

NR-1	Insufficient Data
NR-2	Insufficient Size and/or Operating Experience
NR-3	Rating Procedure Inapplicable
NR-4	Company Request
NR-5	Not Formally Followed

### Long-Term Credit Ratings

A.M. Best uses its long-term credit rating scale when assigning:

- **Debt Ratings** (an opinion as to the issuer's ability to meet its financial obligations to security holders when due) and
- **Issuer Credit Ratings** (an opinion as to the ability of the rated entity to meet its senior obligations).

	Rating	Descriptor
<b>Investment Grade</b>	aaa	Exceptional
	aa	Very Strong
	a	Strong
	bbb	Adequate
<b>Non-Investment Grade</b>	bb	Speculative
	b	Very Speculative
	ccc, cc, c	Extremely Speculative
	d	In Default

Ratings from "aa" to "ccc" may be enhanced with a "+" (plus) or "-" (minus) to indicate whether credit quality is near the top or bottom of a category, and a "u" modifier for Under Review.

Ratings prefixed with an ("i") denote indicative ratings. Issuer Credit Ratings may also be assigned a "pd" modifier, which indicates that a company does not subscribe to A. M. Best's interactive rating process. These Issuer Credit Rating descriptors apply to entities which do not issue insurance obligations.

### Short-Term Credit Ratings

A.M. Best uses its short-term credit rating scale when assigning:

- **Debt Ratings** (an opinion as to the issuer's ability to meet its obligations having maturities generally less than one year) and
- **Issuer Credit Ratings** (an opinion as to the ability of the rated entity to meet its senior financial commitments on obligations maturing in generally less than one year).

	Rating	Descriptor
<b>Investment Grade</b>	AMB-1+	Strongest
	AMB-1	Outstanding
	AMB-2	Satisfactory
	AMB-3	Adequate
<b>Non-Investment Grade</b>	AMB-4	Speculative
	d	In Default

A company's Short-Term Credit Rating also may be assigned an Under Review modifier ("u") that generally is event-driven (positive, negative or developing) and indicates that the company's Best's Rating opinion is under review and may be subject to near-term change. Ratings prefixed with an ("i") denote indicative ratings.

### Rating Outlook

Best's Ratings (A++ to D, aaa to c) are assigned a Rating Outlook that indicates the potential direction of a company's rating for an intermediate period, generally defined as the next 12 to 36 months. Public Data Ratings are not assigned an Outlook. Rating Outlooks are as follows:

<b>Positive</b>	Indicates a company's financial/market trends are favorable, relative to its current rating level, and if continued, the company has a good possibility of having its rating upgraded.
<b>Negative</b>	Indicates a company is experiencing unfavorable financial/market trends, relative to its current rating level, and if continued, the company has a good possibility of having its rating downgraded.
<b>Stable</b>	Indicates a company is experiencing stable financial/market trends and that there is a low likelihood that its rating will change in the near term.

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