



# Model and methodology

PRIVATE CREDIT RATING

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## Abbreviations

|        |                                      |
|--------|--------------------------------------|
| AML    | Anti-Money Laundering                |
| CAR    | Capital Adequacy Ratio               |
| CEO    | Chief Executive Officer              |
| ESG    | Environmental, Social and Governance |
| FSR    | Financial Strength Rating            |
| GNI    | Gross National Income                |
| LCR    | Liquidity Coverage Ratio             |
| MFR CR | MFR Credit Ratings S.r.l.            |
| NOP    | Net Open Position                    |
| NPL    | Non-performing Loans                 |
| OPEX   | Operating Expense                    |

## 1. Scope

This document aims to provide an overview of the main areas of analysis and rating factors on which MFR CR bases its credit rating.

MFR CR adopts this model and methodology to conduct private credit ratings and rating outlooks of financial institutions and financial instruments issued by financial institutions.

The financial institutions to which this model and methodology can be applied are:

- Banks;
- Non-Banking Financial Institutions; and
- Credit unions and financial cooperatives.

The financial instruments to which this model and methodology may be applied are senior, junior and subordinated debt, secured or unsecured (bonds, loans, other instruments).

## 2. Key definitions

MFR CR's credit rating is an opinion on the creditworthiness of a financial institution (issuer) or a financial instrument (issue) and is issued using an established and defined ranking system of rating categories. MFR CR's opinion on the credit quality is based on a thorough analysis of the risk profile and the capacity of repayment of financial obligations of the rated entity.

MFR CR's credit rating is based on a methodology which relies on a data-driven, risk-based and forward-looking approach. Please refer to *Annex 1* for the full list of key definitions and applicable credit rating scales.

A local currency credit rating refers to the likelihood of repayment of financial obligations in local currency, while a foreign currency credit rating considers also the transfer and convertibility risks, which address any regulatory or market restrictions to the conversion of local currency into foreign currency or to make capital transfers among different countries.

MFR CR's credit ratings do not reflect the risk associated to significant and unforeseeable events such as a sudden and unexpected deterioration of financial markets' conditions or the regulatory risk, or frauds, litigations and other institutional failures which cannot be predicted.

Credit rating measures a rated entity's creditworthiness, which reflects the rated entity's ability to avoid defaults in the repayment of financial obligations. For MFR CR, a default is the non-fulfilment of any type of financial liabilities within the specified repayment schedule in a full amount, or in accordance with contractual terms and conditions. This includes the following types of default events:

- i. The rated entity has filed under any applicable bankruptcy, insolvency, or other similar legal proceedings.
- ii. A distressed exchange in which the rated entity offers new or restructured contractual terms that results in less favourable terms of the debt obligation.
- iii. Regulatory decisions/actions taken by the market supervisor (e.g., withdrawal of license).

Long-term credit ratings are generally accompanied by an outlook, which identifies the expected trend of a credit rating. The rating outlook may be one of the following:

- Stable (STA), the rating grade is not likely to change.
- Positive (POS), probable upgrade of the rating grade.
- Negative (NEG), probable downgrade of the rating grade.
- Developing (DEV) signals an uncertain expected trend of the rating grade.

A positive or negative outlook does not mean that a change of the rating grade is inevitable.

### 3. Issuer credit rating

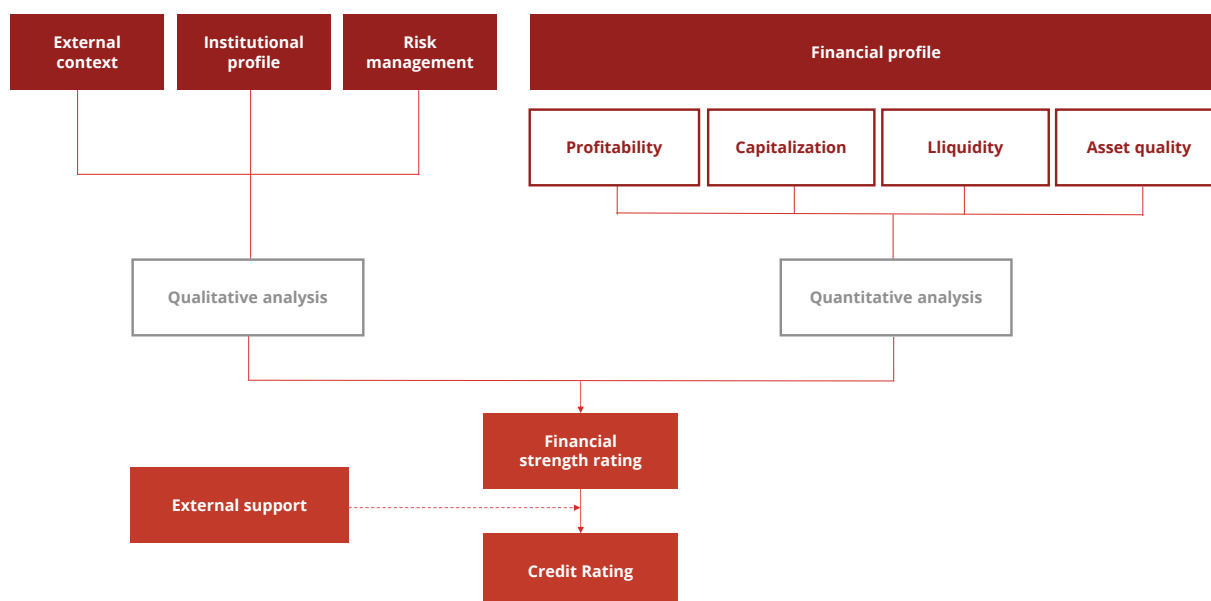
#### Introduction and data providers

The credit rating is an analysis based mostly on the data and information directly provided by the rated entity, which is the main data provider. MFR CR's credit rating methodology implies thorough crosschecks and verification of data received by the rated entity, ensuring very high reliability of data inputted in the rating model. While external data providers are used mostly for the assessment of the context-related risks.

MFR CR's credit rating is composed of two parts:

- a) the financial strength rating of the issuer;
- b) any extraordinary external support from third parties.

The overall assessment of the financial strength of the rated entity is based on both quantitative and qualitative rating factors, which measure the performance and risk profile of the rated entity. Then, the support from third parties is analysed if there are high or medium-high risks of insolvency.



## Financial strength rating (FSR)

The FSR is based on a quantitative and qualitative analysis, including key metrics and the expert judgement of MFR CR's analytical personnel. The quantitative analysis focuses on measuring the performance and quantitative risk profile of the rated entity. The qualitative analysis embraces those aspects which can directly affect the rated entity's creditworthiness (i.e., governance and strategic risks, operational and technological risk, staff related risks, reputational risk, etc.).

For the quantitative indicators, the score is automatically generated based on pre-established thresholds. While for the qualitative indicators, the assignment of the score is based on the expert judgement of the analytical personnel.

The Financial Strength Rating is the result of a weighted average score based on key metrics, which is then adjusted based on secondary ratios. The qualitative analysis (institutional profile, risk management and context) generates additional adjustments and notching.

## External context

### Country risk

The analysis is mostly based on the sovereign rating grade, but it also considers past and forecasted economic growth, macroeconomic stability in terms of inflation, interest and exchange rates and the risk of social conflicts and wars in the country of operations.

### Industry risk

The analysis is based on the level of competition in the areas of operations and the target market. Other aspects which are also analysed include client over-indebtedness risk in urban and rural areas, the efficiency of the available credit risk infrastructure (credit bureaus), the average loan book quality in the financial sector and in the market niche where the rated entity operates.

### Regulatory risk

The analysis is based on the legal, regulatory and supervisory framework applicable to the rated entity and it includes considerations on the quality and effectiveness of the specific country regulatory and supervisory framework applicable to the typology of financial institution to be rated, the lobbying capacity of the entity's industry, and the specific risk of regulatory and fiscal fines for the rated entity.

## Institutional profile

### Ownership

The analysis is based on the quality, stability and commitment of the rated entity's ownership structure, including its financial capacity to support in case of economic contingency. Among the aspects assessed, there are the identity of the owners, focusing on shareholders' diversification, their historical stability and potential/expected changes in the near term, as well as the past and estimated financial support. If applicable, analysis of consequences related to the belonging of the rated entity to a financial group/holding and analysis of consequences related to the existence of subsidiaries or affiliates of the rated entity are also carried out.

### Governance and decision making

The analysis is based on the composition and structure of the governance bodies, the technical competences and skills of the Board members, their ability to provide strategic guidance and supervision to the management team and the level of formalization of the governance processes. Other factors included in the analysis refer to the Board Committees and the Board capacity to determine, update and monitor the risk appetite of the rated entity. Quality, leadership, and strategic planning capacity of the CEO and the top management team are also assessed, as well as the effectiveness of the decision-making and the existence of management-level committees. Other aspects included in the analysis refer to top management turnover, key person risk and the existence of a formalised succession plan.

#### Market positioning and business model

The market positioning of the rated entity is analysed in terms of geographical outreach, market share, loan portfolio volumes, brand recognition, and business model, including product diversification.

### Financial profile

#### Capitalization

The main ratios considered are the capital adequacy and the leverage ratio, which measures the capacity of the rated entity to absorb financial unexpected losses. The profitability analysis is based on the financial and operational results mostly in terms of return on equity, return on assets, earnings, cost to income ratio.

#### Asset quality

Two main components considered here are represented by the loan book and the financial investments. The quality of the loan book is measured through key metrics such as NPL or PAR90, restructured loans, write-offs, risk coverage. This analysis is complemented with additional indicators measuring any relevant concentration risks by geographic area, economic sector, top borrowers. The risk coverage is assessed also considering the level of collateralization of the loan book. The risk profile of the financial investments (securities portfolio) is assessed in terms of concentration (geographical, type of instruments) and risk profile.

#### Liquidity

For the liquidity analysis, key metrics are the core liquidity on total assets and the cash ratio. If available, the liquidity coverage ratio is also analysed.

#### Profitability

The profitability analysis is based on the financial and operational results mostly in terms of return on equity, return on assets, earnings, cost to income ratio.

### Risk management

#### Risk framework

The analysis is based on the effectiveness of the risk management framework and governance, the expertise in risk management at Management and Board level, the existence and proper functioning of a dedicated risk management position or department, risk management policies, monitoring tools and structured reporting.

#### Credit risk management

Analysis is performed on the quality and effectiveness of the credit risk monitoring, credit appraisal and loan approval, debt recovery. The assessment includes the degree of formalization of all credit processes, the compliance with national or international technical guidelines, the adoption of internal thresholds to limit exposure to risky sectors, the inclusion of ESG parameters in the repayment capacity analysis of loan applicants, etc. Regarding the counterparty risk management, the analysis comprises the adequacy of the policies in place, tools and limits, including off-balance-sheet exposures, derivatives (if any), etc. Regarding the equity participations, the analysis focusses only on relevant investments, highlighting the risk profile of each counterparty.

#### Liquidity and funding risks management

Regarding the liquidity risk management, the analysis focuses on the effectiveness of the mitigation strategies, policies and tools, including maturity mismatching, cash flow projections, stress testing, among others. Additional analysis comprises the structure of the funding liabilities, funding concentration risks by top depositors, top lenders, geographical regions or target clients. The stability of deposits from the public (if any), of borrowed funds and any other funding sources (e.g. bonds) are also analysed.

#### Market risk management

The market risks, mostly including foreign currency risk and interest rate risk, are analysed both in terms of exposures as of the cut-off date and mitigation strategies. Regarding the FX risk, the assessment is based on the aggregate net open exposure for all the foreign currencies, together with the degree of in/stability of the local context. The interest rate risk exposure is based on the repricing gap on one year for interest bearing assets and liabilities. The analysis also focuses on the effectiveness of the mitigation strategies, policies and tools for the market risk management.

#### Operational risk management

The analysis is based on the exposure of the rated entity to operational risks and is based on the assessment of the general level of formalization, internal control structure, measurement systems of the operational risks, segregation of duties, preventive controls, compliance with AML regulation. The audited financial statements are also assessed, in terms of availability, unqualified opinions, reputation of the audit company.

#### Environmental and social risks management

The analysis is based on the management of social and environmental risks within the institution with a focus on the strategy, policies and tools in place. The level of awareness, skills, expertise of the management team and the Board regarding environmental and social risks management are analysed. Main risks in terms of client protection are also assessed. The analysis includes some human resources-related aspects and risks such as understaffing, low formalization of policies and procedures, high staff turnover, low staff remuneration comparing with peers, among others.

#### **Extraordinary external support**

If the financial strength rating shows a high or medium-high risk of insolvency, meaning the assigned rating grade stands at non-investment grade, there is an additional analysis on the extraordinary measures implemented or to be implemented from third parties to support the rated entity. This supplementary assessment can determine the increase of the final credit rating grade, through the notching-up of the financial strength rating.



Third parties are affiliate parties or the government or other third parties. The support is assessed in terms of availability to avoid or prevent a default and the extent of the positive impact on the rated entity's creditworthiness in the very short term. The analysis focusses on the effective and proven commitment and capacity of the third party to support.

Affiliate's extraordinary support in case of contingency is assessed also through the degree of correlation or dependence of the rated entity from the affiliate/parent company. This analysis is based on shareholders agreements, parental policies, regulatory requirements, group's strategic planning, among other factors.

State or supranational support is taken into consideration if there is clear evidence and/or a public announcement which confirms the engagement. State support is usually, but not exclusively, provided to financial institutions which are fully or partly owned by the State or whose activities fulfil a public sector mandate. Governments may provide support to a specific financial institution in serious difficulties also to preserve the financial stability of local markets and to protect depositors' savings and confidence towards the financial sector. Other types of public support refer to governmental funding facilities or quantitative easing policies.

#### 4. Issue credit rating

The credit rating of a debt instrument issued by a financial institution is largely based on the issuer credit rating, complemented by additional analysis of all the relevant aspects characterizing the issue itself, as well as the nature and effectiveness of the regulatory framework in which the issuer operates.

When assessing the credit quality of a debt instrument, MFR CR applies a notching system based on a deeper analysis of the structure and contractual characteristics of the debt instrument, including seniority, size of the instrument and level of collateralization, as well as the impact of the regulatory framework and covenants.





## Annex 1 - Key Rating Definitions and Scales

### Credit rating

MFR CR's credit rating is an opinion on the creditworthiness of a financial institution (issuer) or a financial instrument (issue) and is issued using an established and defined ranking system of rating categories. MFR CR's opinion on the credit quality is based on a thorough analysis of the risk profile and the capacity of repayment of financial obligations of the rated entity. MFR CR's credit rating is based on a methodology which relies on a data-driven, risk-based and forward-looking approach.

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MFR CR's credit ratings do not reflect the risk associated to significant and unforeseeable events such as a sudden and unexpected deterioration of financial markets' conditions or the regulatory risk, or frauds, litigations and other institutional failures which cannot be predicted.

### Default

Credit rating measures a rated entity's creditworthiness, which reflects the rated entity's ability to avoid defaults in the repayment of financial obligations. For MFR CR, a default is the non-fulfilment of any type of financial liabilities within the specified repayment schedule in a full amount, or in accordance with contractual terms and conditions. This includes the following types of default events:

- i. The rated entity has filed under any applicable bankruptcy, insolvency, or other similar legal proceedings.
- ii. A distressed exchange in which the rated entity offers new or restructured contractual terms that results in less favorable terms of the debt obligation.
- iii. Regulatory decisions/actions taken by the market supervisor (e.g., withdrawal of license).

### Rating scales

The rating scales are established and defined ranking systems of rating categories. Each rating category has a unique rating definition and includes three rating grades, except for the highest rating categories and the two lowest ones which comprise only one rating grade, instead of three. A rating grade is a letter or combination of letters, including modifiers if applicable, and represents the final output of a credit rating.

The rating scales adopted by MFR CR for the credit ratings differentiate between long-term and short-term ratings:

- a) Rating scale for the issuer (obligor);
  - a1) long-term
  - a2) short-term
- b) Rating scale for the issue (financial instrument);
  - b1) long-term
  - b2) short-term

## Long-term scales

Long-term rating scales are used for issuers and financial instruments with a residual maturity longer than one year. The following two tables represent the long-term global rating scales for issuer and issue, respectively.

| Grade      | Definition   | Scoring         |
|------------|--|-----------------|
| <b>AAA</b> | Exceptionally strong credit quality under the agreed terms and maturities, which would not be affected by possible changes in the issuer, in the sector or in the economy.   | <b>90%-100%</b> |
| <b>AA</b>  | Very strong credit quality under the agreed terms and maturities, which would not be affected by possible changes in the issuer, in the sector or in the economy.  | <b>80%-90%</b>  |
| <b>A</b>   | Strong credit quality under the agreed terms and maturities, which may be affected by a deterioration in the issuer, in the sector or in the economy.  | <b>70%-80%</b>  |
| <b>BBB</b> | Good credit quality under the agreed terms and maturities, which may be affected by a deterioration in the issuer, in the sector or in the economy.  | <b>60%-70%</b>  |
| <b>BB</b>  | Adequate credit quality under the agreed terms and maturities, which is susceptible to weakening in the event of possible changes in the issuer, in the sector to which it belongs or in the economy and may incur delays in the payment of principal and interest.                                      | <b>50%-60%</b>  |
| <b>B</b>   | Moderate capacity to meet financial commitments under the agreed terms and maturities, which is highly variable and susceptible to weakening in the event of possible changes in the issuer, in the sector to which it belongs or in the economy and could result in the loss of principal and interest. | <b>40%-50%</b>  |
| <b>CCC</b> | Limited capacity to meet financial commitments on the agreed terms and maturities, with a medium-high risk of loss of principal and interest.  | <b>30%-40%</b>  |
| <b>CC</b>  | Very limited capacity to meet financial commitments on the agreed terms and maturities, with a high risk of loss of principal and interest.  | <b>20%-30%</b>  |
| <b>C</b>   | Very limited capacity to meet financial commitments on the agreed terms and maturities, with a very high risk of loss of principal and interest.   | <b>10%-20%</b>  |
| <b>D</b>   | Defaulted. The issuer/issue has payment delays, has been declared insolvent or is currently undergoing insolvency proceedings.   | <b>0%-10%</b>   |

### Modifiers

The modifiers "+" or "-" may be assigned to a rating to indicate relative status within a main rating category. The modifiers cannot be assigned to "AAA" or below "CC" grades.

## Short-term scales

Short-term rating scales are used for financial instruments with a residual maturity equal or shorter than one year. The credit rating issued only on the short-term is not accompanied by an outlook.

The following table represents the short-term global rating scale for both issuer and issue.

| Grade       | Definition  | Score           |
|-------------|---|-----------------|
| <b>N-1</b>  | The issuer/issue has excellent capacity to repay short-term debt obligations.   | <b>80%-100%</b> |
| <b>N-2</b>  | The issuer/issue has good capacity to repay short-term debt obligations.  | <b>60%-80%</b>  |
| <b>N-3</b>  | The issuer/issue has moderate to adequate capacity to repay short-term obligations. However, the issuer faces ongoing uncertainties that could affect that capacity.  | <b>40%-60%</b>  |
| <b>N-4</b>  | The issuer/issue has weak to moderate capacity to repay short-term obligations and is currently vulnerable to nonpayment.   | <b>10%-40%</b>  |
| <b>SD/D</b> | SD (Selective default): The issuer/issue has failed to service one or more financial obligations, but the issuer continues to meet other financial obligations.<br>D (Default): The issuer/issue has defaulted on all, or nearly all, of its financial obligations. | <b>0%-10%</b>   |

For specific countries, MFR CR may issue credit ratings on a local scale. While the global scale allows for benchmarking among entities operating in different countries, the local scale applies only to entities within the same country and allows for a greater differentiation among issuers (or issues) within the same jurisdiction.

## Outlook

A Rating Outlook identifies the expected trend of a credit rating and indicates the direction a rating grade is likely to move to, over a one-year or two-year period. In other terms, the rated entity has not yet reached the creditworthiness level required for a rating action, but a clear trend towards a rating action has been identified.

Rating outlooks are assigned only for long-term credit ratings. All rating grades except D are accompanied by a rating outlook.

The assigned rating outlook can be one of the following:

- Stable (STA)
- Positive (POS)
- Negative (NEG)
- Developing (DEV)

A stable outlook indicates that the rating grade is not likely to change. However, it does not exclude a change of the rating grade, which can be raised or lowered without a prior revision to the outlook.

A positive and negative outlook indicate a probable upgrade and downgrade of the assigned rating grade respectively. Yet, a positive or negative outlook does not mean that a change of the rating grade is inevitable.

A developing outlook signals an uncertain expected trend of the rating grade. A developing outlook is transformed into stable, or positive or negative, depending on the outcome of one or more events which occurred or will likely occur in the very short-term.

### Credit watch

A credit watch is assigned by MFR CR if the credit rating cannot be fully defined at a certain moment. MFR CR may consider using the credit watch if some unexpected internal/external events are likely to impact the credit profile of the issuer (or issue) or if the insufficient information provided by the rated entity may alter the rating process and outcome.

The impact of specific events on the credit profile cannot be accurately assessed at the point when they occur, and additional information may be necessary to fully evaluate their impact on rated entities or issues. After issuing a credit watch, the final rating grade can be assigned only after an additional monitoring is held in the short-term.

Some examples of such events are potential mergers or radical changes in the regulatory framework. If a credit watch is issued on an outstanding credit rating, the credit watch indicates that there is a probability of change in ratings assigned and also indicates the likely direction of change. A positive or negative credit watch indicates that the rating could stay at its present level or potentially be upgraded or downgraded. A developing credit watch indicates that the rating grade may be raised, lowered, or affirmed and that the decision depends on the outcome of one or more events in the very short-term.

### Rating actions

MFR CR takes a Rating Action each time MFR CR issues a new credit rating and/or rating outlook or intervenes on an existing credit rating and/or rating outlook by taking a decision aimed at affirming, changing or discontinuing a credit rating and/or rating outlook, except where the decision to affirm a rating is taken by the analytical personnel without a RC meeting. Refer to Credit Ratings Issuance and Monitoring Policy and Procedures for further details on the rating process.

The complete set of Rating Actions which MFR CR may potentially take are the following:

- Rating Assignment:  
A rating is assigned to an issuer/issue which is not currently rated by MFR CR.
- Rating Publication:  
A rating grade and outlook and all mandatory disclosures are made public. This action includes both entities (or financial instruments) rated for the first time and entities (or financial instruments) on which private ratings previously assigned are now published.
- Rating Affirmation:  
The rating has been reviewed with no change in rating grade. Ratings affirmations may also include an affirmation of an outlook when an outlook is used.
- Rating Upgrade:  
The rating grade has been raised in the rating scale.
- Rating Downgrade:  
The rating grade has been lowered in the rating scale.
- Rating Suspension:  
The rating has been temporarily suspended due to noncompliance with regulatory requirements and restrictions on potential conflicts of interest.

- Rating Withdrawal:  
The rating has been withdrawn, and the issuer/issue is no longer rated by MFR CR. This type of action is accompanied by a communication including the current credit rating and outlook, the details motivating the withdrawal and, when possible, the likely direction of any rating movement in case it has been maintained.
- Outlook Assignment:  
The rating outlook has been assigned.
- Outlook Change:  
The rating outlook has been modified.
- Credit Watch Assignment:  
The rating has been placed on credit watch.
- Under Criteria Observation:  
When MFR CR published new or revised criteria (change of existing rating model and methodology) which may have an impact on the existing credit rating and/or rating outlook, but this impact has not been yet quantified. This rating action identifies the beginning of a period during which the new or revised criteria are applied to the existing rating. During this period, which cannot last more than six months, the existing credit rating and/or rating outlook remains valid. If MFR CR believes that the rating will likely change, the Credit Watch is assigned.

### Rating status

The following rating status are identified:

- a) Current
  - Current Assigned  
A rating grade and/or outlook has been assigned.
  - Current Reviewed  
A rating grade and/or outlook has been reviewed generating a rating action.
- b) Withdrawn  
A rating grade (and outlook, if applicable) has been withdrawn and the issuer/issue is no longer rated by MFR CR.
- c) Credit Watch  
The rating has been placed on credit watch.
- d) Under Criteria Observation  
A rating grade (and outlook, if applicable) has been placed in under criteria observation if published new or revised rating model criteria may have an impact on the existing credit rating (and/or rating outlook if applicable), but this impact has not been yet quantified.

### Rating withdrawal

Given that credit ratings issued by MFR CR always remain property of MFR CR. MFR CR has full discretion to determine if and when to withdraw a credit rating.

MFR CR does not withdraw credit ratings simply in response to a request from an issuer. However, it may be appropriate for MFR CR to withdraw the credit rating following such a request if there are other reasons for withdrawal, such as a lack of information, or regulatory constraints.

MFR CR can withdraw a credit rating at any time and for any reason, including, but not limited to the following cases:

- a) If the rating validity has contractually expired;
- b) if the RE defaults, enters bankruptcy, is liquidated or restructures its debt;
- c) if the RE becomes the subject of a corporate reorganization, including acquisitions and mergers;
- d) if the RE no longer exists;
- e) if the quality of information available for assigning a credit is deemed unsatisfactory, insufficient, or raises questions as to whether MFR CR can provide an appropriately informed credit rating;
- f) when the credit rating methodology used to assign the credit rating is no longer applicable;
- g) where there is a regulatory mandate to withdraw;
- h) where certain conflicts of interest conditions arise;
- i) commercial reasons.