Viability Ratings: An Introductory Primer

Special Report

Fitch Launches Viability Ratings: Fitch Ratings today introduces Viability Ratings (VRs) on financial institutions around the globe. These ratings represent Fitch Ratings' primary assessment of the intrinsic creditworthiness of these institutions. Fitch's VRs are assigned on the familiar 19-point long-term rating scale, although using the lower case ('aaa', 'aa+' etc). This report details the rationale driving the introduction of VRs, their definitions, the circumstances under which Fitch assigns them, and how they function in Fitch's overall FI rating framework.

Consistent Ratings Framework: Fitch emphasises that the introduction of VRs does not represent a fundamental change in its approach to bank ratings or a change in opinion on the creditworthiness of rated entities. The Long-Term Issuer Default Rating (IDR) will remain the primary issuer rating for financial institutions, and is driven by an issuer's VR and its Support Rating. The VR reflects the same core risks as the legacy Individual Rating, but with greater granularity and on a more familiar rating scale.

Positive Market Response: The introduction of VRs follows the publication of Fitch's report *"Perspectives on Bank Credit Ratings in a Changing Environment"* (March 2011) and requests for market feedback. The report outlined Fitch's thinking, specifically the proposal to migrate Fitch's long-established bank Individual Ratings, which utilise their own 'A' to 'E' scale, on to the more familiar long-term 'aaa' scale, and to rename them as VRs. Fitch appreciates the market feedback received, which was widely supportive of the proposed evolution.

Benefits of This Enhancement: Specific benefits of this shift include increased transparency regarding the key drivers of a bank's IDR; greater consistency with traditional market-familiar credit rating scales; more granularity in Fitch's opinion on the intrinsic risk of a bank; enhanced visibility on the specific benefits of support; enhanced consistency with the approach that Fitch has already taken with its Support Rating Floors, which are expressed on the 'AAA' scale; greater clarity on the baseline from which debt issues not expected to benefit from sovereign support are notched (e.g., hybrid and other regulatory capital securities);and greater consistency with current regulatory parlance around the subject of 'viability' and 'non-viability.'

Phased Transition: VRs are available on Fitch's website, through data feeds via Fitch's data redistributors, in rating action commentaries and relevant research reports. In addition, spreadsheets with lists of rated entities by region and their corresponding ratings are available on Fitch's website. The transition from Individual Ratings to VRs will run in parallel until 31 December 2011, during which time Individual Ratings, with limited exceptions, will be maintained alongside VRs. In the early part of 2012, all Individual Ratings will be withdrawn.

Related Research

Resolution Regimes and the Future of Bank Support (December 2010)

Bank Ratings, Confidence Sensitivity and Support (October 2008)

The Role of Support and Joint Probability Analysis in Bank Ratings (May 2006)

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The Purpose of Viability Ratings

Viability Ratings (VRs) are designed to be internationally comparable, and represent Fitch's view on the intrinsic creditworthiness of an issuer. Together with the agency's Support Ratings framework, the VR is a key component of a bank's IDR and considers various factors including:

- Industry profile and operating environment
- Company profile and risk management
- Financial profile
- Management strategy and corporate governance

The factors analysed in determining a VR are set out more fully in Fitch's *"Global Financial Institutions Rating Criteria"*, dated 16 August 2010.

The VR excludes any extraordinary support that may be derived from outside of the entity, as well as any potential benefits to a bank's financial position from other extraordinary measures, including a distressed restructuring of liabilities. For a further discussion of what constitutes extraordinary support, see *Viability Ratings and Support* below.

Fitch would normally regard the following as indicative of a bank failing or becoming non-viable:

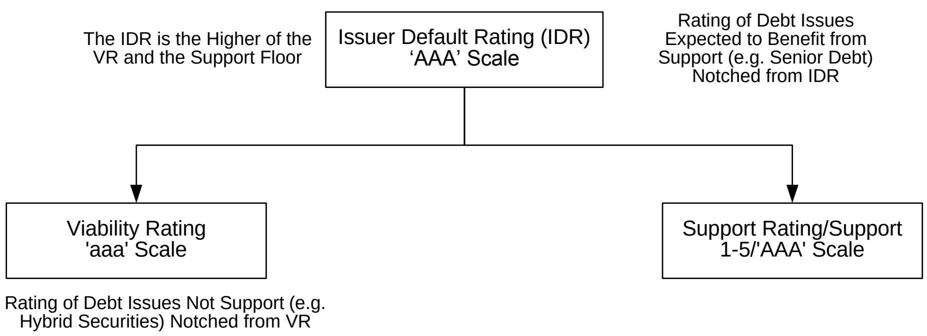
- Defaulting on senior obligations
- Entering a resolution regime, bankruptcy, administrative receivership or similar statutory process
- Triggering non-viability clauses embedded in regulatory (or other) capital instruments
- The execution of a distressed debt exchange as defined by Fitch's criteria.
- Receipt of extraordinary support such that a default or other event of non-viability is avoided

VRs represent not only the capacity of a rated entity to meet its obligations in the absence of extraordinary support, but also in the absence of extraordinary constraints (e.g., transfer and convertibility risk). As such, VRs represent a bank's capacity to maintain ongoing operations and to avoid failure, the latter being indicated by extraordinary and company-specific measures becoming necessary to protect against a bank's default.

Figure 1 sets out the high-level framework of Fitch's bank rating methodology. It is important to note that Fitch operates a "higher of" approach to combining its intrinsic risk analysis and its assessment of the potential for extraordinary support.

Figure 1

Fitch's Bank Rating Methodology



Source: Fitch

Related Criteria

Corporate Rating Methodology - Amended (August 2010)

Short-Term Ratings Criteria for Corporate Finance (November 2010)

Rating Hybrid Securities (December 2009)

Rating Foreign Banking Subsidiaries Higher than Parent Banks (June 2011)

Viability Rating Definitions

Figure 2
Viability Rating Definitions

Rating	Definition
aaa	**Highest fundamental credit quality** 'aaa' ratings denote the best prospects for ongoing viability and lowest expectation of failure risk. They are assigned only to banks with extremely strong and stable fundamental characteristics, such that they are most unlikely to have to rely on extraordinary support to avoid default. This capacity is highly unlikely to be adversely affected by foreseeable events.
aa	**Very high fundamental credit quality** 'aa' ratings denote very strong prospects for ongoing viability. Fundamental characteristics are very strong and stable, such that it is considered highly unlikely that the bank would have to rely on extraordinary support to avoid default. This capacity is not significantly vulnerable to foreseeable events.
a	**High fundamental credit quality** 'a' ratings denote strong prospects for ongoing viability. Fundamental characteristics are strong and stable, such that it is unlikely that the bank would have to rely on extraordinary support to avoid default. This capacity may, nevertheless, be more vulnerable to adverse business or economic conditions than is the case for higher ratings.
bbb	**Good fundamental credit quality** 'bbb' ratings denote good prospects for ongoing viability. The bank's fundamentals are adequate, such that there is a low risk that it would have to rely on extraordinary support to avoid default. However, adverse business or economic conditions are more likely to impair this capacity.
bb	**Speculative fundamental credit quality** 'bb' ratings denote moderate prospects for ongoing viability. A moderate degree of fundamental financial strength exists, which would have to be eroded before the bank would have to rely on extraordinary support to avoid default. However, an elevated vulnerability exists to adverse changes in business or economic conditions over time.
b	**Highly speculative fundamental credit quality** 'b' ratings denote weak prospects for ongoing viability. Material failure risk is present, but a limited margin of safety remains. The bank's capacity for continued unsupported operation is vulnerable to deterioration in the business and economic environment.
ccc	**Substantial fundamental credit risk** Failure of the bank is a real possibility. The capacity for continued unsupported operation is highly vulnerable to deterioration in the business and economic environment.
cc	**Very high levels of fundamental credit risk** Failure of the bank appears probable.
c	**Exceptionally high levels of fundamental credit risk** Failure of the bank is imminent or inevitable.
f	'f' ratings indicate an issuer that, in Fitch's opinion, has failed, and that either has defaulted or would have defaulted had it not received extraordinary support or benefited from other extraordinary measures.

Note: The modifiers "+" or "−" may be appended to a rating to denote relative status within major rating categories. Such suffixes are not added to the 'aaa' VR category or to VR categories below 'b'. Outlooks are not assigned to VRs, although at any point in time, a bank's position and prospects may have underlying trends, for example improving, deteriorating or stable.
Source: Fitch

When are Viability Ratings Assigned?

Fitch believes that VRs and Support Ratings are a valuable tool to give market participants a disaggregated insight into the two principal building blocks of bank default risk, as ultimately expressed in an entity's IDR. As a consequence, this document sets out a number of core principles that govern their assignment and a summary set of rules that apply to these core principles in a number of specific contexts. The intent is to foster consistency and comparability. That said, any rule set naturally requires judgement calls in certain cases. In such cases, Fitch will endeavour to be clear as to the rationale driving where it does and does not assign a VR.

Core Principles

Subsidiarity to IDR: As subsidiary ratings to the IDR, Fitch only assigns VRs (and Support Ratings/Support Rating Floors) to entities to which it is assigning an IDR. (In the majority of cases, this will be a long-term IDR with an accompanying short-term IDR, but in rare cases, the entity might only have a short-term IDR.)

Complementarity. VRs and Support Ratings/Support Rating Floors (VR/SR/SRF) are complementary. They are not assigned in isolation from each other. To the extent that Fitch's current portfolio contains entities that do not conform to this principle, this will be addressed by the end of 2011, either by assigning the "missing" rating or withdrawing the "extraneous" rating, as appropriate.

Key ratings component. The VR/SR/SRF is a central component of the way Fitch rates banks. These ratings are not an optional extra. Where the criteria are met, the full set of ratings is assigned.

Added value. There is a presumption that Fitch will only assign VRs and SR/SRFs when they add material informational value to the published IDR. The assessment of added value needs to be made from an international not a national perspective; ie, what may be obvious to domestic investors may not be so obvious to overseas investors. It should also be noted that the informational value might vary through time and especially in stress scenarios.

Substance over form. As in Fitch's master criteria, this paper uses a fairly broad definition of "banks", which is not determined by local technical and legal definitions. This issue arises most in the realm of non-bank FIs and is dealt with in more detail below.

Consistency of treatment. Broadly similar entities in different geographies should be treated the same way, even if their strict legal form differs.

Within the context of these core principles, the following criteria must also be met:

- The entity must be capable of being meaningfully analysed in its own right. This is particularly the case with subsidiary banks with institutional parents (see below for more details).
- The data available at the rated entity level must meet Fitch's normal data robustness standards.
- The data, and all other relevant inputs, shall be analysed, and if the rating is a public rating, the analysis, with limited exceptions, should be published. In most cases, this would be in the form of entity-specific research, but in the case of some subsidiary banks, this may be included in the parent company research.

Special Cases

Subsidiary Banks

Fitch rates many banks that are subsidiaries of larger banking groups. In the vast majority of cases, the IDR will be largely determined by the relationship with the parent bank, including the likelihood that the parent will recapitalise the subsidiary in extremis. Nevertheless, Fitch believes that, in many cases, insight into the financial and operational condition of the subsidiary adds value both to direct counterparties of the subsidiary and as a building block of the credit risk profile of the parent entity. Fitch therefore assigns VRs (in addition to IDRs) to subsidiary banks when the following conditions are met:

- The subsidiary should have a meaningful standalone franchise that could/would exist without the ownership of the current parent. The bank should, under normal operating circumstances, not be substantially dependent on its parent either for customers, transaction flows and/or funding. (This recognises that under severe stress the level of parent funding might increase substantially, akin to the way a parent bank might become increasingly reliant on central bank funding). Expressed the other way round, the entity should not be substantially acting as a branch or agency of its parent.
- The data available on the subsidiary meets Fitch's normal data robustness standards.
- In the vast majority of cases, Fitch will meet with the subsidiary's own management team. In cases where this is not possible, Fitch will engage with parent/group management on the condition of the subsidiary.
- Where these conditions are not met, Fitch will assign an IDR to the subsidiary bank, which is essentially a derivative of the parent bank rating, without a VR or SR. For further details, see Fitch's *"Global Financial Institutions Rating Criteria"*.

Bank Holding Companies

Fitch may assign ratings to bank holding companies as they are often issuers of debt or involved in other credit counterparty relationships. Where this is the case, there is a starting presumption that Fitch will assign a full set of ratings (IDR; VR; SR/SRF).

The holding company is primarily analysed on the basis of consolidated financial strength. However, as noted in Fitch's *"Bank Holding Companies"* Criteria Report, dated 30 December 2009, explicit consideration needs to be given to some aspects of the holding company that are to a large degree independent of its consolidated financial strength; in particular, whether it is "prudently managed" and maintains "appropriate liquidity".

Banks (and Quasi-Banks) With Public Missions

The credit risk of a public-mission bank is typically a direct (or sometimes indirect) derivative of the sovereign that has entrusted it with the public mission. The public mission often involves activities that are commercially unattractive for full-blown private-sector providers to engage in; eg, they are too risky at a socially desirable price (development lending) or too inefficient to deliver at a commercially desirable price. These factors present a significant distortion to the "intrinsic" profile of the bank, and for this reason Fitch does not (subject to certain exceptions identified below) assign VRs to public-mission banks.

Most public-mission banks are likely to be in public ownership. It should, however, be noted that public ownership, in itself, does not mean that a bank is not assigned a VR and SR/SRF, and that in some jurisdictions many commercial banks are publicly owned, including some that may have a residual public-mission element in their business profile. Such banks are generally assigned a VR.

Conversely, in relatively rare circumstances, private-sector institutions may have a substantial public-mission element to their business, yet still have material considerations about generating a commercial return to their private-sector owners. These private-sector owners may themselves be organised along mutual lines or as shareholders in a quoted company, but this is essentially irrelevant. Such institutions are generally assigned a VR.

Irrespective of the above, if a public-mission bank (either publicly or privately owned) issues rated hybrid capital securities, for which Fitch assumes no (or very limited) potential extraordinary support, then the bank is assigned a VR from which these hybrid securities can be notched.

It should be noted that public-mission banks and their activities do evolve over time, and there may come a point when such a bank is substantially engaged in genuinely commercial activities. At this point, the decision not to assign a VR would be reviewed.

VRs in Groups Benefiting From Mutual Support Mechanisms

Groups rated under Fitch's *"Rating Criteria for Banking Structures Backed by Mutual Support Mechanisms"* (April 2011) will be assigned VRs on a broadly similar basis to that taken with conventional holding company/operating company structures, i.e., the "group" will be assigned a VR on the basis of its consolidated financial strength. The principles of these groups mean that the stronger group members will provide support to weaker, or failing, members, and that mechanisms in place to ensure the fungibility of liquidity and equity reserves form part of the banking group's framework. Individual member banks, even if they satisfy the criteria to be meaningfully analysable, will not generally be assigned a VR.

Non-Bank Financial Institutions

Fitch deploys VRs and SR/SRFs to give ratings users greater insight into the components of an entity's default risk as expressed in its IDR. The agency has developed this approach to reflect the largely unique corporate phenomenon pertaining to the banking industry of potential state support for private-sector creditors of "banks". Occasionally, other corporate creditors have benefited from state support, but this has largely been done on an idiosyncratic basis, which does not lend itself to the systematic separation of the intrinsic strength and external extraordinary support.

Fitch therefore only assigns VRs (and SR/SRFs) to those entities that can reasonably be predicted to be **routinely**, in the event of stress, subject to consideration for potential support. This does not mean that Fitch would always expect them to be supported, but that they would be routinely considered by the financial authorities as potential candidates for such support.

This consideration needs to be made on an international basis; ie, if an entity would reasonably be considered to be the potential beneficiary of support in some jurisdictions (including at least some major ones), then it adds value to international investors if Fitch explicitly addresses this question **in all jurisdictions** via the use of VR/SR/SRFs.

Fitch acknowledges that as a result of the financial crisis and the evolution over the past few years in the nature of financial markets (eg, the development of the so-called "shadow banking" sector), the boundaries of the potential support umbrella have become somewhat blurred. Fitch also notes, however, that there is a concerted effort under way to limit the scope of the support umbrella and potentially even withdraw it altogether. In the light of this, rather than extend the range of entities to which the VR/SR/SRF approach might be applied, Fitch will not assign these supplemental ratings to entities for which it considers that sovereign support might only be considered on an idiosyncratic basis. This includes:

- leasing companies
- finance companies
- credit card companies
- fund managers

The most significant grey area is **securities companies/investment banks**. Consideration is given to the scale and scope of the entity's activities. The narrower the scope, the more likely it is not to have a VR. Conversely, the broader the scope, including on an international basis, the more likely it will be to have a VR. The existence of a banking licence or bank holding company licence within the group significantly strengthens the presumption that it should have a VR, but the primary driver is the form and scale of the business model, not legal status.

Viability Ratings and Support

As noted above, one of the core principles of the VR is its complementarity with Fitch's approach to extraordinary support for banks, as expressed in the agency's SR/SRFs. It is therefore appropriate to summarise this relationship, although it should be noted that the framework for SR/SRFs has not changed as a result of the introduction of the VR.

Fitch assigns Support Ratings on a scale of '1' to '5'. Support Ratings are linked directly to ratings on the 'AAA' scale, and in cases of state support, this link is made explicit through the Support Rating Floor, which is expressed on the "AAA" scale. For example, according to Fitch's published definitions, the highest Support Rating of '1' is defined as:

"A bank for which there is an extremely high probability of external support. The potential provider of support is very highly rated in its own right and has a very high propensity to support the bank in question. This probability of support ***indicates a minimum Long-Term Rating [IDR] floor of 'A-'****."*

Banks with the same Support Rating, including those domiciled in the same country, may have different Support Rating Floors depending on Fitch's opinion on the propensity of the supporter to provide support. This propensity is determined by a range of factors, including the function of the bank (eg, commercial versus public mission), ownership (state versus private) and systemic importance. Full details of the Support Rating methodology, scale and definitions can be found in Fitch's *"Global Financial Institutions Rating Criteria"*.

Ordinary Versus Extraordinary Support

Broadly speaking, those benefits that accrue to all banks because of their status as banks, including routine access to central bank liquidity, are regarded by Fitch as ordinary support and are captured in the VR. Extraordinary support, by contrast, is support that is provided to prevent a fundamentally non-viable bank from defaulting, with the probability of this support being available captured by the Support Rating. Although non-viability and insolvency are not technically identical, they are, in Fitch's view, very closely correlated and in practice often amount to the same thing. In the vast majority of cases, therefore, extraordinary support will take the form of some kind of recapitalisation.

Fitch acknowledges that the distinction between normal and extraordinary can become blurred, especially at times of systemic stress, and on occasion it will only be with hindsight that an assessment of whether a bank has “failed” can be made. However, the difficulty in ascertaining the exact point of failure does not detract from the value of having ratings that assess the probability of such a situation arising, complemented by an assessment of whether such failure would result in default based on the likelihood of external support.

Following a sovereign bailout of a financial institution, governments often maintain a direct financial interest in the health of that institution for an extended period. This interest may take the form of either equity or debt funding (above and beyond normal central bank liquidity provision), or be in the form of guarantees of some or all of the institution's liabilities. In such cases, Fitch will consider whether this direct financial interest increases the propensity of the government to provide further extraordinary support, should it be needed, such that the institution's Support Rating Floor may be raised relative to that of its immediate peers.

A Brief Word on Subsidiary Banks and Institutional Support

While much of the recent market debate on the broad concept of support has focused on sovereign support, institutional support is an important related factor for bank ratings. Although in theory the distinction between ordinary and extraordinary support can also be made for a subsidiary bank relative to its institutional parent, the distinction can be even more blurred, especially where there is central management not only of liquidity but also of capital. In essence, all the normal operating benefits of being part of a banking group are reflected in the subsidiary's VR and, especially in the presence of tight central control, this will therefore often be closely aligned with the VR of the parent. Where the subsidiary has a clearly differentiated risk profile from its parent, there would likely be greater rating distinction at the VR level and in rare cases the subsidiary might have a stronger VR than its parent, although this is likely to be constrained by the risk of cross-contamination within the group. (For further details, see *“Rating Foreign Banking Subsidiaries Higher than Parent Banks”*, published on 13 June 2011.)

The potential for extraordinary support, again usually in the form of some kind of recapitalisation, is reflected directly in the subsidiary's IDR. Historically, banks have been extremely reluctant to let subsidiary banks default because of the knock-on reputational risk, and subsidiary IDRs have typically been closely aligned with the parent IDR. This has been the case even when the parent bank is in severe financial difficulties and benefiting from extraordinary sovereign support. Fitch notes that the dynamics of parent/subsidiary support may evolve significantly under the twin pillars of resolution and subsidiarisation, especially where the parent and subsidiary are in different jurisdictions. In light of this, Fitch is considering whether any framework changes are appropriate to accommodate institutional parent/subsidiary support and will communicate with the market separately on this matter in the months ahead.

The VR Rating Evolution of a Failing Bank… and the Impact of Support

As a bank's intrinsic credit quality deteriorates and the probability of it failing increases, its VR will progress down the rating scale. The rate of migration will vary from bank to bank, but where Fitch's rating committee determines a point of failure, the agency will record the VR being lowered to 'f', irrespective of whether the bank is supported or defaults. While a bank's VR might migrate significantly in times of stress, its IDR might not, depending on Fitch's assessment of the potential for support, as reflected by its Support Rating and Support Rating Floor.

The agency notes that for understandable reasons of maintaining market confidence and commercial confidentiality, a significant lack of transparency often surrounds the process by which the banking authorities deal with failing financial institutions. As a result, it is not always possible for Fitch to determine a bank failure in real time. In such cases, Fitch will therefore seek to assign and publish 'f' ratings on a retrospective basis, as this failure data is valuable in itself in assessing the risk of a portfolio of bank credits and in assessing the performance over time of Fitch's VR ratings.

If, at the point of failure, the bank receives support in order to prevent a default (eg, in the form of freshly injected capital, the removal of problem assets or an explicit guarantee), the VR of a failed bank will within a short period be raised to reflect its new profile.

In most cases, once support is provided, the new VR level (post support) is unlikely to be the level that the bank enjoyed before the onset of its problems, unless Fitch is convinced that all the issues that gave rise to the problems have been fully addressed. This will likely involve franchise issues that tend not to be resolvable over a short time frame.

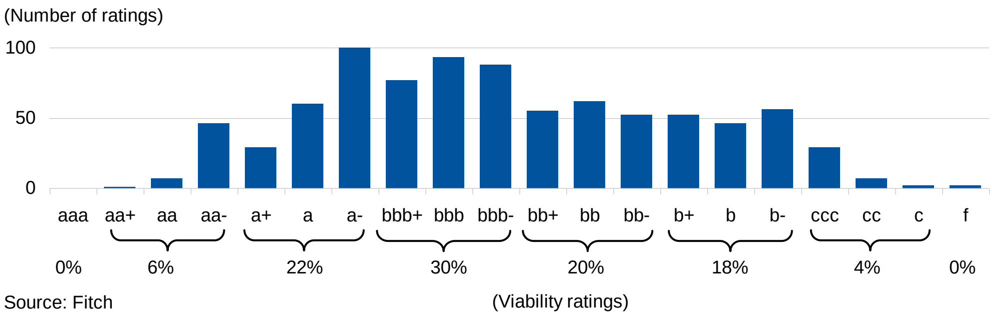
Appendix 1: Ratings Distribution

The following charts present the distribution of the newly assigned VRs and the existing distribution of those banks' Individual Ratings and IDRs. Additionally, as in the March 2011 report, Figures 4 and 5 illustrate the relationship between VRs, Support Rating Floors and IDRs, to give a clear picture of how much sovereign support is currently factored into Fitch's universe of bank ratings.

Figure 3

Distribution of Viability Ratings (VR)

20 July 2011 - all banks with vability ratings and Individual ratings

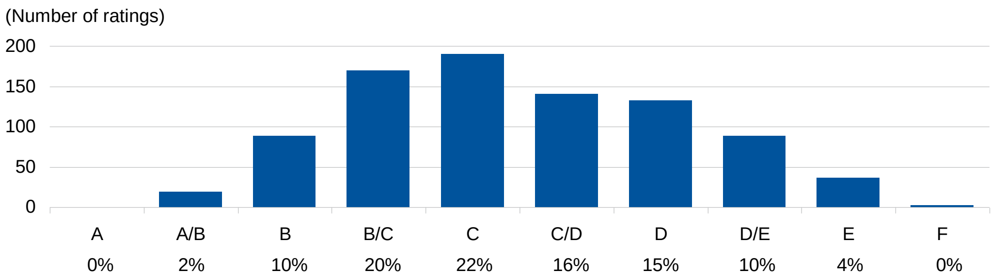


Source: Fitch

Figure 4

Distribution of Individual Ratings

20 July 2011 - all banks with viability ratings and individual ratings

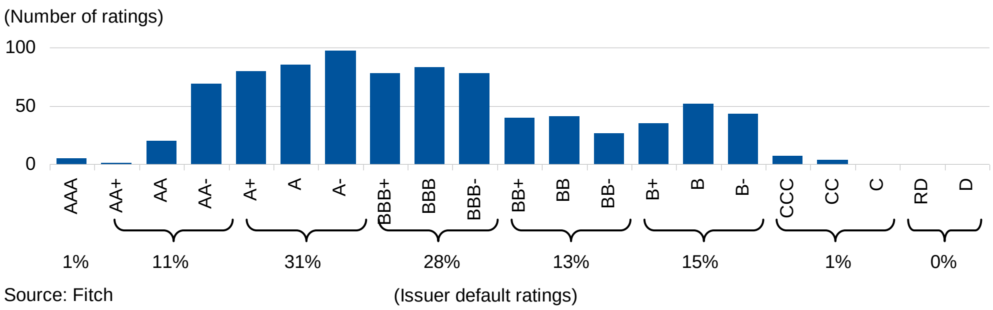


Source: Fitch

Figure 5

Distribution of IDR Ratings

20 July 2011 - all banks with viability ratings , individual ratings and IDRs

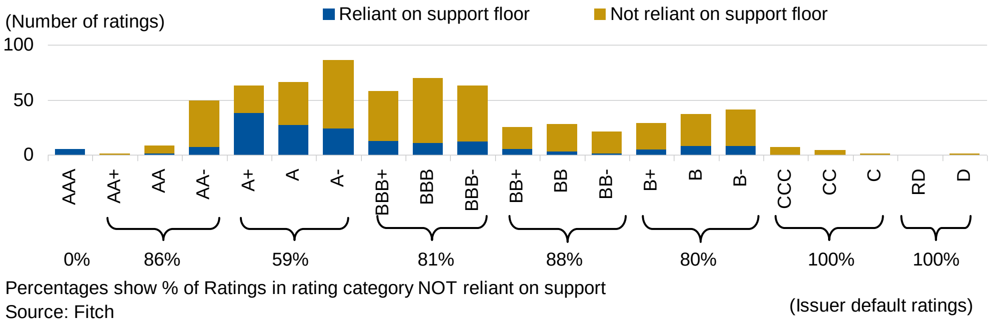


Source: Fitch

Figure 6

Extent of Reliance on Support - By IDR

20 July 2011- all banks with a viability rating, IDR and support floor

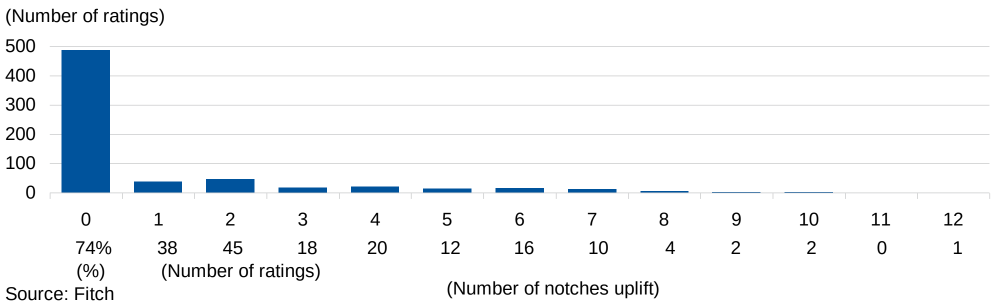


Percentages show % of Ratings in rating category NOT reliant on support
Source: Fitch

Figure 7

Notches of Uplift Due to Sovereign Support (VR to IDR)

20 July 2011 - all banks with a viability rating, IDR and support floor



Source: Fitch

Appendix 2: Mapping Table of Individual Rating to IDRs

Figure 8

Mapping Table of Individual Ratings to IDRs

Individual rating	Long-term rating derived from Fitch mapping
A	AAA AA+ AA
A/B	AA+ AA AA- A+ A
B	AA- A+ A A-
B/C	A A- BBB+ BBB
C	BBB+ BBB BBB- BB+
C/D	BBB- BB+ BB BB-
D	BB BB- B+ B B-
D/E	B+ B B- CCC
E	CCC CC C

Source: Fitch