Rating Methodology of Creditreform Rating AG

Institutional Protection Scheme Banks

Sub-Methodology of Bank Ratings

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1 Introduction

Creditreform Rating AG (also referred to as "CRA") has been conducting ratings since its inception in 2000 and is a recognized European rating agency.

In order to enable interested parties, investors and the interested public to be able to understand a CRA rating judgement, the present complementary rating methodology (sub-methodology) "Institutional Protection Scheme Banks" is disclosed for the rating of banks who are part of an institutional protection scheme. The rating methodology is updated when changes are made in the applicable classification system. Each rating carried out by CRA is based on established principles such as the rating process, basic procedures, fixed rating scales, and additions. This rating sub-methodology, the fundamentals, principles, and the code of conduct of the CRA are freely available on our website (www.creditreform-rating.de).

2 Scope of Application

The **sub-methodology for rating banks (bank rating) / Institutional Protection Scheme Banks** of the CRA refers to banks that have formed a cross-guarantee system against creditors' claims. The CRA defines an institutional protection scheme (IPS) as a liability agreement that is based on a legislative, contractual or statutory liability agreement in order to protect the affiliated institutions and, in particular, ensures their liquidity and solvency in the event of need in order to prevent a default. Such an agreement must be in the form of a written document and must be accessible in order for it to be taken into account in a bank's rating. As a rule, this methodology is used in particular to assess cooperative banking groups, banks in the savings bank sector, and similar IPS.

The present rating system defines the supplementary methodological analytical framework (sub-methodology) for the consideration of a liability arrangement of banks by taking into account the membership in an IPS. In principle, membership in several IPS can also be taken into account. The extent to which membership in an IPS affects a bank's long-term issuer rating is explained in the third chapter.

A bank that is a member of an IPS may benefit from support by the IPS in times of economic and/or financial stress if it can rely on suitable support measures in order to ensure its business development and/or business continuation, financing respectively punctual and complete servicing of its financial obligations. In particular, we understand extraordinary support to be the provision of funds, institutional guarantees, pledge declarations, assumption of liability, letters of comfort, nationalization, conversion of claims, transfer of financial obligations, or other support services that secure the banking business, although this enumeration is not exhaustive. In particular, we define support as the provision of funds, guarantees, assumption of liability, letters of comfort, conversion of receivables, assumption of financial obligations or other support measures that ensure the banking business, whereby this enumeration is not exhaustive. On the other hand, a bank's long-term issuer rating can also be negatively affected by its membership in an IPS, as it can be assumed that the bank will have to assume liability in the event that a member of the scheme runs in financial distress. Consequently, it depends on the financial strength of the members of the IPS and of the individual bank whether it can benefit from membership in the scheme or whether it has a negative impact.

3 Rating Methodology

In case a bank has joined a IPS, as a first step CRA is going to conduct a rating of the bank on a stand-alone basis. In a second step, we conduct the rating process of the IPS in order to obtain an assessment of the financial strength of the IPS. Both ratings are conducted on the basis of the rating process described in CRA's Rating Methodology for Bank Ratings. At this point, we refer to our website (www.creditreform-rating.de) for the methodology. In the final step, the criteria described in section 3.2 are used to determine the extent to which a bank's stand-alone rating is subject to additional notching due to its membership in an IPS. Any notching is performed in the direction of the IPS 's rating. This means that the stand-alone rating of a bank can be upgraded or downgraded depending on the respective stand-alone rating of a bank and the rating of the IPS.

3.1 Rating process of the institutional protection scheme

In the first step, the IPS is rated on a consolidated basis with all institutions affiliated to the IPS. An aggregated information presentation of the IPS is the starting point for this process in order to enable the application of our rating methodology for bank ratings. If a bank is associated with several independent IPS, the IPS’s are rated individually in accordance with the CRA rating methodology for bank ratings.

3.2 Criteria for Analyzing the Implication of the Affiliation to an Institutional Protection Scheme on the Stand-Alone Bank Rating

On the basis of the following criteria, CRA determines the extent to which the stand-alone rating of a bank is subject to additional notching. The assessment is made on the basis of the three characteristic levels (institutional protection scheme rating, minor deviation and significant deviation).

The additional notching can lead to a maximum notching of up to the rating of the IPS (+/- one notch). In a graduated form, the notching may result in only a minor deviation (up to two notches) from the rating of the IPS due to the affiliation to the IPS. Ultimately, however, notching due to affiliation with an IPS may also result in a significant deviation (up to four notches) from the rating of the IPS.

Therefore, CRA assesses the following criteria on the basis of the three levels (institutional protection scheme rating, minor deviation and significant deviation).

a) Regulation and obligation under private law

Legislative liability provisions or liability restrictions between a bank and its IPS are considered. For example, there may be regulatory requirements, which oblige the members of the IPS to guarantee the obligations of another institution. On the other hand, there might also be regulatory restrictions, e.g. on capital/liquidity transfers, that limit the ability of the IPS members to uphold its obligations. In addition to legislative requirements, private liability agreements are also analyzed and evaluated in terms of liability obligations and liability limitations. As an example, contracts, statutes and framework agreements can be mentioned here, whereby banks affiliated with an IPS commit themselves to certain obligations.

If there are clear legislative or private-law liability requirements with no restrictions on mutual liability, this criterion indicates that a bank will likely experience additional notching up to the rating of the IPS. If, on the other hand, there are restrictions on liability, only weak liability provisions or unclear liability provisions or agreements, this indicates that a bank's rating may differ slightly from the rating of the IPS. This is also the case if the liability requirements are only conditionally enforceable and/or there are doubts about the existence of the necessary financial strength for mutual liability for any obligations. If, on the other hand, there are no private contracts or legislative requirements or if the existing agreements or requirements are only limitedly suitable and/or credible (e.g. due to low financial strength) to ensure mutual liability, in this case a significant deviation of the rating of a bank from the rating of its IPS is justified and an additional notching can be applied to a limited extent.

b) Capacity of the Institutional Protection Scheme

Under this criterion, we consider the capacity of the IPS, i.e. the relative size of a bank relative to the size of the IPS, to guarantee for the specific institution and its obligations. On the one hand, one can assume sufficient capacity of the IPS in case of a smaller institution in the event of financial distress. On the other hand, the capacity of the IPS in the event of financial distress decreases with increasing size of the individual institution, which raises doubts as to the extent to which the IPS is able to meet its obligations. Therefore, CRA assumes under this criterion that a rating of a relatively small bank is usually in line with the rating of its IPS and can therefore experience a corresponding notching. In contrast, the larger an individual institution is in relation to the IPS, the lower the additional notching of a bank is likely to be which decreases an potential notching and might lead to a greater deviation of the individual banks rating from its IPS rating.

c) Role and integration of the Institute

The integration and role of a bank in the IPS is analyzed. This primarily involves analyzing the strategic and functional importance of a bank for the IPS (e.g. central institution, issuance of covered bonds).

In this respect, the resolution strategy (single-point-of-entry vs. multiple-point-of-entry) is a strong indicator of the integration and role of a bank in its IPS.

In the case of strong integration and a central as well as strategically important role in the IPS, support by the IPS in the event of financial distress is inevitable. In turn, this indicates that both the IPS and the respective bank should have the same rating and thus a corresponding notching according to this criterion is necessary. If, on the other hand, there is moderate integration into the IPS and/or moderate importance of the institution for the IPS, this indicates a minor deviation of the rating of the specific institution from the rating of the IPS. This is also the case if the resolution strategy has not yet been completely established yet (restructuring phase) or appears to not be credible. On the other hand, a low level of integration into the IPS and/or no strategic importance or function indicates that a significant deviation of a bank's rating from the rating of the IPS might be appropriate, which limits the additional notching.

d) Share Ownership

Under this criterion, CRA takes the size of the shareholding of the institution affiliated to the IPS into account. The larger the IPS 's shareholding in the bank being rated, the more likely this criterion indicates to assign the same rating for the IPS and the bank being rated, which in turn enables a corresponding notching. If, however, a significant share of the bank to be rated (usually 50% or more) is owned by a third party, an indication for a significant deviation of the rating of a specific institute and its IPS is given. The background to this approach is our assumption that a higher level of responsibility and obligation on the part of the IPS is accompanied by its shareholding in the specific bank.

e) Implication of the default of an affiliated bank

Under this criterion, the impact of a bank's default on the entire IPS (e.g. credibility or reputation) is taken into account. The more severe the negative impact of a bank's default on the entire IPS might be, the more likely all members of the IPS are intrinsically motivated to prevent a specific bank's default. Therefore, if there might be strong negative impact that a default of an institution might trigger, the more likely additional notching up to the IPS rating according usually come into play. If, on the other hand, the impact of an institution's default on the IPS is low or negligible, the intrinsic motivation to preserve an institution from default is rather low, which in turn indicates that a significant deviation of a bank's rating from the rating of the IPS might be appropriate. In the case of a moderate negative impact, on the other hand, a minor deviation is of the ratings appears to be most appropriate.

f) Track Record

Under this criterion, CRA considers the support track record of the IPS and its affiliated institutions. A supportive track record strengthens the credibility of the IPS If there is a positive track record in which institutions in financial distress were supported by its IPS or if supportive behavior can be assumed without doubt, this criterion indicates that a bank is likely to receive a notching up to the IPS's rating. If, on the other hand, there are negative precedents in the past where individual institutions were denied from adequate support, or if there are no precedents or doubts about mutual support, this likely justifies a significant deviation between the rating of a bank and the rating of its IPS and thus limits the notching opportunity. If, on the other hand, there are no precedents, but there are no doubts about mutual support, this criterion justifies only minor deviation between the ratings, which allows as a result a corresponding notching.

g) Country Risk

Country risk is the inherent risk that can arise from operating in different countries. The CRA defines country risk as, for example, economic risks, legal risks, political risks and exchange rate risks that may arise from doing business in a country. One indicator of country risk is the rating of the country in which the entity operates. The country risk is relevant if a bank primarily operates in a different country than the majority of the institutions that are members of the IPS. In the event of uncertainty with regard to the home market of the IPS, the registered office of the central institution of the IPS is deemed to be the home country.

If a bank operates in the same country as the IPS, CRA assumes no specific country risk based on this criterion, which in turn argues in favor of notching an institution up to the IPS rating. If, on the other hand, a bank primarily operates in a country other than that of the IPS and this results in only a low risk on the basis of the aforementioned criteria, a small deviation of the rating of a bank from the rating of the entire IPS is appropriate, which in turn justifies the notching accordingly. However, if a bank operates in a country other than the IPS and the country is subject to a significant country-specific risk on the basis of the aforementioned criteria, a significant deviation of the rating of this bank from the rating of the IPS is possible, which in turn limits the additional notching.

3.3 Consolidating the criteria and deriving the impact for an affiliate institute

The criteria a) to g) mentioned in chapter 3.2 are first individually assessed by CRA. Subsequently all criteria are taken into account on a weighted basis in order to derive an overall indication. Due to its importance, criterion 3.2 a) is included in the overall assessment with the highest weighting. To this end, criteria 3.2 b) and c) are taken into account in the overall assessment with a reduced weighting relative to criteria 3.2 a). In comparison to criteria 3.2 b) and c), the weighting of criteria 3.2 d) to g) is yet again lower.

If the weighted aggregation of the criteria mentioned in 3.2 indicates that the rating of a bank should correspond to the rating of the entire IPS, the stand-alone rating of a bank is likely upgraded or downgraded to the rating of the its IPS, whereby a deviation by one notch is possible in particular cases. However, if the weighted aggregation of the criteria mentioned in 3.2 indicates that a minor deviation of a bank's stand-alone rating from the rating of its IPS is appropriate, the rating of that bank may generally deviate by no more than two notches from the rating of its IPS. In general, the deviation of the bank's rating might be above or below the rating of its IPS. Consequently, the stand-alone rating of a bank can be upgraded or downgraded for being part of a IPS in order not to deviate by more than two notches. Ultimately, however, the weighted combination of the criteria mentioned in 3.2 may also indicate that a significant deviation of a bank's rating from the rating of its IPS is appropriate. In this case, the rating of the bank may deviate from the rating of the rating of its IPS by a maximum of four notches, whereby again the deviation may be either above or below the rating of its IPS. As a result, the stand-alone rating of a bank can be upgraded or downgraded following being part of a IPS in order not to deviate by more than four notches.

In general, a bank's stand-alone rating will only be upgraded or downgraded due to its integration into a IPS if there is a clear indication from criteria 3.2 a) to g). In any case, the notching of a stand-alone rating due to inclusion in a IPS will be transparently explained and justified in the rating report.

In certain justified cases, CRA may deviate from the aforementioned criteria and the assessment method or use other criteria to measure the effect of affiliation to a IPS if CRA is convinced that this will ensure a more accurate assessment of the bank's creditworthiness. This may be the case, for example, in special individual constellations, which are not adequately taken into account by criteria 3.2 a) to g). The deviation in the individual case is verified and approved by the rating committee and disclosed in the rating report.

3.4 Rule of significance

In the event that the assessment of criteria 3.2 a) and b) indicates that the rating of a bank should correspond to the rating of its IPS, a special factor is applied in deviation from the rule described in chapter 3.3. In this constellation, the CRA generally assigns the bank the same rating as the entire IPS irrespective of the other criteria of the individual bank. The background to this is the assumption that is as follows. On the one hand, the IPS is fully obligated to vouch for the bank and all its obligations. On the other hand, meeting this obligation does not impose too great a financial burden on the IPS due to the relatively small size of the institution. In this case, the CRA also reserves the right to waive the preparation of a separate rating report and instead refers to the rating report of the IPS.