Rating Finance

Overview of the methodological rating process
for banks and central issuing offices

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Introduction

The Swiss banking sector consists of around 250 banks with 100,000 employees within Switzerland and makes an important macroeconomic contribution, accounting for 5% of GDP. All usual banking services are offered in the market: classic interest business, asset management, and investment banking. However, banking institutions differ greatly in terms of business areas' weight, relevance for the national financial system, and their ownership situation. The Swiss banking sector can therefore be divided into the following categories:[1]

- **Cantonal banks**
- **Big banks**
- **Regional banks and savings banks**
- **Raiffeisen banks**
- **Other banks**
- **Branches of foreign banks**
- **Private bankers**

The cantonal banks are primarily active in the cantonal savings and mortgage business, with some also attributing greater importance to wealth management. Most of them benefit from a more or less comprehensive state guarantee from the respective canton of ownership. The big banks operate worldwide and offer all banking services. They have moreover been classified by the SNB as systemically relevant. Regional banks and savings banks offer their regional clientele traditional interest rate business with savings and investments on the liabilities side and mortgages and corporate loans on the assets side. The Raiffeisen banks, which are part of a security and solidarity network, operate in the same business areas. Although the individual cooperative banks also mainly serve regional customers, the group has a nationwide presence and has also been classified as systemically relevant since 2014.

Other banks include, on the one hand, stock exchange banks, which mainly provide asset management services for domestic and foreign customers. On the other hand, foreign-controlled banks, small credit banks, and other banks that cannot be assigned to any other group are also included here. Investment banking plays a central role for branches of foreign banks, and in some cases wealth management for foreign clients is also highly developed. Finally, private bankers mainly manage the wealth of their domestic and foreign clients.

The Swiss financial market is currently confronted with numerous regulatory changes and requirements as well as other challenges such as digitalization and changes in customer behavior. Due to their differentiated business models, the various types of banks are affected to varying degrees by the individual measures and risks involved.

[1] SNB (2019), Banks in Switzerland 2018. Volume 103, Zurich.

In the wake of the global financial crisis that began in 2007, the stability of the financial system and of the individual banking institutions was reassessed and relevant requirements tightened. This led to Basel III, the reform package of the Basel Committee on Banking Supervision, which focuses on capital and liquidity requirements of banks. Implementation of this set of rules in Switzerland is regulated by the Federal Council's Capital Adequacy Ordinance and Liquidity Ordinance and has taken place gradually since 2013.

Specifically, minimum ratios of risk-weighted assets compared to own funds to be held by banks were increased. Switzerland provides for differentiated rules for the various banking institutions, most of which go beyond the minimum standard required by Basel III (Swiss Finish). In addition, in the event of emerging undesirable developments in the credit market, an anti-cyclical capital buffer can be activated at the request of the SNB, which requires additional own funds of up to 2.5% of domestic risk-weighted assets. This instrument is already being used: due to sustained price increases in the real estate market, a buffer of 1% of the corresponding risk-weighted positions on mortgage loans to finance residential properties in Switzerland had to be held since the 30th of September, 2013; from the 30th of June, 2014, a buffer of 2% is being applied. In addition to these risk-weighted measures, a minimum leverage ratio needs to be met starting January 1, 2018. A minimum requirement of 3% applies to this unweighted equity ratio, which sets core capital in relation to a bank's total exposure, whereas stricter requirements apply to systemically important banks. In addition to these most important quantitative requirements, appropriate disclosure and supervisory standards are also being raised to improve risk coverage.

In many Swiss banks, stricter capital requirements do not lead to immediate need for adjustment, as existing own funds already meet new ratios. Important exceptions are the two big banks UBS and CS. In recent years, they have taken various measures to increase capital adequacy. In addition, UBS in particular has reduced the size of its risk-weighted assets by reducing its investment banking activities.

Significant changes for the banks also result from the automatic exchange of information in force since January 1, 2017. This new global standard aims to prevent cross-border tax evasion within the participating countries and territories. Banks are obliged to collect account information from taxpayers in partner countries and make it available to foreign authorities. Since January 1, 2018, these data must be processed for 78 countries, which entails considerable administrative effort and costs for financial institutions.

In addition to these challenges, there are a number of other regulatory initiatives at both national and international level. One example is the EU's MiFID II Financial Markets Directive, which came into force on January 3, 2018 and increases market transparency and investor protection. In the same direction, a new Financial Services Act (FIDLEG) is currently being drafted in Switzerland. More uniform competitive conditions for financial intermediaries are to result from a new Financial Institutions Act (FINIG), which is currently also under parliamentary discussion. The decree aims to also subject independent asset managers who have not yet been supervised to prudential supervision.

Increasing digitalization is also forcing many banks to make adjustments. Most banks already offer digital solutions at the interface to bank customers, but extensive digitalization measures are also imminent for internal processes. In addition, these technologies also enable the development of new products in the financial sector, which are often created by new players in the market and put traditional providers under pressure.

The purpose of this paper is to provide a brief overview of the various rating aspects involved in assessing the creditworthiness of banks. The following explanations also apply analogously to central issuing offices.

Institutional Framework & Market

In general, a large number of regulatory requirements are aimed at increasing the stability of banks or regulating other aspects of the financial market architecture. These guidelines implicitly define the institutional framework within which Swiss banks operate and often have a major impact on their creditworthiness. In some cases, there are important differences between the various types of banks in the framework conditions relevant to them. This is particularly pronounced in the case of the group of cantonal banks. 21 of the 24 cantonal banks benefit from a comprehensive state guarantee. With the exception of subordinated bonds, the owner cantons are typically explicitly liable for all liabilities of a cantonal bank. The probability that a bond can be repaid in the event of bankruptcy is therefore also closely linked to the creditworthiness of the respective canton.

Another group with a very specific institutional framework are the banks the SNB has designated as systemically relevant under the Banking Act. These include the two big banks UBS and CS, which are also classified as globally systemically relevant, as well as Zürcher Kantonalbank, Raiffeisen, and PostFinance. It can be assumed that the failure of these banks would seriously damage the Swiss economy and the Swiss financial system. Due to this "too big to fail" problem, systemically relevant banks need to meet regulatory requirements that go well beyond Basel III's minimum standard, particularly with regard to capital adequacy requirements. Aim of these measures is to exclude insolvency of respective institutions as far as possible. Should bankruptcy nevertheless become probable, there is a positive probability that a bank in question will be protected from bankruptcy by financial support from the Confederation or the SNB, as was the case with UBS in 2008.

Rating Concept

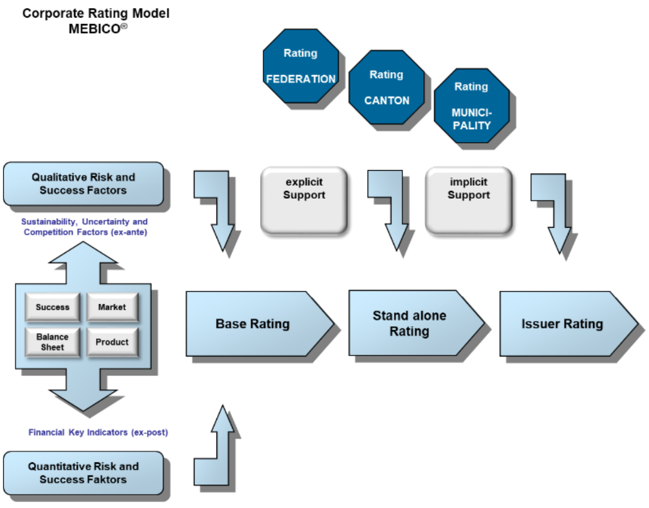
The rating model is designed as an expert system and, by its modular structure, takes account of the fact that the creditworthiness of government-related companies such as cantonal banks is determined both externally (exogenous) and internally (endogenous). In a first step, the exogenous creditworthiness factors are systematically analyzed, identified, and evaluated. In a second step, the endogenous creditworthiness factors are assessed on the basis of quantitative and qualitative factors.

Rating Architecture

Due to possible financial support guarantees, conceptual distinction between basic rating, stand-alone rating, and issuer rating in the banking segment is significant, as shown in Figure 1. The basic rating is based on the quantitative and qualitative rating factors that characterize a financial institution. The stand-alone rating also takes into account the different forms of explicit support by third parties. This is particularly relevant in the case of cantonal banks, which have explicit financial guarantees in the form of state guarantees from their owner cantons.

Under certain circumstances, the issuer rating may also benefit from implicit support from the public sector. This includes the case of systemically relevant banks, which, given their importance for the Swiss economy and the Swiss financial market, are likely to receive financial support from the Confederation and the SNB in the event of imminent bankruptcy.

It should be noted that the basic rating of a bank based on financial ratios and other qualitative factors is often significantly lower than the issuer rating of an explicit or implicit guarantor. Such support intentions can therefore have a major influence on the creditworthiness of an institution as expressed in the issuer rating. The systematic assessment of any explicit or implicit guarantees from owners and/or implicit support from the public sector in a first step of the credit assessment is therefore particularly important.



1 *Credit rating of banks*

Rating Methodology

The methodological basis for rating assignment is an asymmetrically extended logit function, which realistically reflects the dynamics of credit risks. In particular, in the case of cantonal banks, for example, it allows consistent consideration of the financial and legal interdependence between the public sector as the owner or guarantor of an institution through various parameters and indices. The methodical system allows a risk-adequate and objectively directly comparable assessment of the creditworthiness of banks.

Rating Criteria

When assessing creditworthiness, both qualitative and quantitative elements are taken into account when assigning a corporate rating to a bank. In the quantitative part, the credit risk is identified, analysed, and assessed on the basis of bank-specific ratios from balance sheets and income statements from previous years (ex-post situation). This provides an objective picture of an institution's autonomous financial behavior in comparison with other banks. In the qualitative part, the credit assessment is supplemented by various risk and success factors which have a systematic influence on the future development of the credit risk (ex-ante trend).

Qualitative Rating Criteria

Qualitative risk and success factors are systematically identified and evaluated by the rating committee. As part of the rating process, credit-relevant issues in four areas of the qualitative rating criteria for banks are relevant (non-exhaustive):

Financial-Legal Interdependence & Support

- Financial guarantees of the owners
- Possible bailout by higher levels of government in a stress scenario

Institutional Framework & Market Environment

- Regulatory requirements (e.g. capital ratios) and regulatory supervision
- Political and regulatory risks (e.g. untaxed assets, foreign market access)
- Price development in the real estate market
- Total debt situation of private households

Corporate Structure and Transparency

- Legal form and complexity
- Corporate governance
- Internal controls and risk management
- Accounting and disclosure standards
- Balance sheet structure and off-balance sheet liabilities

Competitive Position & Corporate Strategy

- Corporate strategy design
- Earnings stability and its diversification
- Geographical diversification in lending business
- International orientation
- Strategic risk profile of the company

Quantitative Rating Criteria

The systematic identification and evaluation of the financial circumstances takes place in form of a balance sheet rating. As part of the rating process, four credit-relevant factors within the financial autonomy and sphere of influence of a bank are relevant (non-exhaustive):

Assessment of Capital Structure and Indebtedness

- Core capital ratio and total capital ratio
- Leverage ratio
- Debt financing structure and its potential
- Deposits / Loans

Assessment of Liquidity

- Cash and cash equivalents
- Liquidity coverage ratio

Assessment of Earning Power and Profitability

- Cost-income ratio
- Interest margin
- Profit margin
- Return on assets

Assessment of Risk Profile

- Percentage of impaired receivables
- Proportion of mortgage claims
- Extent of off-balance sheet business
- Creation of provisions
- interest rate swaps

Outlook

The Swiss banking sector is currently undergoing a transformation process that will continue in the coming years. The many changes in the international and national regulatory environment have a considerable impact on business practices of the individual institutions and the future composition of the entire banking sector. The higher capital requirements associated with the implementation of Basel III require large banks, in particular, to adapt their corporate structure and business strategy, and restrict smaller institutions' room for maneuver. Whenever the required measures go beyond the standards in other countries, there will also be distortions in competition between Swiss banks and their foreign competitors.

After significant cash outflows in recent years, implementation of the automatic exchange of information poses further challenges for the international wealth management business. Delivering tax data to foreign tax authorities will require a great deal of organizational effort and thus cause additional costs. It can be assumed that the concentration process in wealth management will continue.

Numerous other regulatory projects are leading to a general increase in compliance costs, especially for smaller banks. These institutions are also particularly challenged by changes in customer needs and digitalization.

At a political level, priority will be given in the near future to ensuring that Swiss banks continue to have access to the EU market. An important building block is the equivalence of relevant areas of Swiss financial market law and their recognition by the EU. The restructuring of the regulatory environment will therefore continue in the coming years and require appropriate consideration in the credit assessment of banks.

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