

Analysts

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■ Introduction

A major part of Fitch Ratings’ business consists in the rating of banks (the term “bank” for the purpose of this report includes bank holding companies and bancassurance holding companies, bancassurance companies operating as single legal entities, investment banks and private banks) in a wide variety of countries with substantially differing social and historical traditions, political systems and prevailing economic philosophies. Experience has taught us that the goal of arriving at a tenable rating of a bank’s creditworthiness is not to be achieved by establishing a model of the “perfect” bank defined in terms of a set of universal ratios and other empirical criteria and then comparing the subject bank with the model. This approach may be practicable within one closely regimented, uniform banking system; extended across borders it quickly leads into quicksands of incomparability and irrelevance.

In rating banks on an international basis our approach has to be flexible but not so flexible as to lack any coherent methodology. A basic precept of our rating method is that we should get to understand the business of the bank in question (and the risks inherent to this business), the objectives of its management, the environment it operates in and the most likely future development of its business. This assists us in arriving at a rating judgement rooted in an international perspective, which, nevertheless, accommodates the particular circumstances of the bank (whether national, regional or sectoral), preventing hasty prejudgements based on criteria which are in one way or another inappropriate.

In the same spirit, in carrying out our analysis we try to avoid imposing unnecessarily demanding requests for data which may well be irrelevant or inapplicable to the system of which the bank is a part. However, as international banking becomes more and more sophisticated (and thereby more complicated), we have had to expand the range of our analysis to deal with these developments. Since we are presenting here a conspectus of our whole methodology, these more arcane facets of banking have to be included. But, it should not be assumed that, for example, in the case of a bank that genuinely has no involvement in credit derivatives, we will waste time and resources by pestering the bank about this subject. On the other hand,, there are certain universally applicable attributes of banks - asset quality is a good example - for which we consider it is possible, and necessary, to set standards which have a degree of uniformity. This, in turn, requires a degree of uniformity in the data banks provide to us.

Our objective is to maintain a co-operative relationship with the banks we are rating: we strive to be open about what we are looking for and ultimately about why we came to our particular rating decision; we trust that management and owners of banks we rate will be equally frank and forthcoming. Rating relationships should be long term and based on the understanding that it is in both parties’ interests to make sure a professional and independent result is achieved.

In some, albeit relatively few, cases, Fitch does not have a formal rating relationship with the bank it is rating, and its analysis of such banks is based principally on public information (Fitch Initiated Ratings).

■ The Rating Process – From Initiation to Completion

Once we have received a request for a new rating of a bank and accepted it (this is subsequently followed up by a fee letter), we follow the procedures outlined below:

Analysing the Bank's Economic and Operating Environment

The economy in which a bank operates has a significant bearing on its financial performance, and it is essential to take into account any economic risk that may affect its creditworthiness. We thus look at the basic economic indicators of the country in question, (generally derived from the sovereign risk analysis undertaken by our Sovereign Ratings department) such as the size of its economy, GDP growth, inflation, growth in consumer lending, savings and investment, trends in unemployment, exchange rates, bond yield and national and/or regional property price indices. We also take note of structural changes in the economy and any problems that the economy may have experienced in the past or that it may face in the future (e.g. structurally high inflation, devaluations or liquidity crises). The country's political stability is also taken into account.

If we do not already have the information in-house, it is then necessary to collect and analyse data relating to the banking system in which the bank in question operates and to the place of the bank within that system. This process includes analysis of the relevant national banking market and of existing and potential competition in that market and also of the degree of concentration within it. It requires examination of the role and functions of the banking supervisory authorities in the country in question (we generally have regular meetings with these authorities), of the degree of state control (or decontrol) of that country's banking system, of the requirements for public reporting by banks and of the accounting practices that lie behind the figures publicly reported by banks. It may also be necessary to extend this examination beyond the frontiers of the country in question to take in such phenomena as the European Union's "single banking market" and its bank capital adequacy, accounting and consolidated supervision Directives, including the recent "Conglomerates" Directive. On a still wider scale it is necessary, to take into account the capital adequacy guidelines of the Basel G10 Committee, most notably those laid down in the 1988 Basel G 10 Capital Accord and its subsequent amendments, as well as those in the proposed new Basel Accord (Basel II).

While our rating process does not include an audit of a bank's financial statements, it does examine

accounting policies and the extent to which they accurately reflect a bank's financial performance and balance sheet integrity. We aim to judge the aggressiveness of accounting practices used by banks and restate figures where necessary to make a bank's financial data comparable with those of its peers. Fitch also takes into account peculiarities of different accounting regimes as well as the impact of adopting the IAS's International Financial Reporting Standards (IFRS) or US GAAP in some regions of the world, particularly in the case of IFRS, their blanket introduction in 2005 in the European Union.

In order to carry out adequate analysis of a particular bank (see "*Analysis of the Bank*", below), it is helpful, although not absolutely essential, to establish a "peer group", either of comparable banks within the country in which it is based or of similar banks in different countries. In Fitch we are assisted in such analysis by a comprehensive database.

Bank Questionnaire

Based on our initial analysis of publicly available data, we prepare a questionnaire for presentation to the management of the bank to be rated. A copy of our "prototype" questionnaire is attached as an appendix to this report. This is intended to serve as a basis which may be adapted from one country to another or for the particular circumstances of the bank being rated. As may be seen, the questionnaire covers nine broad topics, all of which to varying degrees normally form the framework for our subsequent analysis, and we revert to them in the relevant sections, below. Although the questionnaire taken as a whole may appear daunting, it would be quite unusual for all of it to be presented, unedited, to any one bank.

We prefer to receive WRITTEN responses to our questionnaire in advance of our meeting with management so that we have time to digest them before the meeting. However, this may not always be practicable: in this case, the solution may be for the bank's management to give a presentation, which includes its responses, at the time of our meeting (see below).

Meeting with Bank

As already indicated, the next step is a meeting with senior management of the bank in question to discuss and assess the data provided. Such meetings are often arranged with investor relations departments or rating agency liaison officers in more sophisticated banking groups. Our aim being to obtain an overview of a bank's various activities, we need to meet several members of the senior management team as well as leaders of significant business divisions or subsidiaries.

The length and number of meetings with management depend on the complexity of the entity being rated, but, normally the first time we rate a bank there will be one such meeting, and it will last for around one day (and sometimes longer). For its part, Fitch does its best to ensure meetings are efficiently run, with management well briefed in advance on what we will require.

Subsequently there will be regular contact between Fitch and the bank and also follow-up meetings, perhaps to review interim figures or to discuss a major development in the bank's business and certainly at least once a year to review its latest financial figures. We expect banks we rate to inform us of significant developments in advance of their general publication.

Analysis of the Bank

Normally there are two (and in some cases more) Fitch analysts assigned to each rating; they will have the requisite language facility and may, depending on the bank's location, come from one of our offices outside either London or New York. As already noted, the topics of our questionnaire determine the principal facets of our analysis, on which the analysts will be concentrating during their meeting with the bank's management and subsequently. Undoubtedly the most important of these topics is **Risk**, in particular exposure to credit and market risk. Other significant topics within which risk of various kinds is also to some degree subsumed are: **Funding and Liquidity, Capital, Securitisation, Performance/Earnings, Market environment and planning, Management and Strategy, Corporate Governance, Ownership, and Audit** (see "*The Analytical Process*", below).

Approach to Differing Structures

As stated in the introduction to the attached questionnaire, we always prefer to analyse consolidated accounts. However, this does not necessarily mean that we wish to analyse only the consolidated figures of the holding company of a banking group. Much will depend on the purpose behind the rating. If it is an issuer rating (i.e. the rating of a legal entity), then it is preferable to analyse the consolidated figures of that entity, but if it is a rating of a group holding company, then it may be desirable to analyse both its consolidated AND its unconsolidated figures. If it is a rating of a particular security issue, then we will wish to analyse the results of the issuing entity, which may be a subsidiary or a sub-subsidiary of a group holding company. It may be, however, that the issue being rated is guaranteed by the group holding company or at least by a sub-holding company further up the group pecking order. In such a case we will also

want to examine the consolidated figures of the guaranteeing entity.

We are rating an increasing variety of banks, including retail, investment, mortgage, co-operative, savings and private banks, and while the basic analytical approach to all these institutions is the same, there are specificities relating to each type of institution which need to be dealt with in more detail.

We are also rating an increasing number of "bancassurance" or "Allfinanz" groups, i.e. groups incorporating both an insurance and a banking activity. We consider that the integration of banking and insurance operations leads to different risk and benefit profiles compared with traditional financial services operations. Our approach to these groups depends to some extent on the business model employed and its strategic benefits or deficiencies, the structure of the group and support. Industry dynamics, operational performance and structure of revenues, quality of management, risk management, controls and capital adequacy, including the fungibility of capital, are also analysed. As well as this "top down" approach, Fitch also analyses each significant operating company separately. A crucial element of the analysis of bancassurance groups is capital adequacy. Currently Fitch takes a "bottom-up" approach to this by analysing the bank and insurance operations separately. However, in view of its conviction that capital employed within bancassurance groups is becoming increasingly fungible, Fitch also places significant emphasis on the consolidated management of capital adequacy by bancassurance groups. More detailed information on the analysis of bancassurance groups can be found in Fitch's "*Bancassurance Rating Criteria*" report published in August 2002 and available on Fitch's website, www.fitchratings.com.

Draft Report

Following their initial meeting with a bank's management and subsequent analysis of the data obtained, the analysts draft a rating report on the bank. Depending on the terms of the fee letter and the particular circumstances, a short-form report (one page of text forming a rating summary or so-called Credit Update, plus spread sheets) or a long-form report (our so-called Credit Analysis, comprising a Credit Update, plus ca. four pages of rating analysis, plus spread sheets and an annex, which provides explanatory notes to the spread sheets) may be published; the rating process is the same in either case.

The analysis in the text of the long-form report is arranged under main and sub-headings which tie in

with the topics covered in “*The Analytical Process*”, below and in the bank questionnaire.

Presentation of Draft Report to Bank

We send our draft report (without ratings) to the bank being rated, for two reasons:

- to give management the opportunity to agree the data in the report;
- to allow management to determine whether we have included any information in our draft which was given in confidence and which should be excluded on these grounds.

Amendment and Subsequent Circulation of Report to Credit Committee; Composition of the Committee

We amend our report in accordance with any comments from the bank, which meet the criteria in the above paragraph, and circulate it together with other, relevant documentation (see below) among the members of a credit committee, which normally has a complement of up to seven voting members.

There is no single, standing credit committee; rather there is a committee for each country we cover, or, in some cases, for each peer group of banks. The two (or more) analysts who visited the bank, did the analysis and wrote the report are always members of its credit committee. The committee will also include one or more senior Fitch analysts who have relevant experience. The remaining members are chosen from among Fitch staff members whose principal responsibility is analytical coverage of banks in another country or other countries. This disparate composition has a twofold purpose: the first is to ensure objectivity in the ratings: the second purpose is to ensure uniformity of rating on a cross-border basis.

Fitch's credit committees have no outside members culled from the ranks of the "great and the good", or from anywhere else. It might be thought that the presence of such personages would encourage objectivity; in practice everyone has some form of prejudice or axe to grind which, under stress, may emerge as a real conflict of interest. In particular, when national economies and credit are deteriorating, the great and the good are loath, as they understandably see it, to accelerate the process by lowering ratings.

Credit committee Meeting; Assignment of Ratings

At the credit committee meeting the analysts responsible for the work done so far present the rest of the committee with the report they have drafted, which has since been seen by the bank and possibly

amended, as explained above, to accord with its comments. They also present relevant confidential data, which they have not been able to include in the report, and peer group analyses comparing the bank with its domestic and foreign peers. To add a formulaic, non-intuitive element to the rating decision and thereby to help ensure greater consistency, the analysts also present to the committee computerised score sheets on which they have assigned scores to the bank for profitability, credit risk, market risk, operational risk, funding, liquidity, capital, franchise and diversification, management and strategy, economic, regulatory and banking environment, size and potential outside support. These scores are used to arrive at "implied" ratings. (The scoring system is subject to periodic review and refinement.) The implied ratings are not treated as definitive; they are considered only as further input to the rating decision so that there remains a strong subjective element in our final judgements - a subjectivity tempered by several years' experience (allowing a reasoned extrapolation of the future), by common sense and by specialized knowledge and research. Neither subscribers to our rating service nor the bank being rated are informed of its rating scores.

Our reports are updated on an annual basis (although Credit Updates may be updated more regularly if circumstances should require it, for instance if one or more of a bank's ratings change). Ratings are reviewed at least once a year by a credit committee.

Dissemination of the Ratings

When a bank being rated for the first time has been informed of the decision of the credit committee, it has no specific recourse to appeal against this decision. Although it may request an appeal, Fitch retains the right to turn down such a request. If an appeal is entertained, it is incumbent on the issuer to provide new information.

In the case of a dispute about a subsequent rating action, again there is no specific right to appeal. An appeal may, however, be entertained if the issuer can provide new information. In this case, the appeal should be resolved as expeditiously as possible, in general within forty-eight hours of the rating decision.

Once a bank has been officially informed of the ratings that have been assigned, the rating report and the ratings will be dispatched to our subscribers who include over 3,000 major institutions worldwide. In addition, our ratings will be made available to investors and the public by means of the "wire" services, press releases and our website (www.fitchratings.com).

■ The Analytical Process

Fitch bases its analysis of banks on a number of quantitative and qualitative factors, the most significant of which are covered by the following:

Risk Management

This includes an analysis of the bank's appetite for risk and the systems it has in place for managing risks. We examine the independence and effectiveness of the risk management function, whether all risks are managed together under the same umbrella, the procedures and limits that have been implemented, who sets these limits and the degree to which these procedures and limits are adhered to. Finally, we endeavour to assess senior management's understanding of and involvement in risk management issues and we also examine the reporting lines in place.

If a bank has securitised or is planning to securitise some of its assets as part of its risk management policy, we will examine the motivation for this. The most common reasons for securitisation include better management of risk concentrations, the disposal of problem loans or more capital-intensive assets, the reduction of exposure to lower-spread assets, better funding diversification, improved liquidity, and regulatory capital relief (see "*Securitisation*", below).

In recent years many banks have upgraded and significantly improved their risk management systems, and this effort is being intensified in the face of the impending implementation of Basel II, planned for 2007/8. For instance, many major banks either have developed or are in the process of developing internal rating systems in order to be able to apply the internal ratings based approaches proposed in the new Accord for the calculation of their credit risk and thereby to reduce their regulatory capital needs. Under the terms of the proposed new Accord, various credit risk mitigation tools will also be available to banks in order to reduce their credit risk, and these could have a significant impact on some banks' credit risk profile. Banks are also developing more sophisticated systems for the measurement of operational risk, which will require capital coverage under the revised Accord (see "*Operational Risk*", below). While no change in the measurement of market risks is anticipated in the Accord, banks also continue to develop and fine-tune their market risk management tools in order to be able to measure market risks more effectively.

Credit Risk

Here we look at all credit risks whether they arise from on-balance sheet activities (including loans,

fixed-income and equity securities, and interbank deposits and loans) or off-balance sheet commitments. We also look at the possible additional risk for senior unsecured creditors arising from any securitisation undertaken by the bank (see "*Securitisation*" below).

We examine the structure of the bank's balance sheet, including the relative proportions of different asset categories. Generally, but not always, the loan book constitutes the most significant portion of a bank's assets, and thus a comprehensive review of this is essential (even if it does not account for the bulk of the balance sheet, it is generally where most risk lies). In this context, we ask for a breakdown of lending by type of loan, size, maturity, currency, economic sector and geographical distribution. We also look at concentrations of credit risk, including large exposures (generally over 10% of equity) to individual customers and credit risk concentrations in particular industries.

We analyse those loans considered as "problem" loans, whether they be "sensitive" or "watchlist" (i.e. still performing) loans, non-performing or restructured loans. Here it is important to have a clear in-house definition of "problem" and non-performing" loans, as these can vary from one country to another. In assessing the underlying risk of any problem loans, the adequacy of any security and reserve coverage is taken into account. As far as loan loss reserves are concerned, we examine the different types of risk reserve in place (e.g. specific, general, etc.), the bank's overall policy towards provisioning, its historical loan loss experience, and its write-off and recovery policies. Asset quality is assessed using both absolute and relative criteria and, where possible, we compare ratios with those of both domestic and international peers.

As regards the quality of other (non-customer loan) assets, we analyse both the fixed income and equity securities portfolios, in terms of the general quality of the securities, their maturity, any undue concentration or particularly large individual exposures and the valuation of these securities. Likewise, an analysis of a bank's interbank deposit and loan book will take into account size, maturity, and concentration of the book as well as the creditworthiness of the counterparties.

Banks are taking on increasing off-balance sheet commitments, and it is important to analyse the risks involved. Such commitments include guarantees and letters of credit as well as derivatives, such as interest rate and credit default swaps. They also include, as mentioned above, assets which have been securitised.

The use of derivative instruments by banks is today extremely widespread, and as part of its rating process, Fitch looks at the gross notional and net fair values of a bank's derivative portfolio; it also considers the types of derivative instruments the bank uses and the purpose for which it uses them. As far as credit risk is concerned, it examines the systems used by banks for measuring credit exposure, their valuation policies and the quality of counterparties. Apart from credit risk, derivative instruments also give rise to market, legal and operational risks, which also have to be taken into account (see below).

On the trading side, distinctions should be made regarding the purpose behind derivatives. These instruments may be used to facilitate customer transactions, establish proprietary positions, and/or to mitigate risk. Fitch analyses the trading book by purpose, product, and counterparty sectors to identify real and potential areas of concentration. Derivatives may also be employed for asset/liability management purposes. In these instances, the bank enters into derivative contracts in order to manage the interest rate, currency and equity-linked exposure on its own long-term borrowing.

Credit derivatives are, in particular, being increasingly used by commercial banks as a management tool for diversifying and reducing credit risk, and the market for these instruments has grown dramatically over the past few years. While credit derivatives have enhanced the ability to transfer credit risk throughout the market, thereby fostering greater efficiency and diversification of risk, the rapid growth of the market, its lack of transparency and its relative immaturity mean that it is important to analyse banks' credit derivative exposure and ensure that there is no undue concentration of credit risk (taking its credit derivative book together with all other sources of credit risk). As part of its analysis of a bank's credit derivative exposure, Fitch takes into account both the amounts of protection sold and bought by a bank, the motivation for the use of these products, a breakdown of credit derivative activity by product, and the underlying ratings of counterparties and reference entities. Any credit events relating to credit derivatives experienced by a bank, as well as the financial reporting procedures relating to its credit derivatives book are also examined.

Market Risk

Our analysis of market risk covers all structural and trading risks across a bank's entire business (including on- and off-balance sheet business). As far as structural risks are concerned, we examine the bank's asset and liability management strategy, and

the role of position taking, hedging and accounting in this strategy. We look at the levels of interest rate, foreign exchange and equity risks on and off-balance sheet and how these compare with the limits set for each of these risks.

On the trading side, we examine the general strategy of the bank in regard to its trading activities (is it a significant position taker or are its trading activities mainly related to client business or hedging transactions?). We then analyse the trading book by product and market, with a focus on the measurement of risk (Value at Risk - VAR, stress scenarios, etc.), volatility of revenues and bottom-line profitability.

We also analyse the market risk in any equity participations held in a bank's banking book, taking into account any undue concentration of risk and how these participations are valued.

Operational Risk

Operational risk has historically been defined as all other risks other than market, credit and liquidity risk. In the context of Basel II, however, the Basel Committee has adopted a narrower definition of operational risk: "the risk of loss resulting from inadequate or failed internal processes, people and systems or external events". This definition includes legal risk but excludes strategic and reputation risk.

While Fitch has for some time implicitly analysed operational risk as part of its credit rating process, the combination of risk measurement advances in the financial sector and new regulatory demands has prompted the agency to adopt a more formalised and explicit approach to these risks.

Our analysis of operational risk focuses on a number of issues, including a bank's definition of such risk; the quality of its organisational structure and operational risk culture; the development of its approach to the identification and assessment of key risks, data collection efforts; and overall approach to operational risk quantification and management. We also look at how successful financial organisations have been in integrating these approaches into a logical framework so that they reflect back and inform each other.

For further information on Fitch's approach to assessing operational risk, see our special report "*The Oldest Tale but the Newest Story: Operational Risk*", published January 2004, and a follow-up report, "*Operational Risk Management & Basel II Implementation: Survey Results*", published April 2004, both available on Fitch's website, www.fitchratings.com.

Other Risk

As already indicated, a risk often not encapsulated in the above categories is reputation risk, which can be significant for some banks, particularly those active in private banking. A good name and brand image are often an important differentiator of long-term performance in an industry which is becoming increasingly commoditised.

Funding and Liquidity

Main areas to analyse here are the structure and diversification of a bank's funding base (in particular the proportion of retail and wholesale funding), including any marked concentration of deposits or borrowing, significant trends in funding sources and in the bank's liquidity. The main risk for a bank's funding is not being able to renew or replace maturing liabilities, either at all or at a reasonable cost. A well diversified and stable funding base and a good spread of suppliers within each source type can limit this risk. It is thus important to analyse the composition of a bank's deposit base and other sources of borrowing by size, maturity, geographical source and currency. We also examine the role of securitisation as part of a bank's funding plan (see "*Securitisation*", below).

As far as liquidity is concerned, we analyse both the bank's internal sources of liquidity (marketable securities, maturing loans, etc.) and external sources (such as access to capital markets, stand-by lines from other banks and rediscount facilities at the central bank). As an insurance policy against being unable to cover a shortage of cash flow, most banks hold a portfolio of marketable securities and other assets, which can be sold quickly for cash in case of need. In addition, central banks and some of the larger banks often specify certain assets that are acceptable as collateral for short-term borrowing. It is, however, important to assess how marketable a bank's marketable securities portfolio really is and whether such securities would be sufficiently liquid in the case of a crisis. Finally, banks should have a clear contingency plan, organised on a regional basis, in case they run into difficulties, specifying who is responsible for the management of liquidity in a crisis, what action is to be taken and at what point, and what arrangements exist with "last resort" lenders.

Capitalisation

A bank's equity capital provides a cushion to absorb unreserved losses and thereby allows it to continue as a going concern, thus staving off insolvency, or, if insolvency does become inevitable, to some finite degree absorbing losses which would otherwise have to be borne by creditors. Both the absolute size of a bank's equity capital and its capital adequacy (i.e.

the size of its capital in relation to its risks) are thus fundamental considerations when analysing its creditworthiness, although contrary to the belief of some market observers, capitalisation is not the only concern for rating agencies.

Since it is primarily risk capital, there is no obligation for equity to be paid back to anyone, and there can be no obligation for it to pay the equivalent of interest. There are, however, usually expectations on the part of investors that equity capital will generate some sort of return. On the other hand, if there is any form of obligation to pay a return, then the capital in question is not pure common equity but debt.

Fitch has its own standard quantitative measures of capitalisation which it applies to banks across the board, the principal one being pure common equity as a percentage of total average assets. It also looks at the amount of preference shares and hybrid debt issued by a bank (including the terms and provisions of these instruments in order to evaluate the financial flexibility afforded to the bank during periods of stress). While the agency is comfortable when preference shares and hybrids combined do not exceed 25% of a bank's pure common equity, any breach of this barrier may not be given any capital (or equity) credit by Fitch.

While the evolution of a bank's capitalisation is an important part of our analysis, we also examine closely the quality of capital: what percentage of the capital base is pure common equity and how much is in the form of preference shares, subordinated debt, perpetual debt, and other forms of quasi-equity or double-counting of equity (such as silent participations, double leverage, revaluation reserves, embedded value, unrealised gains, underprovided non-performing loans and overvalued assets). Management's policies with regard to minimum capital ratio objectives, share buy-back programmes and dividend payouts are also taken into account, as are the bank's ability to raise new capital and its internal capital generation record.

It is also important to analyse the level of "free capital" a bank has. If the entirety of its capital base is, for instance, tied up in long-term participations or fixed assets, it will not have any "free" (i.e. immediately available) capital with which to absorb unreserved losses.

Fitch additionally looks at the trends in a bank's regulatory capital ratios, both in absolute terms and in relation to those of its main peers. It takes into account any peculiarities in the calculation of regulatory ratios in the country where the bank is domiciled, i.e. any deviation from the current Basel

G10 capital adequacy guidelines or, where relevant, from the EU capital adequacy regulations.

With preparations for Basel II in full swing, Fitch is also monitoring the progress of banks towards implementation of the new Accord in 2007/8. While regulatory capital adequacy ratios are in general not expected to change dramatically as a result of the new regulatory guidelines, the impact will vary from one bank to another.

Securitisation

The rapid growth of the securitisation market by volume and product over the past few years raises significant issues for bank ratings in terms of balance sheet gearing, funding, credit risk and performance analysis. Securitisation can provide banks with added liquidity and access to cost-effective funding, aid them in the management of their credit risk exposure, provide regulatory capital relief and enhance earnings performance measures. However, while it does in many cases bring benefits to a bank, there are also risks inherent in securitisation transactions, which have to be taken into account and managed accordingly.

As part of its rating process, Fitch evaluates the impact of any securitisation transactions a bank has undertaken. This analysis is carried out on a case-by-case basis, taking into account the particular characteristics of each transaction, the benefits and risks associated with it and the issuer's motive for carrying out the transaction. When calculating capital ratios, it is also important to impose a check of adding back to the balance sheet any assets that have been securitised. (See next paragraph but one, below.)

Although securitisation may offer banks various opportunities, the funding advantages are often the most significant. It may serve to reduce a bank's funding costs while also providing added liquidity. It can also provide an alternative to on balance sheet financing and a strong contingency source in the event of turbulent capital markets. However, several forms of liquidity risk (such as the possibility of large asset pools in revolving asset transactions requiring balance sheet funding in the event of early amortisation) are inherent to securitisation activity, and these also need to be taken into account.

While securitisation can also provide banks with a tool to manage their credit risk more effectively, it may not result in a complete and absolute risk transfer. Even though securitisation transactions do not legally require the issuer to absorb credit risk beyond its residual exposure, there may still be a moral obligation to do so. In order to protect its reputation in the securitisation market and retain

access to this source of funding, a bank is often compelled to "save its securitisation" by providing support to a deteriorated pool of assets. The analysis of a bank's securitised assets is thus usually an essential part of analysis of its potential credit risk.

From a regulatory standpoint, securitisation can also allow a bank to increase the leverage or gearing of its capital base. This is generally more significant for true sales of assets (i.e. where the securitised assets are held off-balance sheet) than for synthetic transactions, although this can vary from one country to another, depending on regulatory requirements. The impending new Basel Capital Accord may, however, reduce the capital adequacy advantages currently enjoyed by banks when securitising assets. As mentioned above, Fitch already takes account of the impact on capital ratios of securitised assets in its rating approach, and for those banks with significant securitised assets, or in the case of sectors with a noticeable dependence on securitisation for funding, appropriate ratios of capital/managed (i.e. on- and off-balance sheet) assets are included in the spread sheets, if appropriate data are publicly available.

Securitisation can have a positive impact on earnings performance, in particular on ROE ratios. In Fitch's experience, the recourse to securitisation is, however, rarely motivated by a desire to improve short-term earnings performance.

For a more detailed account of Fitch's view of the influence of securitisation on banks' ratings, please see our report "*Securitization and Banks*", published in February 2004 and available on Fitch's website, www.fitchratings.com.

Earnings and Performance

As the income earned by a bank may ultimately affect its solvency, this is another important area to analyse. Fitch looks at the historical trend of a bank's earnings performance, the stability and quality of its earnings and its capacity to generate profits. While taking into consideration its operating environment, Fitch compares significant performance indicators for a bank with those of its peers. Where possible, it also analyses earnings for each of the bank's business lines. In this context, it looks at the trends in:

- net interest revenue, including the evolution of interest spreads in each business line, trends in lending volumes and evolution of funding costs;
- non-interest income, including more stable revenues in the form of commissions and inherently more volatile trading revenues;
- non-interest expenses, breaking down personnel and other expenses, and comparing the expense

level not only with total income but also where possible with earning assets, to the number of branches (in the case of retail banking) and to the number of employees;

- provisioning levels, together with the capacity of the bank's earnings to absorb provisions;
- exceptional income and expenditure items, as well as developments in taxation charges.

Where necessary in its ratings analysis, Fitch makes adjustments to a bank's reported income statement figures, so that financial performance indicators are as comparable as possible from one bank to another and from one country to another – although, given the differences in accounting and reporting standards, cross-border comparisons are not always particularly meaningful.

Earnings prospects are also closely examined, based on budgets and forecasts given to us by a bank, as well as any medium-term plan it may have. External factors which may influence future earnings trends are taken into account, as well as management's track record in providing reliable budgets and forecasts.

Market Environment

A number of aspects relating to the environment in which a bank is operating can have a significant influence on its creditworthiness. Some of the most important are:

- the size and health of the bank's domestic economy, as well as prospects for future economic growth;
- any structural problems that might be facing the economy (such as high inflation);
- the country's political situation;
- the structure of the banking sector in general, relative size of various banks, concentration of market, recent consolidation trends;
- the bank's competitive position within the banking sector, its market shares in its main business lines, and its ability to influence prices; also competition from other banks and non-bank financial institutions;
- regulatory environment, including the role of the supervisory authorities, quality of bank supervision, reporting requirements, regulations relating to specific types of financial institutions and to specific financial products;
- history of bank failures within the country in question, attitude of the regulators in providing support to banks and other financial institutions in need, existence of deposit guarantee schemes;
- quality of accounting, auditing, and reporting standards within the country.

Diversification of Business and Franchise
Fitch analyses the diversification of activities undertaken by a bank, in geographical, domestic and international, and industrial sector terms. It also examines the diversity of services and products it provides to customers and its ability to create new products. It takes into account the strength and depth of a bank's franchise as well as its ability to safeguard existing business and gain new business.

Management and Strategy

An effective management and well-defined strategy are essential ingredients for a successful bank. As part of its assessment of a bank's management, Fitch looks at the organisational structure of the bank, the dependence of the management team on one or more persons, coherence of the team, the independence of management from major shareholders, and management's track record to date, in terms of building up solid business mix, maintaining operating efficiency and strengthening the bank's market position. It also analyses the quality and credibility of management's strategy, examining plans for future internal or external growth. When evaluating future plans, significant credit is given for delivering on past projections and sticking to strategies. Although judgement of management is subjective, financial performance over time provides a more objective measure.

Corporate Governance

Fitch's analytical approach to corporate governance has evolved over the years. While Fitch has always taken aspects of corporate governance into account within its credit rating process, it has recently formalised a more systematic framework for reviewing a company's corporate governance practices. This general methodology is explained and expanded upon in a special report, *"Evaluating Corporate Governance: The Bondholders' Perspective"*, published in April 2004 and available on Fitch's website, www.fitchratings.com. In assessing corporate governance, Fitch analyses governance data and information systematically, and also performs more contextual, qualitative reviews of an individual company's governance practices. In this "Bank Rating Methodology" we highlight those aspects that are most relevant to banks.

While much of the recent public debate on this subject has been concentrated on equity-holders, Fitch is particularly concerned with evaluating the quality of a bank's corporate governance practices from a bondholder's perspective. Important aspects of the corporate governance methodology which are covered in our credit analysis of banks include:

- The independence and effectiveness of the board of directors. An independent, active and committed board of directors is an essential element of a robust corporate governance framework. The role of the board is to work with management in steering the company to its performance objectives and to provide critical, impartial oversight of management performance. A board that is not committed to fulfilling its fiduciary responsibilities can open the door to ineffective or irresponsible management behaviour.
- Oversight of related party transactions that may lead to conflicts of interest. Such transactions, which include those between senior management or major shareholders and the bank, may warrant closer review, particularly if the related party is, as a result of the transaction, faced with a competing set of incentives that is separate from the financial performance of the bank.
- Board oversight of the audit function. Governance of the audit process is an important safeguard in protecting the integrity of a bank's financial reporting. It is the responsibility of a bank's audit committee (or equivalent) to monitor the work of external and internal auditors, and at the same time to ensure that the company's audit is conducted independently and objectively.
- Executive and director remuneration. If remuneration exceeds market norms and standards, it can cause a drain on a bank's financial resources; it also suggests a lack of financial discipline that might pervade the culture and operations of the company more generally.
- Complex holding company structures. In cases where a bank has a complex holding company structure, there are unique challenges in evaluating the decision-making process, lines of hierarchy and financial obligations and liabilities. In analysing these banks the fundamental issue is to explore the underlying reason or motivation for the complexity of the organisation.
- Banks which are owned by private individuals and families. On the one hand, the concentration of equity ownership might indicate that the majority shareholders have a strong vested interest in creating long-term value and closely monitoring management behaviour. On the other hand, a potential concern in such cases is that the owners might rely heavily on extracting

funds from the bank as source of income or to fund other business activities, potentially undermining the financial stability of the bank.

- As part of its analysis, Fitch also examines other aspects of corporate governance whose impact on bondholders is less clear cut; these include equity ownership by executives and directors and the existence of takeover defences, such as "poison pills" that dilute the interests of potential acquirers and thus make a target bank's stock look less attractive (for further discussion of Fitch's approach to executive/director stock ownership and takeover defences, see our special report "*Evaluating Corporate Governance: The Bondholders' Perspective*", referred to above).

Fitch is of the view that a bank's corporate governance practices can have a material impact on its credit quality. In particular, fundamentally weak corporate governance could make bondholders vulnerable to potentially significant credit losses, and thus may warrant a negative rating action. Exceptionally strong governance practices could warrant a special mention or other positive recognition in the credit analysis but generally will not drive a positive rating action.

Ownership and Support

The ownership of and potential support available to a bank is crucial to our Support ratings and ultimately our Short- and Long-term ratings (see "*The Fitch Support Rating*", below). We analyse the stability of the shareholding structure of the bank, as well as the ability and willingness of either its owners or the government to bail out the bank in case of need.

■ Rationale of Fitch's Rating Assessments

The Particular Nature of Banks

Banks operating in free market economies are in most ways like other business entities, but there are significant differences: the most important is the role of banks in the supply of, the demand for and the price of money (i.e., in most cases, the national currency). This peculiarity may set even the most humble and unobtrusive bank in such an economy apart from, say, the largest retail store business or a major real estate developer. Our rating assessments have to recognise this peculiarity.

To pursue the example, the collapse of one retail store chain or of a real estate company is scarcely likely to endanger a whole economy or even the world economy; the collapse of a bank may, by its contagious effect, do just that. Consequently, even

the most laissez faire administrations in the purest of pure market economies may still be seen to hesitate before standing aside to allow the default of a bank, and particularly of one which is a constituent of the national or international payments system or presents some other systemic risk. However, when the chips are finally down, the authorities may crack and rescue the bank, rationalizing the action afterwards with suitable post hoc, ergo propter hoc arguments. There are, nevertheless, growing differences in the attitude of the authorities in different jurisdictions (see our special report “*Bank Support in the Developed World*” – published September 2002 and available on our website, www.fitchratings.com)

Most national bank regulators have two principal motivations. In the first place, and most importantly, they want confidence in their banking system to be maintained. However, they also want, and this can be in conflict with the first objective, market participants to behave in a prudent and professional manner. One of the best ways to ensure prudence is to allow a degree of risk, i.e. occasionally to allow bank depositors or creditors to lose money. In many countries there are deposit guarantee schemes in place in order to protect retail depositors, so that any losses would generally be incurred by wholesale creditors, which would be less embarrassing for the authorities. However, if this were to become a regular occurrence, it would undoubtedly impinge on the maintenance of confidence in the whole system. It is, therefore, in the interests of the bank regulator/central bank to be deliberately vague about which banks it would support and when, or in the words of a former President of the New York Federal Reserve Bank, Gerald Corrigan, to create an undercurrent of “constructive ambiguity”.

Thus, a particularly important factor to be taken into account when rating banks is the presence (or possibly absence) of a lender/rescuer of last resort, and a very important part of our background, analytical work is an attempt to assess whether, and under what circumstances, a bank would be supported, and by whom. Although regulators may be cryptic, a schedule of regular calls upon them, of reading between the lines of their obiter dicta on other related, and even apparently unrelated, matters can help to build up a fair understanding of their current views. It is also advisable to track changes (if any) in national governments’ (as opposed to regulators’) attitude towards bailing out banks.

The Fitch Support Rating

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. 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; in fact for each bank rated they set a Long-term debt rating floor, but they do not assess its intrinsic credit quality. This is the function of the Individual rating (see below). It should be emphasized that Support 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.

The Support rating definitions (for details please see “*Fitch Rating Definitions*” on Fitch’s website, www.fitchratings.com) 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.

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

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 a country ceiling “cap” in the case of institutional support.

As already mentioned, two types of potential support 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 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:

1. 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
2. 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).

Finally we emphasise that in our Support rating we are not analysing how “good” or “bad” a bank is, but merely whether it would receive support if it ran into difficulties. However, this issue, while of great importance to any assessment of credit standing, cannot be the only consideration. For reasons of prudence and self-protection, investors and other counterparties and their advisers and executive employees would generally prefer that they deal with banks that are viable and will remain so. Even though it may not be his or her own money at stake and the bank in question is sure in the end to be bailed out, no corporate treasurer seeks a starring role in debacles such as the virtual collapse and then rescue of *Crédit Lyonnais*. The same may be said of those creditors who found themselves exposed to the Nordic banks rescued by the state in the late 1980s and early 1990s, or indeed those exposed to many of the Japanese banks today.

The Fitch Individual Rating

The Individual rating is designed to assess a bank’s exposure to, appetite for, management of and absorption capacity for risk, and it thus represents Fitch’s view on the likelihood that the bank would fail and therefore require support to prevent it from defaulting.

In assigning an Individual rating to a bank the credit committee bases its decision on the findings of the Fitch bank analysts described under “*The Analytical Process*”, above, concentrating in particular on the extrapolation of these findings into the future. Principal considerations are profitability, balance sheet integrity (including capitalisation), franchise, management, operating environment, consistency, as well as size (in terms of a bank’s equity capital) and diversification (in terms of involvement in a variety of activities in different economic and/or geographical sectors). As already noted, we normally establish a domestic, and if possible international, peer group for comparison purposes. The topics of comparison are essentially the same world-wide but can vary according to the type of bank (e.g. merchant/investment bank v. commercial bank; German *Landesbank* v. German *Universalbank*). The ratios used are also essentially the same, but can vary because of differing national banking practices and differing reporting standards and conventions. As already noted, we carry out a cross-border comparison, but this is necessarily complicated by the variety of these practices, standards and conventions. Nevertheless, we make every effort not to fall into the trap of intellectual insularity and do not, for example, effectively insist that those standards set by the so-called “Anglo-Saxon” countries’ banks are a universally applicable gauge of viability.

Long-Term and Short-Term Credit Ratings

In addition to our Support and Individual ratings, we also assign ratings to securities, both long-term and short-term, issued by most of the banks we rate. The function of such ratings (based on the scales of “AAA”/“F1+”) is not to provide an assessment of how good or bad a bank is, but simply to answer the question: “If I lend money to this bank via this instrument, how certain is it that I will be repaid in a timely fashion?”. Accordingly “Investment grade” ratings (Long-term “AAA” – “BBB-” categories and Short-term “F1” – “F3”) indicate a relatively low probability of default, while those in the “speculative” or “non-investment grade” categories (Long-term “BB+” – “D” and Short-term “B” – “D”) either signal a higher probability of default or in the ‘D’ category that a default has already occurred.

Fitch’s credit ratings for banks are driven by their Support and Individual ratings. The Long-term rating is explicitly linked to the Support rating by the existence of rating floors. Thus, depending on the level of a bank’s Support rating, its Long-term credit rating cannot fall below a specified floor. A good Individual rating, on the other hand, may drive a Long-term rating up above its Support rating floor.

While Short-term and Long-term credit ratings applied to a bank (commonly referred to as counterparty, senior unsecured or issuer ratings) assess its general creditworthiness on a senior basis, ratings assigned to specific issues made by a bank take into consideration the relative preferential position of the holder of the security and also take into account the terms, conditions, and covenants attaching to that security. Long-term ratings assigned to subordinated debt and preferred stock issues are generally “notched” off the Long-term credit rating, with the degree of notching or number of rating grades below senior debt being narrower for investment-grade banks than for banks with non-investment grade ratings (see our criteria report *“Rating Preference Stock and Hybrid Securities of Financial Institutions”*, dated May 1999 and our special report *“The rise and rise of preference share capital in Europe (Horses for courses)”* dated May 2000, both available on Fitch’s website, www.fitchratings.com).

International Short- and Long-term ratings may be assigned to both foreign currency and local currency debt issues. Foreign currency ratings are generally subject to a “country ceiling” established by Fitch’s sovereign ratings department, although banks can, in some circumstances, achieve higher Long-term ratings than their sovereign Long-term rating. A good example is that of banks rated by Fitch in EU countries which have ratings lower than “AAA”. Local currency ratings assigned to banks will also, as a rule, be subject to a “sovereign ceiling” (in that the sovereign state’s local currency rating will generally be the highest rating of any entity in its jurisdiction). However, banks with particular strengths may on occasion exceed it (see our special report *“Rating Banks above the Local Currency Sovereign Rating”* dated June 2001, available on Fitch’s website, www.fitchratings.com). Both foreign currency and local currency ratings are internationally comparable assessments. The local currency rating measures the probability of payment in the relevant sovereign state’s currency and jurisdiction and, unlike the foreign currency rating, does not take into account “force majeure”.

“National” ratings are generally assigned to banks in emerging markets, where there is a demand for such

ratings. In effect these national ratings are an assessment of credit quality relative to the “best” credit risk in a country; this “best” risk will normally, although not always, be the state, which will accordingly be assigned a “AAA” Long-term rating. As such, the national rating scale is not subject to the sovereign ceiling imposed on foreign currency international ratings. National ratings for banks in one country are not comparable with those assigned to banks in another country, nor are they comparable to Fitch’s international rating scales (although they are correlated with the local currency ratings in as much as they should show the same relativities between issuers - see Fitch’s criteria report: *“National Ratings”* dated February 2000 and available on Fitch’s website, www.fitchratings.com)

In order to indicate the direction in which a Long-term rating is likely to move over a one- to two-year period, Fitch assigns outlooks to these ratings; these may be “Positive”, “Stable” or “Negative”. A “Positive” or “Negative” rating outlook does not, however, imply that a rating change is inevitable. Similarly, ratings for which outlooks are “Stable” could be upgraded or downgraded before an outlook moves to “Positive” or “Negative” if circumstances warrant such an action. Occasionally and exceptionally, Fitch may be unable to identify the fundamental trend. In these cases, it is possible to assign an “Evolving” outlook.

All ratings, with the exception of Support ratings, may be placed on Rating Watch to notify investors that there is a reasonable probability of a rating change and the likely direction of such change. These are designated as “Positive”, indicating a potential upgrade, “Negative”, for a potential downgrade, or “Evolving”, if ratings may be raised, lowered or maintained. Rating Watch is typically resolved over a relatively short period.

All Fitch’s bank issuer/issue ratings are determined by a credit committee in accordance with a judgement combining the Fitch Individual and Support ratings (essentially assessing the propensity to fail and probability of default) .

Details of the full range of Fitch’s rating definitions may be found under *“Fitch Rating Definitions”* on Fitch’s website, www.fitchratings.com.

■ Appendix: General Bank Rating Questionnaire Applicable to All Countries

■ Introduction

This questionnaire is intended as a prototype which may be adapted by eliminating irrelevant sections or added to in order to become the questionnaire for the rating analysis of a particular country's banks, a particular type of bank, or of a particular bank. In case undertaking such an adaptation is not justified or in an emergency, the prototype may serve unchanged as the actual questionnaire to be used for a particular bank.

The main headings have been chosen to reduce overlapping of topics to a minimum; nevertheless, since the activities of a bank intermesh, there is bound to be some overlap.

In regard to questions which require financial data, it should be assumed that in the case of a new rating we are asking for a minimum of three years' annual figures and a maximum of five years', depending on availability and the particular circumstances. We would also like quarterly (or, if not available, half-yearly) data over a two-year period. It should be stressed that we wish to inconvenience the rated entity as little as possible: if data requested are available as internal management information but in an ostensibly rather different form from that actually asked for, then the management information will often suffice.

Unless we have been specifically assigned to rate an unconsolidated entity, it should always be assumed that we require consolidated data, and in general we would expect such data to be independently audited. In the case of a bank holding company or parent bank, we need consolidated data for the whole group; in the case of the banking subsidiary of a bank holding company or parent bank, we need consolidated data for that subsidiary. In the case of countries where banks (or particular classes of banks) do not have to produce consolidated figures, we clearly cannot insist, but this deficiency will have to be taken into account by Fitch's credit committee when the company in question is rated.

■ Market Environment and Planning

1. If the structure of the bank/group is complex, may we have a legal and operational organigram?
2. We would also like, if possible, an organisation chart of the bank's main operational subsidiaries and affiliates.

3. We would like a description of the bank's current main business activities, as well as details of plans either to withdraw from any of these activities or to enter into new activities. Are you intending to make any significant external acquisitions or are you planning to develop your business by organic growth?
4. Are there any plans to develop new products or services?
5. Do you have operational partnerships with other financial institutions and/or are you planning to enter into any such partnerships?
6. We should like an assessment of your competitive position, both domestically and internationally? How do you view competition in the market and what role do you expect your bank to take in any consolidation of the banking sector?
7. How dependent is your business on the state of the major economies in which you are operating? What is your current assessment of these?
8. What are your current market shares in your principal business lines? What are your targets (if any) for increasing these market shares? Do you have any specific targets for percentage asset growth, percentage return on assets and on equity? If so, we would like details. Is there any order of priority for achieving these, and how do you intend to do so?
9. What has been your capital expenditure over the past three years on technology and automation? What are your plans for further technological development?
10. What is the state of your labour relations?
11. Please provide information on pension liabilities (specifying whether they are on- or off-balance sheet). Do you operate a "fully funded" pension scheme? If this is the case, is there an obligation which requires the bank to fund any deficit which may arise on pensions, and if so how this would be carried out? Has the bank provided against future liabilities?

■ Ownership

1. Have there been any significant changes in your ownership recently? Are any planned in the near future?
2. We should appreciate details specifying beneficial as well as nominal ownership.

3. What is the substance of the potential support from shareholders for the bank?

■ **Audit/Control by National Banking Supervisory Authority and Accounts**

1. May we have a copy of the latest report by the independent auditors to the national supervisory authority/latest report on the bank by the national supervisory authority's own examiners/auditors?
2. According to which convention are your accounts drawn up (e.g. national GAAP, IAS, US GAAP, EU Accounts Directives for banks, etc.)? Is this likely to change in the foreseeable future?
3. For banks operating in the EU, how advanced is your bank in its preparations for the implementation of IAS in 2005? What impact is the implementation of IAS likely to have on your accounts? What is the estimated cost of this implementation?
4. For banks operating outside the EU and not already reporting according to IAS, what impact would it have on your accounts if you did adopt IAS?

■ **Corporate Governance**

The questions in this section are illustrative of the issues currently explored in our analysis of corporate governance practices. In taking a principles-based approach to evaluating corporate governance, Fitch will continue to refine its analytical approaches as the governance field and bank practices evolve. Therefore, we anticipate that over time the questions we ask regarding corporate governance will evolve as well. The following questions will not all be relevant to every bank and therefore, if not applicable, can be ignored.

1. Has the bank drawn up a set of corporate governance policies? Does it have any mechanisms or review processes for monitoring how these policies are applied?
2. Board independence and effectiveness (for those banks which have a two-tier board system, these questions are more applicable to the supervisory board):
 - How many directors does the bank formally designate as "independent"? What are the bank's criteria for defining a director as "independent"?

- Do any of the directors have commercial or personal relationships with the bank beyond their board responsibilities? For example, are any of the directors involved in a charitable organisation that has received funding from the bank or its senior executives? Are any of the directors employed by an important counterparty or client of the bank?
- What type of professional background do the directors have? What are their primary areas of expertise, in particular as relates to banking or financial risk management?
- How are the bank's principal risks presented to the board? How does management convey significant elements of the organisation's credit, market and operational risk management systems to board members (particularly if these systems are based on technical modelling concepts)? If there have been any recent changes or developments in the bank's risk management systems, what specific thoughts or guidance has the board provided to management on these changes?
- We would like, if possible, to have some examples of the types of issues that the board has considered or reviewed in the past year. If there have been recent cases where the board did not approve or support a proposal from management, what were some of the reasons the board provided for its decision?
- Please give us details of any significant questions that were posed or guidance provided by the board to management during its past few meetings. For example, if the company faced any unexpected or negative events affecting its operations (e.g., operational failure, poor financial results), what were some of the main issues that the board focused on? Please provide some examples of issues on which the board has asked management to follow up or provide additional explanation.
- What is the length of time that each of the directors has served on the board?
- If there is a nominating committee in place, is it comprised of independent outsiders? If there is not a nominating committee, who is responsible for the nomination of board members?

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- What are some of the main factors or attributes that the nominating committee (or equivalent) considers in identifying possible director candidates? How is the pool of candidates determined?
 - What is the CEO's role in the nomination process? Do any recent appointments have prior affiliations or relationships with the CEO?
 - What is the board's process for setting the agenda of topics to be covered at meetings? What role do the directors individually play in determining the list of discussion topics?
 - Do any of the directors serve on the boards of other companies and, if so, how many? As a general matter, what other professional commitments do the board members have?
 - How often, and for how long, does the board meet each year? How much time do directors spend, on average, in preparing for and attending board meetings?
 - If the bank has audit, compensation and nominating committees, how often do these committees meet?
3. Related party transactions:
- What are the firm's policies on related party transactions? If these policies are written, please provide us with a copy.
 - Does the bank currently engage in any related party transactions? If so, what are the terms and conditions of these deals and how are they negotiated? What is the business purpose of these transactions? How do the transactions benefit the company? What types of information did the board receive in its review of the transactions? What types of questions, if any, did they pose about the transactions?
4. Oversight of the audit process:
- Does your bank have an audit or governance committee? If so, how many of the members of this committee are deemed to be "independent" directors?
 - What type of accounting or corporate finance background do the members of this committee have?
- What are the committee's procedures for reviewing major accounting issues, potential audit risks, and the quality of internal control systems? What are some examples of recent decisions this committee has taken in regard to the bank's accounting practices and internal control processes? What is the committee's approach to anticipating or preparing for forthcoming or expected changes in accounting policy standards?
 - What is the scope and scale of any non-audit services provided by the bank's external, independent auditor?
 - If the bank engages in complex structured finance transactions (for example, with a corporate client), what types of internal controls or audit procedures are in place to help manage the risks (e.g., credit, operational, legal, reputation) that may be associated with these transactions? For example, what types of control processes does the bank have to ensure that neither the bank nor the client uses these transactions to circumvent reporting requirements, evade tax liabilities, or further improper activities?
 - Does the bank have internal auditors? If so, what processes does the audit or governance committee have for overseeing or monitoring their work?
5. Management compensation/remuneration:
- What are the components of the CEO's overall compensation (e.g., including base salary bonuses, stock or option awards, below market-rate loans, corporate perquisites, etc.)?
 - Does the bank have a compensation/remuneration committee or equivalent? If not, who is responsible for the determination of the compensation/remuneration of executives?
 - If there is a compensation committee or equivalent in place, how many of its members are deemed to be "independent" directors? What guidelines does the compensation committee use in setting executive compensation levels? For example, does the committee look to the compensation levels at competitor banks as a benchmark?

- Is management compensation linked to any specific performance indicators? If so, what is the reason or rationale for choosing these particular indicators?
6. Executive/Director stock ownership:
- Do senior executives and/or directors own shares, options, restricted stock or other forms of equity in the bank? If so, how substantial are these holdings (e.g., how many shares/options in total)?
 - Does the bank explicitly encourage or promote stock ownership as an incentive mechanism? If so, for how long has the bank followed such a strategy?
 - What (if any) conditions or restrictions are placed on stock-based compensation? For example, how long is the vesting period for restricted stock?
 - Have executives or directors recently sold any of their holdings in the bank's stock? If so, how much?
7. Takeover defences:
- Does the bank have any takeover defences (e.g., "poison pills" that dilute the interests of potential acquirers and therefore make the target's stock less attractive) in place or other mechanisms to maintain ownership control? Does the bank have a dual-class share structure with certain holders having preferential rights over others?
 - More generally, what practices or processes does the bank have in place to ensure that minority shareholders or other major stakeholders participate in the governance process?
8. Complex holding company structures:
- Is the bank part of a broader holding company structure with multiple subsidiaries? If so, we would like to have full details of the legal consolidated structure.
 - What are the financial relationships between the subsidiaries and their parent? What types of transactions occur between the various subsidiaries and the parent? What are the bank's policies regarding the payment of dividends between parents and subsidiaries? Do major operating subsidiaries have a separate oversight and control structure?
- Are any of the bank's subsidiaries incorporated in a foreign regulatory jurisdiction?
9. Majority-controlled companies:
- If the bank's shareholders are private individuals or families, are these involved in any other businesses? If so, are there any financial or commercial relationships between the bank and those businesses? What is the legal structure of these different business holdings? What is the size of these businesses (revenues, assets, pre-tax profit, equity, etc.)?
 - How are private individual or family owners compensated? What are the bank's dividend policies? Do the owners have drawing accounts and/or do they borrow from the bank? If so, please give details.
 - If the private individual or family owners do not own 100% of the bank, who are the other shareholders? How are they represented on the board?
 - How has the bank's corporate governance structure evolved over time as the bank has grown?
- Performance/Earnings
1. If published annual earnings figures differ substantially from the unpublished, management accounts figures, then we should welcome receipt of a reconciliation of the published figures with the accounts used by management.
 2. We would like as detailed as possible a breakdown of earnings by business line. We would also like to have profitability figures for each business line (in terms of operating and/or net income as a percentage of allocated equity capital).
 3. We should like to have your comments on the development of the bank's net interest revenue and net interest margins. What is your policy re recognition of interest on "problem" loans (see "*Risk – Lending and Other Counterparties*" below); has this policy changed recently?

4. We require a breakdown of fees and commissions by type. We would also like your comments on the recent development of these items.
5. We require a breakdown of other income.
6. What percentage of your operating earnings do you consider to be recurrent? In relation to your trading activities, what proportion of revenues is customer related and how much is own-account trading?
7. We require a breakdown of operating expenses with a commentary on significant changes up or down and an explanation of the tax charge, if this is not straightforward. Please provide details of any restructuring charges incurred, and whether these are included in operating or exceptional expenses.
8. We need an explanatory breakdown of exceptional income and expenses, including any significant capital gains, provisions for unrealised capital losses, and goodwill charges.
9. We need details of appropriations (if any) to equity or quasi/equity reserves made as deductions from income and/or of transfers (if any) from equity or quasi/equity reported as income in the bank's published figures.
10. We would like a copy of your budget for the current financial year? We would also appreciate receiving management's assessment of earnings and other prospects for the current year and beyond. If you have a medium-term business plan, we would like to have a copy.
11. Which businesses do you consider to have the most potential in terms of earnings growth for the bank?

■ Risk

Risk Management

1. How would you describe the bank's appetite for risk in general?
 2. How are risks managed within the bank? Is there an independent risk management function? If so, does this function cover all risks (credit, market and operational)? Who heads this function and who does he/she report to? An organigram highlighting the various responsibilities and reporting lines within the risk management function would be useful.
3. If there is no separate risk management function, we should like details of the organisation of your risk management systems.

Lending and Other Counterparties

1. We need details of your counterparty assessment and credit/exposure approval procedures and limits. In particular:
 - Do you impose country/geographic limits on your lending? If you do, who sets them and who can alter them and for what reasons?
 - Do you impose industry/economic sector limits on your lending? If you do, what industry/economic sector definitions do you use? Who sets the limits and who can alter them and for what reasons? How do you differentiate between the borrower's industry classification and any collateral offered by the borrower? For example, is a loan to a motor-repair business collateralized by a private dwelling house defined as a service industry loan or a real estate loan?
 - Do you impose limits on loans to individual borrowers? If you do, how do these tie in with any limits set by the law or by the regulatory authorities? Who in the bank sets these limits and who can alter them and for what reasons?
 - In relation to real estate lending what are your loan-to-value (LTV) policies and your valuation procedures?
2. In relation to Basel II:
 - Which of the three options offered by the proposed new Accord relating to credit risk are you planning to adopt: Advanced IRB, Foundation IRB or Standardised approach?
 - Have you generated default and recovery statistics in-house or have you bought them in? How comprehensive are these statistics? In which sectors are you most advanced? How far back do your statistics go?
 - We would like details of your internal rating systems? For which businesses are these already in place and for how long have they been in operation? Do they comply with the requirements of the latest version of Basel II? For which businesses do you not yet have rating systems in place and what are

- your plans for implementing systems for these businesses?
- What, if any, stress-testing procedures do you have in place?
 - Have you calculated the impact the new Accord will have on your capital coverage of credit risk? If so, what is it?
3. We require an approximate breakdown of the bank's non-bank risks (both on- and off-balance sheet) in terms of economic sector (as you define them), of ultimate country risk and of currency.
 4. What percentage of your lending is secured? What is the nature of that security and how is it valued?
 5. We need information on the make-up of your risk (both on- and off-balance sheet) in terms of size, i.e. concentration of exposure to single entities including groups of related entities.
 6. We require a list of your twenty largest non-bank risk exposures.
 7. Do you lend to "hedge funds"? If so, please provide details of the principal exposures.
 8. We would like an update of your emerging market country exposure, including sovereign, inter-bank and corporate risk, as well as details of reserve levels and any new provisions and/or write-backs of provisions made during the last reporting period. What internal ratings have been assigned to these exposures?
 9. We would like a breakdown of your real estate portfolio and details of your criteria for making such loans. What are your average LTVs for residential mortgage lending and for commercial real estate lending? What are the maximum LTVs allowed?
 10. What percentage of the portfolio is in the form of residential housing loans? Within this portfolio, please provide a geographical distribution of lending, as well as a breakdown of properties under development, rented properties and owner-occupied properties and a breakdown of the portfolio by internal rating. We also require details of any repossessed properties.
 11. Please give a breakdown of any commercial real estate loan portfolio in terms of office, retail, industrial or other. We also require a geographic breakdown of the portfolio, a breakdown by internal rating and details of any repossessed properties on your books.
 12. We would like details of your personal loan portfolio, including how you define personal loans, the maturity of this market in your country, the existence of any credit bureaux, and information on criteria for granting personal loans and any scoring systems you have put in place.
 13. We need information on any exposure you have to your major shareholder(s) or to any associates or affiliates of your major shareholder(s).
 14. We require a list of your twenty largest interbank exposures plus assessment criteria for such exposures and limits in place.
 15. We also require a list of the largest counterparties in your securities portfolio (both trading and investment) as well as a breakdown of these portfolios by internal and external rating category if possible.
 16. How do you define and assess your "doubtful" and/or "non-performing" (or equivalent) exposure? Are definitions different for personal loans from those for corporate loans? We need details of these loans and other exposures, specifying whether they are domestic or foreign. We also need to know how much, if anything, you have provided against them. See "*Capital, Hidden Reserves and Loan Loss/Risk Reserves*", below. (In this context we require a list of your 20 largest problem loans and your 20 largest accumulated loan loss provisions.)
 17. Please give us details of any restructured loans. How do you classify overdrafts/bullet repayment loans?
 18. How do you ensure the maximum recovery on loans that have gone bad? Do you have a separate "Recoveries" section? If so, how is it organised and how does it operate? How successful has it been?
- Contingent (Including Off-Balance Sheet) Risks
1. We will need details of any assets and income streams that have been securitised (see "*Securitisation*", below).
 2. We will also need details of any other significant off-balance sheet liabilities, in particular:

- Derivatives business: we are interested in the consolidated derivatives portfolio of the entire bank or banking group.
 - What are your main derivative products? Could we have a breakdown by notional principal and your estimate of outstanding risk (with an explanation of how you have calculated this)? We would also like a list of the largest derivative counterparties.
 - What technical tools are employed to price, value and monitor positions?
 - How frequently are price valuations validated? By which individuals and/or databases are values substantiated?
 - Are there exposure limits based on instrument type? How are they determined? By whom?
 - Are there maturity limits by product, counterparty, investment grade or business sector?
 - How are policy breaches dealt with?
 - How many times over the past year have your internal limits been exceeded? By how much?
- integrated with cash positions? If so, describe how these are reported and managed on an integrated basis. How are hedge vs. trading positions reported?
5. What are the key risk management, operational, reporting and IT issues arising from your CDX business? How are these being addressed?
 6. Have you experienced any operational losses from model risk/valuation issues, disputes or inaccurate position reporting?
 7. Please give us details of the types of CDX you use: single name credit default swaps, credit linked notes (CLN), synthetic CDOs and basket products, total return swaps, spread options and any others.
 8. Please give us details of your gross sold and bought positions in CDXs (broken down by type of product) as well as your net sold/bought positions, before and after other offsets, including cash positions.
 9. Do CDXs serve as an overall hedge against other credit risks? If so, explain?
 10. To what degree are net CDX positions less than perfectly matched, either by tenor, name or other mismatch, thereby creating a degree of basis risk? How are such risks managed?

Credit Derivatives

1. Is your bank active in the credit derivatives (CDX) business, and if so, for how long has it been involved? If not, please ignore the remaining questions in this section.
2. What has been the overall rate of growth of this business?
3. What are the primary motivations for using CDXs: hedging, trading, alternative investment, risk-based capital relief, portfolio rebalancing (relative value trading) and/or economic capital management?
4. Please provide us with organisational details of your CDX business and the reporting lines. Who, for instance, is responsible for the risk management of this business? Is senior management involved? Who books the transactions, settles cash, sends documentation and who calculates the impact on the profit and loss account? Who approves the valuation of CDXs and the risk models used? Are you able to aggregate and monitor CDX positions by business line and legal entity? Are CDX positions and risk management reporting
11. Besides gross and net notional sold/purchased positions, what other measures do you use internally to measure and manage CDX exposures (e.g. MTM exposure or value on default)?
12. What percentage of credit risk has been transferred via CDXs (as well as other hedges)?
13. Describe the decision process for using hedges.
14. What is the amount of your total credit exposure including the net position in CDXs? How does it break down by sector?
15. Please give details of specific risk concentrations that have been hedged.
16. If you use CDXs as a form of alternative investment, what is the size of your investments relative to your cash portfolio? Is the protection sold funded (e.g. CLNs) or unfunded? How much do these investments contribute to the separate lines of revenue? What are the ten largest reference entities and industries you have exposure to? If you are holding CDOs, please

give a breakdown by origination, asset type and current ratings.

17. Please give us details of the top ten counterparties in terms of protection purchased (including MTM and notional exposures). To what extent is your counterparty risk mitigated by netting and collateral arrangements? What sort of triggers are in place to collateralize exposures? Do you have a contingency plan in the event of a large counterparty default?
18. Please describe the accounting treatment of your CDX business: mark-to-market vs. accrual; trading vs. hedging. Do financial results for credit derivatives include hedging and trading activities? Can you break out performance results for hedging vs. trading?
19. Where do CDXs appear in your financial statements and supporting footnotes?
20. How are key financial ratios influenced by accounting treatment of credit derivatives (e.g. are asset quality and reserve ratios understated or overstated compared to a pure cash lender)? Is protection sold or purchased captured in traditional leverage and capital adequacy measures?
21. What proportion of your CDXs is off-balance sheet? How are these reflected in your financial ratios and analysis?
22. What percentage of cash CDO investments is carried at original face vs. lower impaired value? What percentage is deemed to be a candidate for additional impairment?

Securitisation

1. Please give us a breakdown of any assets and/or income streams you have securitised by type of technique used :
 - Consumer and corporate assets (ABS)
 - Commercial and Residential Mortgage Backed Securities (CMBS & RMBS)
 - Asset-backed Commercial Paper (ABCP)
 - Balance-sheet Collateralised Debt Obligations (CDOs), either true sale or synthetic.

If your bank has not securitised any assets or income streams or invested in any securitisation issues, please ignore the remaining questions in this section.

2. What is the total volume of assets securitised in each of these categories on a nominal and risk-weighted basis ?

3. What was the motivation for securitising the assets or income streams in each case?
4. How were such assets determined ? Were they, for instance, “cherry-picked”?
5. Has the bank securitised any non-performing loans?
6. How are the assets treated from an accounting and regulatory point of view?
7. How have the securitised assets performed in relation to equivalent assets left on-balance sheet?
8. Has the bank ever supported any of its issues either directly, e.g. the purchase or substitution of assets that were securitised or lending to the special purpose vehicle (SPV) outside contractual obligations or indirectly, e.g. deferral of fee income due from the SPV?
9. In case assets have to be brought back on-balance sheet, for example, because of a regulatory ban on securitisation issues, does the bank have any contingency funding plans in place?
10. How would the bank’s medium-term funding strategy be affected by a hypothetical closure of the securitisation market? Again, what contingency plans are in place to address such an eventuality?
11. Does the bank hold any junior subordinated/ “first loss” tranches of its own securitisation issues, which are currently deducted from regulatory capital?
12. Is the bank an investor in other institutions’ securitisation issues, such as junior subordinated/“first loss” paper? If so, how much paper does it hold and is it deducted from regulatory capital?
13. Are there any plans for further securitisations in the future? If yes, what types of structures and what types of assets?
14. What effect will the latest version of the proposals relating to capital coverage in the new Basel Accord have on the bank’s securitisation activity?

Supplementary Questions for CDO Securitisations

1. Are there any mechanisms in the transactions which reduce any residual income from the

assets for the bank, e.g. such as excess spread on the securitised portfolio which covers loss in the portfolio, or interest-rate sub-participation (or similar) to refund losses borne by the first loss investors?

2. For synthetic structures, is the underlying asset always protected to its full term, or may the term of the underlying assets be longer than the protection under the CDO?
3. Has the transaction an optional call right? If yes, what are the conditions and when can it be called?

Supplementary Questions for ABCP Securitisations

1. Does the bank sponsor an ABCP conduit? If not, please ignore the remaining questions in this section.
2. If so, is it a “single seller”, “multi-seller”, “synthetic”, “securities-backed” conduit or an SIV (structured investment vehicle)?
3. What is the total volume of paper issued through this (these) conduit(s)?
4. Are the conduits backed by liquidity facilities, i.e. are such facilities at least equivalent to 100% of the programme’s size?
5. What proportion of the liquidity facilities is provided by the bank?
6. Do these facilities possess any credit enhancement features?
7. Does the bank provide liquidity facilities to other conduits not sponsored by it?
8. Does the bank hold any related junior subordinated tranches, or provide any other form of credit enhancement/support to its conduits? If so, how are these treated for regulatory capital purposes?
9. Is such support available for all transactions under the programme or transaction-specific (i.e. available only for an individual seller within the programme)?
10. Are the ratings of any of the bank’s conduits explicitly or implicitly tied to the bank’s own rating, e.g. by the provision of support facilities such as liquidity lines?
11. Does the following “scenario” description fit any of the bank’s ABCP conduits? If the bank

were to lose its Tier 1 (“F1+” or “F1”) or its Tier 2 (“F2”) issuer status, it might either be unable to roll over or restricted in rolling over its commercial paper. For example, if the bank was downgraded, the conduit might be prevented from rolling over commercial paper until a replacement provider with the appropriate rating had taken over the support role, or the bank itself had cash collateralised its obligations under the facility and placed such collateral in an appropriately rated bank account. At what stage in such a scenario would the programme be wound up?

12. What programmes does the bank provide back-up facilities to? What specific structural or other triggers would cause such lines to be drawn?
13. What contingency measures does the bank have in place to deal with its funding/liquidity needs should trigger events be crystallised and its programme wound up or back-up facilities drawn?
14. If the bank is the sponsor of a synthetic ABCP programme, are these funds deposited with the bank? If so, how much and on what terms? Is there a contingency plan in place should such funds have to be repaid because of a structural trigger event?

Market Risk

1. In calculating market risk, do you use the concept of “Value at Risk” (“VAR”) or a similar measure? If so please give us the following information for each product portfolio:
 - What method do you use for calculating value: historical simulation, variance/covariance, Monte Carlo simulations or other?
 - What observation period do you use for historical data?
 - What confidence interval do you use?
 - What holding period do you use?
 - What was the high, low and average VAR in the most recent reporting period?
 - How does VAR utilisation compare with limits set?
 - How many days (if/any) was/were the VAR limit(s) exceeded? What was the largest excess? What was the reason? What action was taken?
2. How do you value your market risk transactions? Do you, for instance, use fair value accounting?

3. For regulatory capital adequacy purposes, which method do you use to calculate your market risk: the standardised or internal models approach?
 4. Do you use stress testing? If so, could you give us a recent schedule explaining the results (assuming all limits are fully utilised) and the assumptions behind them, either in terms of scenarios or confidence levels used?
 5. If the above are not applicable, do you have a system for measuring market risk? If so, please provide details.
 6. What instruments do you trade? How are your trading activities organised?
 7. What are your current limits by major trading area (fixed income, equities, etc.) and what has been the average, highest and lowest utilisation of these limits over the past financial year? Have these limits been exceeded at any time, and, if so, what action has been taken?
 8. What is the size of your trading activities and which are the most important of these activities?
 9. How much experience do you have in your different trading activities and how profitable have these businesses been in the past?
 10. How much of your trading activity is client-related and how much for your own account?
 11. We require a breakdown of the different types of market risk you run, e.g. interest rate risk (including spread, basis and directional risk), equity risk, currency risk, etc. What is the greatest source of market risk for the bank? How diversified are the risks?
 12. We need an assessment of the bank's interest rate/currency sensitivity.
 13. What degrees of mismatch are allowed?
 14. How is this policy implemented? How successful has it been to date?
 15. With regard to your fixed-income securities portfolio, we require a breakdown of your trading and investment (or equivalent categories) securities, distinguishing between types of securities. We also need details of any portfolio which is managed separately at the discretion of senior management.
 16. Likewise, we would like a rough breakdown of your equities portfolio, and in particular details of the largest exposures in the portfolio.
 17. How do you measure equity risk in your banking book? In relation to Basel II, are you planning to adopt the market-based approach or the PD/LGD approach to calculating capital coverage of your equity exposure?
 18. What are your portfolio valuation policies (both in relation to bonds and to equities)?
 19. What are your policies for managing investment risk?
- Operational Risk
1. How do you define "operational risk"? Do you include strategic and reputation risk in this definition?
 2. Who is responsible for the bank's operational risk management framework? Is this framework subject to independent review? If so, who conducts this review and how often does it take place?
 3. Who is responsible for reporting to the board on operational risk? Are there designated operational risk managers and, if so, how are they assigned (by business line, region, transaction, etc.)?
 4. In identifying business lines, do you use the Basel II definitions? If not, how do your definitions map to the proposed new Basel Accord definitions?
 5. In order to identify and assess operational risk, do you currently use: self assessment (or scenario analysis), risk mapping, key risk indicators, score cards, threshold limits and/or other measurements? Which processes do you intend to be using by 2007/8?
 6. What, if any, concerns do you have about the overlapping of operational risk with credit and market risk events?
 7. In respect to Basel II, which method do you intend to adopt to measure operational risk in each of your business lines: the basic indicator, standardised, alternative standardised or advanced measurement approach?
 8. What have been the costs to date of developing these methodologies and what is the anticipated or budgeted expenditure for the period running up to 2007/8?
 9. How much capital coverage do you estimate that your operational risk will require (in absolute terms and as a percentage of your total

economic and regulatory capital)? Please give details by business line if possible.

10. Do you have loss data collection in place for each business line? If so, how long has it been in place? If not, when do you intend to introduce it?
11. What were the total number of losses and total loss amount, both direct and indirect, by business line and event type over the past 3 years?
12. Do you apply threshold limits to losses recorded? If so, what are these limits?
13. How does your historical data collection compare with the results of your self-assessment or scenario analysis?
14. Do you use an external loss database? If so, how effective is this? How many observations does the data contain? What is the geographical split of the observations? How often are these data updated? What are the deficiencies in the external loss database?
15. Do you subscribe to other qualitative data sources? If so, how effective are these? What is the geographical split of the observations? Where are the deficiencies in these external data sources?
16. Does insurance form part of your present operational risk mitigation strategy? If so, please indicate, by business line and event type, how much of your risk is currently covered by insurance? What is the cost of this insurance by business line and event type? If you do not currently have insurance, do you expect to do so in the future? Do you use any other operational risk mitigation techniques?
17. Does the bank have any client litigations outstanding? If so, we would like details of these. What measures, if any, does it have for reducing the risk of client litigation?
18. Does the bank have other risks of legal origin?

Other Risks

1. If you have an asset management business, please provide a breakdown of assets managed between private banking, institutional asset management, fund management and any other category. We should also like a breakdown of investors by nationality, by size of portfolios managed and by any other characteristics which appear relevant to you. Please provide the share of the top ten customers in each asset management category. What is the percentage split between discretionary and non-discretionary management?
 2. We should also like a breakdown by type of instrument (equity/fixed interest) and, within these, issuer, currency and maturity (if applicable).
 3. If you administer "fiduciary" funds/deposits, what are their totals, by country of origin and by currency? How are they invested – country, currency and nature of investment?
 4. Is there any latent risk to you in these funds/deposits? For example, although these funds are legally at the client's risk, have you ever/would you ever refund clients for any loss incurred on them? Please cite circumstances.
 5. If you have a custody business, we should like data on the volumes and profitability of business involved and details of clients. Does the bank act as a custodian or sub-custodian for funds it does not manage? We would like a list of your sub-custodian network and also details of your IT capability in this area.
 6. How far would your bank go to support its reputation? Would it, for instance, support all its major subsidiaries? Would it support its securitisations, even if legally it is not obliged to?
 7. Please give details of any other risks not already mentioned that your bank may be exposed to.
- Funding and Liquidity
1. We wish to obtain an understanding of the principal sources and likely volatility of your funding. We thus require a breakdown of your funding by type of depositor/lender, currency and type of instrument. To this end, we require a list of the twenty largest providers of deposits and other funding.
 2. Do you have any information which would help to assess the historical stability of your retail funding base?
 3. We need to know how dependent you are on any major shareholder[s] for your funding.
 4. In the case of bank borrowing, we require an indication of the concentration of such borrowing, the currencies involved and the countries of origin of the lenders.

5. Are there any significant long-term borrowings which will mature this year?
 6. We would like details of outstanding debt in issue, including the type of debt, currency and maturity.
 7. Can you provide us with your funding plan for the next 12 months, indicating the likely form (senior, subordinated, etc.) and timing of any debt issuance? In particular can you supply details of any plans to raise regulatory hybrid capital?
 8. We require details of any standby lines of credit which are available to the bank? Please inform us whether these are confirmed or unconfirmed lines.
 9. We would like a table showing the contractual and expected maturity of assets, liabilities and off-balance sheet items in each currency ("gap" analysis). If there are any negative gaps, how does the bank plan to find the necessary liquidity?
 10. Please provide us with a breakdown of liquid assets by type.
 11. If available, please provide us with copies of regulatory returns relating to liquidity ratios.
- Capital, "Hidden Reserves" and Loan Loss/Risk Reserves
1. We require details of your capital/weighted risk ratio calculated according to the existing Basel G10 guidelines or, where relevant, the EU capital requirements (i.e. including both credit risk and position risk weightings).
 2. We also need details of the calculation of your capital adequacy ratio in accordance with the national requirements if these differ from the existing Basel G10 Accord (or, where relevant, the EU capital requirements).
 3. We require details of any hybrid debt issues outstanding (that are included in the bank's Tier 1 capital), including preference shares.
 4. We also need details of any other forms of quasi-equity (such as silent partnerships, revaluation reserves, embedded value, unrealised gains, underprovided non-performing loans and overvalued assets) which are included in your calculation of capital.
 5. We require details of any double leverage.
6. Does the bank have any plans to raise Tier 1 capital in the foreseeable future (other than by internal capital generation)?
 7. Have you calculated your capital adequacy ratio according to the latest version of Basel II? Will the new Accord lead to a decrease or increase in your capital coverage requirements?
 8. We need details of your "hidden"/"inner" reserves (if any) whether officially recognised and qualifying as eligible capital or not.
 9. We need a breakdown of the movements on your consolidated loan loss/risk reserve(s)/allowance(s)/accumulated provision(s), i.e. the opening balance, the transfer (provision) from income for the year, adjustments for exchange rate variations, write-offs (charge-offs) against the reserve(s), recoveries of past write-offs and write-backs of past provisions and the closing balance of the reserve(s)/allowance(s)/accumulated provision(s).
 10. We require an analysis of the closing balance of the above reserve(s) in terms of economic sector, ultimate country risk and currency.
 11. We need details of any valuation reserves (i.e., market value higher than carrying value) on securities, foreign exchange and precious metals.
 12. We need approximate details of any real estate undervaluations/overvaluations.
 13. Please provide us with details of your most significant intangible assets.
- Insurance Activities
1. What sort of insurance activities is your bank active in: life assurance, non-life insurance or both? If you do not have any insurance operations, please ignore the following questions.
 2. How are your insurance activities organised? If they are carried out by separate subsidiaries, how are these subsidiaries accounted for in your accounts?
 3. How long have you been in the insurance business? Did you set up the business from scratch or did you acquire an insurance business?
 4. How are insurance products distributed: (e.g. bank branches, insurance agents, independent financial advisers, brokers)? What proportion of

- the insurance business is sold through bank branches?
5. How is your insurance operation positioned in the domestic market and what market shares does it hold?
 6. What are the short- and long-term strategies of your insurance operation? Please provide a business plan if possible.
 7. Is your insurance business currently performing well? Please give relevant income statement data for the past three years? Approximately how much of your group's consolidated total revenues and net income is derived from insurance activities?
 8. We would like a breakdown of your insurance company's(ies') investment portfolio by major asset class and industry sector.
 9. How are insurance risks factored into consolidated bank capital adequacy ratio. Do you deduct the value of the insurance participations from regulatory capital (and, if so, from Tier 1 or from total capital). What special allocation of capital is made for the regulatory requirements of the insurance business? How fungible is the capital between your banking and insurance businesses?
 10. What is the present value of the future profits of the life insurance business and how is this calculated?
 11. What (if any) are the amounts of intra-group lending between the banking and insurance operations?
 12. What (if any) guarantees or support agreements exist between the banking and insurance components of the group?

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