

# **KBRA's Rating Process**

Version: March 8, 2011

## **Overview**

Kroll Bond Ratings operates two separate rating services: a subscriber paid rating service offering financial strength ratings on nearly 18,000 institutions and companies; and an issuer-paid ratings business offering publicly available ratings on issuers and obligations. The rating process varies somewhat between the two operations to reflect differences in the business models used.

## **Subscription Rating Service**

The Kroll Bond Ratings Subscription Rating Service (SRS) is a subscriber-based business offering independent and unbiased ratings on financial institutions, sovereigns and corporations. Founded in 1984, the company has been recognized as an impartial and innovative leader in providing financial strength ratings on domestic and international financial institutions, title insurers, sovereigns and the largest U.S. corporations. Typical subscribers who use SRS financial strength ratings include cash managers and treasurers of Fortune 500 companies, state municipalities and other government agencies, investment banks and portfolio managers. SRS ratings are, except in rare circumstances, unsolicited. That is, they are offered without a request from, or in consultation with, rated entities.

## **SRS Rating Process**

In order to provide timely, accurate and broad rating coverage, the SRS employs a rating process that combines statistical model results with analyst oversight. The SRS statistical models benefit from years of experience and are updated as needed to reflect industry changes and trends. Model results are individually checked by at least two analysts before publishing to our ratings database.

### *Data Sources*

Financial strength ratings issued by the SRS are based primarily on regulatory filings for U.S.-based banks, savings and loans, credit unions and bank holding companies. Quarterly updates are obtained from the National Technical Information Service (NTIS). For certain institutions we also obtain information from public websites, including those of the rated institution, the U.S. Securities and Exchange Commission (SEC), the Federal Deposit Insurance Corporation (FDIC) and those of various public media sources and financial information providers. Data for foreign banks and U.S. corporations are obtained from third party vendors, websites and other public media sources. Ratings for title insurance companies are based primarily on regulatory filings, and in some cases, on discussions with rated firms.

Occasionally, a rated institution will contact SRS analysts to offer additional information not contained in a public or regulatory filing. SRS has in place policies to prevent the misuse of any non-public data.

### *Initiating and Maintaining Ratings*

In accordance with its business model, SRS assigns financial strength ratings to all commercial banks, credit unions, savings and loans and the largest bank holding companies that file quarterly regulatory statements with the U.S. Federal Financial Institutions Examination Council (FFIEC). One exception is that SRS currently does not assign ratings to trust companies. SRS assigns ratings to the largest U.S. public corporations and strives to rate all licensed title insurance companies.

It is SRS policy to update credit ratings every 90 days for commercial banks, bank holding companies, credit unions, savings and loans, and corporations. These ratings are produced using an algorithmic model. SRS ratings of title insurance companies and foreign banks are updated semi-annually for title insurance companies and foreign banks, when data is available, using both quantitative and qualitative analysis. Under certain circumstances, SRS analysts also monitor key websites, such as the FDIC's and SEC's, for events that could affect the financial condition of a rated institution. For larger publicly traded institutions, stock prices are monitored, as these may signal concerns about an institution's financial condition.

When SRS receives an *ad hoc* request to rate an institution not previously rated, the issuance of the rating will depend, among other factors, on the timing of the request and the time it takes to complete the analysis.

SRS will not issue ratings for institutions whose charter is less than three years old unless the institution has undergone a change in charter (for example, a bank changing its charter to become a thrift). SRS identifies unrated, new institutions with the rating captions, "NB", "NT", or "NCU", indicating a new bank, new thrift, or new credit union, respectively.

SRS reserves the right not to rate any institution by assigning it an "NR" symbol or deleting it from our services.

### *Two-stage Rating Process*

As noted above, SRS ratings combine a quantitative analysis (which may include use of an algorithmic model) with human oversight. As updated regulatory and financial filings are released, they are formatted and loaded into the SRS database.<sup>1</sup> Where a statistical model is used, the data from regulatory and financial reports are examined for missing values and to insure that no changes have been made to field labels.

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<sup>1</sup> The release cycle varies across sectors and accounts for the sequencing of updated rating releases.

For model-derived ratings, the data is run through a ratings algorithm and a rating is generated for each institution, along with a set of standardized financial and operating measures or ratios. The results are output to pre-formatted computer templates that are used by trained analysts who check each institution's rating with an eye towards anomalous results, as described in an internal Rating Guidelines memorandum. In some cases, the analyst will over-ride the model generated rating. An electronic record-keeping system stores the rationale for any over-rides.

For ratings that do not employ an algorithmic model, an analyst reviews certain quantitative data, and synthesizes those findings with qualitative information from relevant data sources to produce a rating.

A second analyst reviews the ratings and, for each rated institution, either concurs with the first analyst's assessment or suggests a different rating outcome. When there is a disagreement – generally a rare outcome – a rating committee (see below) may be convened.

The SRS analysts carefully review the regulatory and financial data received and assume that it is accurate. If we detect an error – or a rated institution points out an error – we will consider whether to re-rate the institution and notify subscribers of any rating change.

After both analysts have finished reviewing the ratings (and made changes, where appropriate), the results are stored to the ratings database<sup>2</sup> and promptly released to subscribers. An email notification alerts subscribers to a ratings update for a particular sector.

#### *Interim Ratings / Rating Appeals*

In situations where SRS becomes aware of a material data change, an enforcement action, a severe decline in an institution's financial condition, or other unforeseen circumstances, a rating committee may be convened and, if deemed appropriate, an interim (off-cycle) rating change will be entered into the database. If SRS has mis-rated an institution due to an error, it is our policy to issue a corrected rating as soon as possible.

Interim ratings are uploaded to the SRS website and entered into a "Rating Exceptions" spreadsheet. The rating and associated date are maintained as part of the rating record for each affected institution.

#### **KBRA Issuer-Paid Ratings**

In order to provide ratings on specific obligations (bonds, notes, deposits, policy claims, etc.) and to the issuers of these obligations, KBRA offers issuer-paid ratings. Such

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<sup>2</sup> For certain groups of rated issuers, including the largest 100 within particular sectors, a member of senior management performs a third review of the ratings.

ratings are generally solicited and assigned with the cooperation of the issuing entity. The rating process typically begins with the issuer or its banker contacting KBRA to see if we are able to rate the institution or obligation being offered for sale.<sup>3</sup> Our decision to assign a rating will be based on a view of our available resources and expertise to provide a rating, as well as a consideration of whether actual or potential conflicts of interest exist.

After deciding to move forward, the rated entity provides supporting financial data and projections. Its management team will meet with KBRA analysts and a series of discussions will ensue. For structured finance transactions, the issuer will provide information on the underlying assets and deal structure. KBRA analysts will examine the information and proceed to gather its own data pertinent to the rating at hand.

In assigning a rating to an issuer or obligation, KBRA analysts adhere to board-approved credit rating methodologies. KBRA credit rating methodologies cover a broad spectrum of topics. Individual methodologies may be concerned with the way the KBRA analyzes issuers (companies, institutions and entities) and obligations (bonds, deposits, insurance claims, etc.) within an industry sector, asset class and/or region. Other methodologies apply globally, and reflect the meaning of the KBRA rating system and the role of external support for a rated issuer.

The established methodologies offer guidance as to the important risk factors and, where feasible, relative weightings to place on these. These “roadmaps” to the thinking underlying a rating are available on the KBRA website. If KBRA deems it necessary to create or modify a rating methodology or model, or to otherwise revise its rating practices, such changes are submitted to KBRA’s rating policy committee for approval.

Each rated issuer is assigned a lead analyst, who in turn, reports to a managing director. Once a rating recommendation has been reached, the lead analyst will call a rating committee (see below) after consulting with his or her managing director. After the rating committee has concluded, the lead analyst informs the issuer and the markets of the rating outcome. In most cases, this will take the form of a press release and posting to the KBRA website.

On an ongoing basis, the lead analyst (or designated team, in the case of certain structured finance transactions) will monitor the issuer in order to assess the appropriateness of the assigned rating. If circumstances meaningfully deviate from expectations, the analyst may call another rating committee to place the rating on review for change, or, in some cases, to simply change the rating.

As such, ratings are monitored continuously – to the extent new information becomes available – and will generally not need to be affirmed on a regular schedule.

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<sup>3</sup> Investors may also approach KBRA to seek ratings for a particular security or loan, or to rate a portion (or all) of its portfolio.

## Rating Committees

### *Purpose*

The purpose of a rating committee is to provide a formal forum for the determination of ratings and to offer an appropriate level of governance and oversight with respect to significant rating actions and decisions.

### *Frequency/Duration*

A rating committee will meet as needed, depending on the timing of rating mandates, availability of new information and credit developments. The most senior member of the committee typically serves as the chair of the committee and is responsible for ensuring the meeting stays on topic and for taking the vote. Prior to a rating committee meeting, the analyst or manager calling the meeting will normally provide an agenda outlining topics for discussion. If a time-sensitive concern arises about an institution or financial matter, a meeting can be called without an agenda.

### *Reasons for Convening*

A rating committee may convene for the following reasons:

- To assign a new rating to an issuer, obligation or class of obligations;
- To place a rating under review or remove it from review;
- To change a rating;
- To withdraw a rating.<sup>4</sup>

### *Committee Members (all have voting rights)<sup>5</sup>*

A rating committee will consist of one or more analysts and a managing director (or equivalent). At a minimum, three members are required for the rating committee to hold a vote. Considered item(s) for action/approval will be approved based on a majority vote. Disagreements with a rating committee's decisions are handled through an internal appeals process.

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<sup>4</sup> A rating committee is not required in order to withdraw a rating in the case of routine maturing of debt.

<sup>5</sup> If a committee member has a conflict of interest in regard to an item to be discussed during a committee meeting, that member will be considered a non-member for the purposes of that particular meeting and may not participate in the meeting, vote on proposals discussed during the meeting, or otherwise influence the meeting.

# **KBRA Subscription Rating Service's Methodology for Rating US Banks, Savings and Loans, Bank Holding Companies and Credit Unions**

Version: March 8, 2011

The KBRA Subscription Rating Service (SRS) provides both an objective and subjective evaluation of the financial condition of an institution. The subscription rating services provide the user with a means to quickly evaluate the institution's financial strength without having to perform a lengthy financial analysis. It is important to note the trend and stability of the KBRA SRS rating. Downward trends in the financial rating indicate deterioration in the organization's financial condition, while continuous changes in the financial ratings may be indicative of instability. Banking organizations having low ratings (C, D or E) are likely to have financial problems and, for this reason, the accompanying ratios should be evaluated.

Note that while domestic banking rating methodologies are very similar, several key differences exist. Domestic banks and thrifts currently perform nearly the same tasks; as such, KBRA SRS applies the same methodologies to both of these entities. Similarly, bank holding companies often consist of only a banking subsidiary. Therefore, KBRA SRS applies similar rating methodologies to both banks and smaller bank holding companies. For larger bank holding companies, the rating methodology relies more on subjective analysis to account for the complex structure of the companies and possible international operations. Credit unions, while rated based on the KBRA SRS bank determinants, are treated differently during the rating process, as credit unions are unique in the domestic banking industry. Credit unions are nonprofit, tax-exempt institutions; therefore, KBRA SRS does not place as much importance on earnings when rating credit unions. Additionally, regulators hold credit unions to different capitalization standards than other domestic banking entities. KBRA SRS applies these capitalization standards when assigning ratings to credit unions.

## **Liquidity**

Liquidity measures an institution's ability to meet its anticipated short- and long-term obligations to customers and creditors. A high degree of liquidity enables an institution to meet unexpected needs for cash without the untimely sale of investments or fixed assets, which may result in substantial realized losses due to temporary market conditions or tax consequences. Liquidity for financial institutions is difficult to measure since their liquidity position changes daily and the data reflected in the financial statements may not reflect their current position. It is important to measure liquidity, however, because a lack of liquidity may bring about the failure of the bank when financial problems become apparent. KBRA SRS primarily considers temporary investments minus volatile liabilities-to-average assets and loans-to-average assets.

## **Asset Quality**

The measurement used to assess a bank's asset quality is its amount of nonperforming assets. Nonperforming assets is a term used to describe assets on which revenue recognition has been discontinued or is restricted. Nonperforming assets include both nonperforming loans and securities and other real estate owned or acquired in connection with the collection effort on loans. Financial institutions generally fail due to a large percentage of nonperforming assets as compared to total capital and loan loss reserves. Asset quality also affects earnings through provisions to the loan loss reserve. An inadequate reserve will require additional provisions, which reduces earnings. Poor asset quality can also affect earnings through reduced interest income. Loans, which are past due and are not paying interest as scheduled, have a negative impact on interest income.

## **Capital**

A bank's capital position is of paramount importance to its overall financial condition. Earnings are the primary means for banks to increase capital internally, which is accomplished through retained earnings (net income less dividends paid). For many small community banks, retained earnings are even more important, because they are often the only practical source of raising capital. If a bank is not profitable, losses will decrease its capital strength, which may ultimately affect the institution's overall safety, soundness and viability. Because of banks' multiple functions, the great degree of leverage they employ in carrying out their economic role, and their access to a safety net, society has a keen interest in the health and wellbeing of the banking system. The level of government regulation and supervision, unique to insured depository institutions, has evolved over the years. Only in recent years, however, have U.S. banking agencies established specific standards for capital in relation to the risk of loss rather than simply commenting on institutions' capital adequacy to managers and boards of directors on a case-by-case basis, often in qualitative terms. KBRA SRS measures capital strength mainly through the institution's amount of regulatory capital (through combinations of equity, loan loss reserves, subordinated debt, and other accepted instruments) as compared to its risk-weighted assets (loans and securities, for example) and asset equivalent off-balance sheet exposures (such as loan commitments, standby letters of credit, and obligations on derivative contracts). Analyzing a bank's capital level in this way increases the emphasis on common equity and restricts the amount of loan loss reserves that can be counted as capital. It also recognizes the relative degree of credit risk associated with various assets by setting different capital requirements for some assets that clearly have less credit risk than others.

## **Earnings**

As described above, a bank's capital strength is of paramount importance to its overall financial condition and earnings are the primary means for banks to increase capital internally, specifically through retained earnings. Earnings help an institution cover expenses, provide for loan and other losses, support growth, add to capital and pay

dividends. Earnings also provide insurance against losses, are a means to support asset growth, and support the bank's ability to pay dividends to shareholders, which can improve its ability to raise capital externally. The institution's dividend policy is of importance since excessive dividends can weaken a bank's capital position. Banks located in rapidly growing markets must be attentive to their rate of earnings' retention so they may properly plan for new capital funds as needed.

For most banks, the loan portfolio comprises the majority of earning assets although interest income can be derived from other earning assets. Noninterest income is typically the second largest source of revenue for a bank. It consists of fees and charges that are not interest related, such as: service charges on deposit accounts, trust income, other real-estate owned rental income, gains/losses on trading accounts assets, and fees and commissions for other services and activities.

## Financial Strength Rating Scale

The KBRA financial strength rating is a measure of the overall financial condition of an institution and its ability to meet its credit obligations.

- A** An institution with an exceptional financial profile, little or no nonperforming assets, and is highly capitalized with strong earnings. This grade represents the highest level of financial soundness. The entity is highly likely to meet its credit obligations under severe economic, financial and business conditions.
- B** An institution with an adequate financial condition that is likely to meet its credit obligations under difficult economic, financial and business conditions.
- C** An institution with an adequate financial condition but is more susceptible to adverse changes in economic conditions that could affect its ability to meet its credit obligations.
- D** An institution whose financial condition is judged to be relatively weak and its ability to meet financial obligations could be affected by adverse economic, financial or business conditions.
- E** An institution that is likely to have financial problems and poor financial ratios. Careful consideration should be made concerning investments in this institution. The institution has a much higher probability of failure than institutions with higher ratings.

Note: KBR may append + or - modifiers to ratings in categories **A** through **C** to indicate, respectively, upper and lower risk levels within the broader category.

- NB** A new institution which is less than three years old and which is not rated, but its financial data is presented and an "NB" is shown in the rating field.
- NT** A new savings & loans which is less than three years old and which is not rated, but its financial data is presented and an "NT" is shown in its rating field.
- NR** An atypical bank, bank holding company or S&L, or an institution missing key financial data necessary to derive a rating.

## **KBRA SRS Peer Groups and Rating Criteria**

### **Description of the Subscription Rating Service**

When determining the overall financial condition of a company, KBRA SRS feels that size matters, especially for financial institutions. Larger institutions have greater access to capital markets and generally, with larger staff, potential fraud is less of a risk. For financial institutions, KBRA SRS performs peer analysis based on the following peer groups:

Peer Group 1: Mega Institutions

Peer Group 2: Large Regional Institutions

Peer Group 3: greater than \$3 billion and less than \$10 billion

Peer Group 4: greater than \$1 billion and less than \$3 billion

Peer Group 5: greater than \$300 million and less than \$1 billion

Peer Group 6: greater than \$100 million and less than \$300 million

Peer Group 7: greater than \$50 million and less than \$100 million

Peer Group 8: greater than \$25 million and less than \$50 million

Peer Group 9: greater than \$10 million and less than \$25 million

The KBRA SRS rating system objectively and subjectively rates insured U.S. commercial banks and state-chartered saving banks on a quarterly basis using a uniform set of criteria. The financial conditions of all banks are analyzed quarterly. Data for newly chartered banks are shown but new banks are not rated until they have been in existence for three years. (Please see *KBRA's SRS Rating Process*, March 8, 2011.)

### **The KBRA SRS Rating Criteria**

The criteria used in the rating system are based on a concept of financial soundness that evolved from extensive research dealing with banks. By measuring and aggregating ratios representing liquidity, asset quality, capital, and earnings, bank ratings are derived from A+ to E four times a year using data from Reports of Condition and Income that are filed with federal bank regulators.

The KBRA SRS rating criteria derives a financial rating based on key financial ratios representing liquidity, asset quality, capital, and earnings. If one were to rate an institution objectively on a peer basis alone, a major deterioration in an institution's financial condition may not be picked up in the ratings. A score of financial soundness is then derived for each institution and mapped into a financial rating. For larger bank holding companies, a separate financial analysis is performed each quarter that re-evaluates their ratings. Discussions with an institution's management may occur when we feel a major downgrade is warranted, or when we feel that a smaller institution may be in danger of failing. Releases are sent to our subscribers when a large domestic or foreign bank is significantly downgraded outside of the normal rating cycle, and each quarter additional releases are sent to subscribers about institutions whose financial condition is of concern to KBRA SRS.

Under the KBRA SRS rating system, weights on key financial variables can shift depending on extenuating circumstances. For example, if asset quality, capital and earning conditions of a bank are sound then the liquidity weight is relatively low. However, if any of these factors weaken significantly, or in aggregate for a bank that is dependent on borrowed funds, then the liquidity factor is given greater weight.

### **Evaluating the Financial Condition of an Institution**

A downward trend in the KBRA SRS rating is a likely indicator of deterioration in the institution's financial condition and a steady increase in the rating generally signals an overall strengthening of the institution's financial position. A high steady "A" or "B+" rating indicates a strong financial condition. Most institutions will fall into the "A" and "B" rating categories. "C+" is the lowest investment grade rating KBRA SRS assigns to financial institutions. Institutions having a "C" or below rating are considered below investment grade. These institutions are likely to have either a relatively weak overall financial condition or a weakness in one more of the key financial ratios, likely falling into the bottom quartile of their peer group. Ratings are displayed on KBRA SRS's website for several time periods that allow users to identify trends of deterioration or improvement in an institution's overall financial condition. The lower the rating the greater the concern one should have about the financial condition of the institution.

"C" rated banks are likely to have one or more of their financial metrics below the bottom quartile of their peer group, or a combination of these variables may indicate an overall weakness in financial condition.

"D" and "E" rated institutions are likely to have financial problems (and therefore poor financial ratios) and careful consideration should be given prior to investing in, or doing business with, these institutions. These entities are likely to have a higher probability of failure than institutions with higher ratings. As detailed in *KBRA SRS Rating Definitions* (March 31, 2011), a rating assignment of "NB", "NT", or "NCU" indicates a new bank, new thrift, or new credit union, respectively, whose charter is less than three years old. The "NR" symbol stands for not rated. Institutions receiving an "NR" symbol are institutions that KBRA SRS has decided not to rate due to their atypical structure or due to incorrect or missing data, or because the institution has requested that KBRA SRS not rate it. KBRA SRS reserves the right not to rate any institution by assigning it an "NR" symbol or deleting it from our services. It should be noted that inaccurate reporting by institutions of their financial data will likely result in incorrect KBRA SRS ratings for those institutions. The ratios listed below are some of the key indicators of an institution's financial soundness used in the KBRA SRS rating system.

## Definitions of KBRA SRS Financial Ratios

<b>KBRA SRS FINANCIAL RATIO DEFINITIONS</b>	
<b>Abbreviation</b>	<b>Ratio Description</b>
<b>TOTAL ASSETS</b>	Total consolidated assets reported in dollars (millions or thousands depending on the service used).
<b>EQTY CAPT</b>	Total equity capital shown in dollars (millions or thousands depending on the service used).
<b>INC QTR (000)</b>	Net income reported for the current quarter; i.e., fourth quarter net income would only be for the final quarter and not for the full year.
<b>INC CUM (000)</b>	Cumulative net income; i.e., cumulative net income for the September rating period (September 30) would include income for the first nine months.
<b>NET INC/CAPT</b>	Annualized income divided by total equity, also know as return on equity, ROE.
<b>LIQUIDITY RATIOS</b>	
<b>TI-VL/ASTS</b>	<p>Temporary investments minus volatile liabilities divided by average assets. PCT is the bank's peer group percentile ranking for the ratio.</p> <p><b>Temporary investments:</b> Interest bearing bank balances due from depository institutions, securities with a maturity of one year or less, federal funds sold, and securities purchased under agreements to resell.</p> <p><b>Volatile liabilities:</b> Time deposits greater than \$100,000, interest bearing foreign deposits, and other borrowed money with a maturity less than one year and federal funds purchased. A ratio of zero or better is preferable.</p>
<b>LNS/ASTS</b>	Ratio of total loans, net of provisions for loan losses, to average assets. A smaller number indicates greater liquidity.
<b>CDS&gt;100/AST</b>	Time certificates of deposits of \$100,000 or more plus open-account time deposits of \$100,000 or more divided by total assets. A smaller number indicates greater liquidity.
<b>SEC&gt;5 YR/AST</b>	Fixed rate debt securities with a remaining maturity of over five years divided by total assets. A smaller number indicates greater liquidity.
<b>ASSET QUALITY RATIOS</b>	
<b>NONPERFORM ASTS / ASSETS</b>	Nonperforming assets include other real estate owned, loans past due 90 days or more and still accruing and loans placed on nonaccrual divided by average total assets. PCT is the bank's percentile ranking for its ratio within its peer group based on asset size shown in the front of the service. A ratio close to zero is ideal.
<b>NONPERFORM ASTS / CAPT.</b>	Nonperforming assets as defined in the above definition divided by total equity capital plus reserve for loan losses

	minus goodwill. A ratio close to zero is ideal.
<b>LOSS RSRV. /AST</b>	The bank's reserve coverage ratio. The ratio of a bank's reserve for loan and lease losses to its total amount of total assets. A larger number is preferable.
<b>CHG-OFF / ASTS</b>	Ratio of gross losses on loans charged to the loan loss reserves (annualized) to total assets.
<b>CAPITAL ADEQUACY RATIOS</b>	
<b>TIER 1 / R. AST</b>	Measures the bank's "Tier 1" capital relative to its risk-weighted assets and shows the bank's percentile ranking among its same-sized peers. Although each regulator has its own slightly different definition of "tier one" capital, it is generally thought of as: 1) the bank's common stock and related accounts (such as retained earnings); 2) qualifying non-cumulative perpetual preferred stock and related surplus, and; 3) minority interests in the equity accounts of unconsolidated subsidiaries less any intangibles (such as goodwill). The bank's risk-weighted assets measure the bank's assets, as well as the "credit equivalence" of assets.
<b>T.CAPT / R. AST</b>	Measures the bank's total capital in relation to its risk-weighted assets. The numerator, total capital, is defined as "Tier 1 capital" plus "Tier 2" capital. Tier 2 capital, also known as supplementary capital, is generally defined as: 1) the bank's allowance for loan and lease losses (up to 1.25% of risk-weighted assets); 2) all remaining perpetual preferred stock not included in tier one capital; 3) "hybrid capital instruments" and "mandatory convertible debt securities", and; 4) term subordinated debt and intermediate-term preferred stock.
<b>Tier 1 / LEVERAGE</b>	Ratio measures the bank's total Tier 1 capital, defined as total capital less intangibles, divided by the average assets less intangibles held by the bank during the current period. Please note that the leverage ratio that KBRA SRS calculates uses the regulatory definition of Tier 1 Capital. i.e., it does not reflect unrealized gains or losses on securities classified as "available for sale."
<b>GAIN SEC / CAPT</b>	Net unrealized gains or losses classified by the bank as "available for sale" as a percentage of period-end equity capital (regulatory definition--see above). This ratio shows the possible erosion of a bank's equity capital should it be forced to sell these securities at current market values.
<b>EARNINGS PERFORMANCE RATIOS</b>	
<b>INT INC</b>	Annualized interest income placed on a tax-equivalent basis. Categories included in interest income are interest and fee income on loans in domestic and foreign offices, income from lease financing receivables, interest income on balances due

	from depository institutions, interest and dividend income on securities, income from assets held in trading accounts, and interest income on fed funds sold and securities purchased under agreements to resell.
<b>INT EXP</b>	Annualized interest expense. Categories included in interest expense are: interest on transaction and non-transaction accounts held in domestic and foreign offices, interest on demand notes issued to the U.S. Treasury and other borrowed money, interest on mortgage indebtedness and obligations under capitalized leases, interest on subordinated notes and debentures, and the expenses associated with fed funds purchased and securities sold under agreements to repurchase.
<b>NET INT INC</b>	Annualized net interest income placed on a tax equivalent basis. PCT is the bank's peer percentile ranking for the ratio.
<b>NON INT INC</b>	Annualized noninterest income includes deposit service charges, trading commissions, foreign exchange trading and other foreign transaction income, and other income. PCT is the bank's peer percentile ranking for the ratio.
<b>OVERHEAD</b>	Annualized total overhead expense includes personnel expense, occupancy expense, and other operating expenses. PCT is the percentile ranking of the ratios within the bank's peer group.
<b>PROV LOAN RESER</b>	Provisions made to the loan-loss reserve as a percent of assets.
<b>PRE TAX INC</b>	Pretax income placed on a tax equivalent basis shown as a percent of assets.
<b>NET INCOME</b>	Annualized net income (cumulative) as a percent of assets as of the reporting period and for the last year-end period. D, M, J, and S stand for the reporting periods of December, March, June, and September, respectively.
<b>LOAN TYPES AS A % OF LOANS</b>	
<b>COM &amp; IND</b>	Commercial and Industrial loans divided by total loans.
<b>C&amp;D REAL ESTATE</b>	Commercial and development real estate loans divided by total loans.
<b>PER LNS</b>	Personal loans (consumer loans) divided by total loans.
<b>OTH LNS</b>	Other loans, which is equal to total loans minus the above categories.
<b>OTHER RATIOS</b>	
<b>NPA CHG</b>	Quarterly change in reported nonperforming assets.
<b>AST CHG</b>	Change in average assets from the year ago period
<b>EQTY CAP CHG</b>	Change in total equity capital from the previous quarter.

# KBRA Subscription Rating Service's Methodology for Rating Title Insurance Companies

Version: March 8, 2011

## *Claims-Paying Ability*

The KBRA Subscription Rating Service (SRS) rates the claims-paying ability of approximately 60 title insurance underwriters in the United States on a quarterly basis using data from the June and December regulatory filings and, whenever possible, qualitative data provided by the title companies.

The service enables mortgage lenders to comply with Fannie Mae's requirement that "Lenders must independently verify the ratings for the title insurance companies they use with the applicable rating agency once every six months." KBRA is an accepted rating company for title insurance underwriters by the Federal National Mortgage Association ("Fannie Mae").

KBRA has developed two separate claims-paying ability services that contain Title Insurance Underwriter Ratings and a single Commercial Capacity service.

	<b>Ratio/Item Definitions</b>	<b>Data/Ratings Spread</b>	<b>Financial Statements</b>	<b>Background Information</b>	<b>Areas of Operations</b>
<b>Extensive Service</b>	Yes	2 pages	Yes	Yes	Yes
<b>Standard Service</b>	Yes	2 pages	No	Yes	Yes

## *Commercial Capacity*

The KBRA SRS Commercial Capacity Rating Service for Title Insurers is an independent source of critical information on the capacity of title insurers to write large policies--and to assume reinsurance--in conjunction with major commercial real estate and mortgage lending transactions. The service is designed to assist in the establishment of an insurer's single self-supported risk limit, as well as the structuring of facultative reinsurance transactions by financial institutions, major insurance companies, real estate attorneys, and other participants. In order to be included in the service, a title insurer must be capable of assuming a risk of at least \$1,000,000; as such the number of companies included in the service may fluctuate from one period to the next.

## **Introduction**

Title insurance companies are rated by KBRA SRS on a scale of "A+" to "E." Companies having ratings of "A+" to "C+" are viewed as being secure in their ability to pay claims. Title insurance companies with ratings of "C" and below are viewed as

being vulnerable regarding their future Claims-Paying Ability. *KBRA SRS does not typically charge title insurance companies for their rating.*

The rating system was designed to help facilitate the sale and resale of mortgages by providing the purchaser with ratings on the financial ability of title insurance companies to pay future claims.

## **Methodology**

Title insurance companies Claims-Paying Ability ratings and Commercial Capacity limits are based on a quantitative and qualitative analysis of the company's financial condition, regional economic conditions, industry trends, and evaluation of management based on quarterly financial reports, company releases, and, when possible, discussions with management.

The KBRA SRS Claims-Paying Ability ratings for title insurance companies have been prepared primarily for the guidance of lenders originating mortgages for the secondary mortgage market and for title insurance policies issued in conjunction with such residential transactions. The ratings are not intended to be indicative of any title insurance company's capacity to write large commercial title insurance policies. KBRA SRS's ratings have been accepted for use by the Federal National Mortgage Association (Fannie Mae).

KBRA SRS ratings have been developed primarily for those licensed title insurers who issue residential loan title insurance policies. Holding companies and other affiliates who engage only in reinsurance transactions, whether facultative or pursuant to treaty arrangements, are not rated. As risk assumed on larger transactions can affect a title insurance company's overall Claims-Paying Ability, the self-imposed limits and other relevant available information have been listed for each rated company. Many individual title insurance companies have financial support arrangements from other title insurers, affiliated or unaffiliated, which may affect the company's Claims-Paying Ability. These considerations can, in some cases, be paramount, overriding the financial assessment of the individual company. The basis for each company's rating has been set forth for each company. Users of the KBRA SRS ratings needing more information on such arrangements should contact the individual company.

When issuing a Claims-Paying Ability rating, an analyst may consider any or all of the ratios listed below as well as supplementary data discovered as a result of the analyst's research, or provided by the title companies. In addition, the analyst will only compare financials within a single peer group defined by size. For example, an analyst will not compare the return on assets of an underwriter in Peer Group 1 (greater than \$100 million-in-assets) to that of an underwriter in Peer Group 4 (less than \$10 million-in-assets). Note that the June Claims-Paying Ability book presents fewer ratios than the December Claims-Paying Ability book.

## Financial Ratios

**Liquidity Ratios** measure the ability of the company to generate sufficient cash from premiums, investment income, and the sale of liquid assets in order to meet its liability for incurred but unreported claims. Since the expected liability for such claims is not reported at present under current statutory accounting practices, the more liquid the company's assets relative to its trend in incurred and paid claims, the better its ability to meet such obligations as they are presented in the future. This analysis includes an evaluation of the company's assets for liquidation, cash flow, and duration of its liabilities.

**NET LQD ASTS/EQTY+SPR:** Ratio of net liquid assets to total equity capital (surplus as regards to policyholders) plus the statutory premium reserve, expressed as a percentage. See the first liquidity ratio for the definition of net liquid assets.

**NET LIQUID ASSETS/AVG. CLAIMS:** Ratio of net liquid assets (cash and cash equivalents, securities of non-affiliates, and receivables less known claims reserve and other liabilities) to five-year average claims (including paid losses, incurred losses, and loss adjustment expenses). This ratio is expressed as the number of years of average claims the company can pay with its existing net liquid assets.

**GOING CONCERN:** Ratio of going concern liquid assets to average claims. This ratio measures the company's ability to meet its future trended claim obligations by using its liquid assets without resorting to the use of its statutory premium reserve.

**LQD TY/AVG. CLAIMS:** Going concern assets are defined as: cash and cash equivalents, securities of non-affiliates, less the company's statutory premium reserve. The denominator is the same that is used in the previous liquidity ratio. This ratio is also expressed in the number of years of average claims in going concern assets.

**NET LQD ASSETS/TOTAL RSV:** Ratio of net liquid assets (defined above) to total loss reserves. Loss reserve data is from Schedule P of the December Form 9 statements (interim periods use previous December data). A ratio of 1.0 or greater means that a company has enough net liquid assets on hand to meet all of its present and expected future claims obligations relating to currently outstanding policies.

**Asset Quality Ratios** take into consideration the uncertainty of claims to be presented in the future. Loss trends, comprised of paid losses, incurred losses, and loss adjustment expenses, are evaluated relative to the company's equity plus statutory premium reserve. Loss trends are also evaluated relative to premiums earned in order to measure the company's relative demands on assets to meet obligations for claims presented in the future. Low past claims expenses relative to the industry, within geographic regions as appropriate, indicate that the company is better managing its underwriting risks. The analysis includes an evaluation of the total net assets that can be readily liquidated to meet claims.

LOSSES & LAEs: Losses and loss adjustment expenses incurred for the period expressed as a percentage of period-end assets.

AVG CLMS/TITLE PREMS EARNED: Ratio of average claims to total title premiums earned during the year (annualized for interim statements), expressed as a percentage.

HIST. INCRRD LOSS RATIO: Ratio of cumulative net losses and allocated loss adjustment expenses incurred to cumulative net premiums written and other income, expressed as a percentage. Data is from the December Schedule P from the Form 9 statements (interim periods use previous December data).

AVG CLMS/TITLE PREMS EARNED: Ratio of average claims to total title premiums earned during the year (annualized for interim statements), expressed as a percentage.

HIST. INCRRD LOSS RATIO: Ratio of cumulative net losses and allocated loss adjustment expenses incurred to cumulative net premiums written and other income, expressed as a percentage. Data is from the December Schedule P from the Form 9 statements (interim periods use previous December data).

**Capital Adequacy Ratios** and statutory premium reserves are the cushion for which a title insurance company can absorb unreported claims. The higher these levels, the better. Also important to a company's strength is the level of earnings that is retained as capital. The analysis of capital includes the evaluation of both long-term and short-term debt to capital and fixed, charged coverage ratios.

EQTY+SPR/ T. AST: Ratio of total equity capital plus statutory premium reserve to total period-end assets, expressed as a percentage.

SPR/IBNR: Ratio of the statutory premium reserve to loss reserves on Schedule P expressed as a percentage.

CHG EQ+ CHG SPR/ T. ASTS: Ratio of the change in both equity capital and statutory premium reserve during the period, expressed as a percentage of total assets.

NI-DIV/ T. ASTS: Ratio of earnings retained for the current period--current period's net income less dividends declared--expressed as a percentage of total assets.

DIV/NET INC.: The company's dividend payout ratio--dividends declared during the period divided by current net income.

EQTY+SPR/ T. AST: Ratio of total equity capital plus statutory premium reserve to total period-end assets, expressed as a percentage.

SPR/IBNR: Ratio of the statutory premium reserve to loss reserves on Schedule P expressed as a percentage.

CHG EQ+ CHG SPR/ T. ASTS: Ratio of the change in both equity capital and statutory premium reserve during the period, expressed as a percentage of total assets.

NI-DIV/ T. ASTS: Ratio of earnings retained for the current period--current period's net income less dividends declared--expressed as a percentage of total assets.

DIV/NET INC.: The company's dividend payout ratio--dividends declared during the period divided by current net income.

**Earnings Ratios** can vary significantly for title insurance companies because of the cyclical nature of the overall industry. During downswings in the business cycle, companies having a higher percentage of revenues generated from their own staff and facilities are likely to have higher expenses than those companies who rely more heavily on agents. The opposite is, of course, likely during economic expansion. Also, during economic decline, claims are likely to rise. Timely analysis of quarterly financial statements to determine both the strength and direction of earnings are performed each period.

*Note: All earnings ratios are taken from the current period income statement and associated schedules (annualized for interim statements).*

TOTAL OPER. INCOME: Total operating income (gross revenues) for the period expressed as a percentage of period-end total assets.

LOSSES & LAEs: Losses and loss adjustment expenses incurred for the period expressed as a percentage of period-end assets.

TOTAL OPER. EXP: Total operating expenses for the period, expressed as a percentage of period-end total assets.

NET OPER. GAIN/(LOSS): Net operating gain or loss (total operating income less total operating expenses) for the period expressed as a percentage of period-end total assets.

NET INVEST. GAIN/(LOSS): The company's net investment gain or loss during the period, expressed as a percentage of period-end total assets. Net investment gain/loss includes interest or dividend earnings from securities plus realized capital gains or losses on securities sold.

PRE-TAX INC.: Pre-tax income for the period (consisting of net operating income/loss plus net investment income/loss) expressed as a percentage of period-end assets.

NET INC.: The title insurance company's after-tax return on assets. Ratio of total net income (annualized for interim periods) expressed as a percentage of period-end total assets.

## **Evaluating The Financial Condition Of A Title Insurance Company**

A KBRA SRS rating of "A+", "A" or "B+" indicates that a title insurance company has a strong overall financial condition that will allow it to meet its future claims. As a rule, these companies have good operating earnings, are well capitalized, and have adequate reserves.

Most title companies will fall into the "B" or "B-" rating category. The range in financial soundness and ability to meet future claims is fairly large for this category. For this reason, one should compare the individual ratios when making decisions among these companies.

Companies rated "C+" may have some financial ratios that are below average, but are considered "investment grade."

Companies rated "C" or "C-" may be financially weak in one or more areas of liquidity, asset quality, capital and reserves, and earnings.

"D" and "E" rated companies are likely to have a lower probability of meeting their future claims (as shown by poor key financial ratios). Careful consideration should be made when dealing with these companies.

Companies with an "NR" symbol either have not submitted sufficient data to be rated for the corresponding period, or KBRA SRS is concerned about the quality of the data reported or KBRA SRS chooses not to rate the company for other reasons.

**PLEASE NOTE:** Some companies may receive higher ratings than would be warranted by an analysis of their individual financial condition. This may occur either when the company is affiliated with a strong parent or when the company either has coinsurance agreements or issues "joint & several" policies with other title companies. In the case of joint & several policies, the company is assigned the rating of the company who is jointly liable for claims.

KBRA SRS currently rates companies that control nearly 100% of the industry's assets, and our continuing objective is to rate all companies who underwrite title insurance. **However, KBRA SRS reserves the right to drop a company from its rating service or withhold rating a company when it is concerned about the integrity of the data or when we feel we do not have a proper dialogue with management concerning the title company's financial condition.**

# **KBRA Subscription Rating Service's Methodology for Rating Foreign Banks**

Version: November 1, 2010

The KBRA Subscription Rating Service (SRS) ratings provide both an objective and subjective evaluation of the financial strength of a foreign bank. KBRA SRS's subscription rating service provides the user with a means to quickly evaluate an institution's financial condition without having to perform a lengthy financial analysis. It is important to note the trend and stability of the KBRA SRS rating. Downward trends in the rating indicate deterioration in the organization's financial condition, while continuous changes in the financial ratings may be indicative of instability. Banking organizations having low ratings (C, C-, D or E) are likely to have financial problems and, for this reason, the accompanying ratios should be evaluated.

Note that while the international bank rating methodology is similar to that for US domestic banks, several key differences exist. For large international bank holding companies, the rating methodology relies more on subjective analysis to account for the complex structure of the companies and their operations. Additionally, country risk is usually taken into account while rating foreign institutions.

## **Description of the KBRA SRS Foreign Bank Rating Service**

The KBRA SRS Foreign Bank Rating Service provides financial data and ratings for approximately 280 of the world's largest non-US banks. Unlike other KBRA SRS ratings, the rating criteria used to evaluate a foreign institution's financial condition will vary with each country. When evaluating the financial condition of a bank within a certain country, one must refer to the Ratio Definitions preceding the data in order to determine what items are included within each individual ratio.

Currently, the KBRA SRS Foreign Bank Rating Service incorporates ratings for banks in over 60 foreign countries, with many countries having an individual page for their banks' ratings. For both organizational purposes and for ease of use, KBRA SRS has incorporated into geographical segments countries with a relatively small amount of banks that are rated per country (e.g., Central America or the Middle East).

KBRA SRS foreign bank ratings are shown for prior periods in order to provide the user with an important measure of the institution's trend toward improvement or deterioration, as is done in the KBRA SRS services for domestic institutions. All data will be reported on a consolidated basis whenever possible.

## **Source of Data**

KBRA SRS obtains information on all rated foreign banks primarily from the banks' official websites and through correspondence with the banks' investor relation groups. KBRA SRS also obtains information from third-party data suppliers. It should be noted

that KBRA SRS analysts carefully review the information and edit the data as best as they can. If an error occurs, we will re-rate the institution and if there is a rating change, a release will be sent to notify subscribers.

KBRA SRS ratings are subject to change. Due to the difficulty in obtaining data on a timely basis for international institutions, there may be a possible time lapse between the date of the reported financial and the assignment of a rating. Although this is not always the case, we typically try to update the rating of the banks in each country simultaneously. We recommend that customers call KBRA SRS for any verification they deem necessary.

### **The KBRA SRS Rating Criteria for Foreign Banks**

The KBRA SRS rating criteria derives a financial strength rating based on key financial ratios representing liquidity, asset quality, capital, and earnings. Releases are sent to our subscribers when a large domestic or foreign bank is significantly downgraded, and additional releases may be sent to subscribers about institutions whose financial condition is of concern to KBRA SRS.

A downward trend in the KBRA SRS rating is a likely indicator of deterioration in the bank's overall financial condition, while a steady increase in the rating generally signals an overall strengthening of its condition. A steady "A" or "B+" rating indicates a strong overall financial condition.

A large portion of banks will fall into the "B" or "B-" rating category. The range in financial soundness is fairly large for this category. For this reason, one should compare the individual ratios when making investment decisions among these banks.

Banks rated "C+" or "C" have average to slightly below-average financial ratios. Banks rated "C+" have the lowest "investment grade" ratings for foreign banks, and are likely to have one or more of their financial metrics in the bottom quartile of their peer group.

Banks rated "D" and "E" are likely to have financial problems, i.e., poor financial ratios. Careful consideration should be made about investments in these institutions. These banks are likely to have a higher probability of failure when compared to banks with higher ratings.

### **Definitions of Key KBRA SRS Financial Ratios**

#### **Liquidity**

Liquidity risk is the risk to a bank's earnings and capital arising from its inability to meet obligations when they come due without incurring unacceptable losses. Bank management must ensure that sufficient funds are available at a reasonable cost to meet potential demands from both fund providers and borrowers. Although liquidity risk dynamics vary according to a bank's funding market, balance sheet, and inter-corporate structure, the most common signs of possible liquidity problems include rising funding costs, requests for collateral, a rating downgrade, decreases in credit lines, or reductions in the availability of long-term funding. The sophistication of a bank's liquidity

management process will depend on its business activities and overall level of risk. However, the principles of liquidity management are straightforward: a well-managed bank, regardless of size and complexity, must be able to identify, measure, monitor, and control liquidity risk in a timely and comprehensive manner.

Liquidity measures an institution's ability to meet its anticipated short- and long-term obligations to customers and creditors. A high degree of liquidity enables an institution to meet unexpected needs for cash without the untimely sale of investments or fixed assets, which may result in substantial realized losses due to temporary market conditions or tax consequences. Liquidity for financial institutions is difficult to measure since their liquidity position changes daily and the data reflected in the financial statements may not reflect their current position. It is important to measure liquidity, however, because a lack of liquidity may bring about the failure of the bank when financial problems become apparent. When the largest institution within a country has liquidity problems the host country will likely come to the bank's aid, hence the importance of the sovereign rating.

### **Asset Quality**

The measurement used to assess a bank's asset quality is its amount of nonperforming assets. Nonperforming assets is a term used to describe assets on which revenue recognition has been discontinued or is restricted. Nonperforming assets include both nonperforming loans and securities and acquired property, primarily other real estate owned acquired in connection with the collection effort on loans. Financial institutions generally fail due to a large percentage of nonperforming assets as compared to total capital and loan loss reserves. Asset quality also affects earnings through provisions to the loan loss reserve. An inadequate reserve will require additional provisions, which reduces earnings. Poor asset quality can also affect earnings through reduced interest income. Loans, which are past due and are not paying interest as scheduled, have a negative impact on interest income.

### **Capital**

A bank's capital position is of paramount importance to its overall financial condition. Earnings are the primary means for banks to increase capital internally, which is accomplished through retained earnings (net income less dividends paid). For many small community banks, retained earnings are even more important, because they are often the only practical source of raising capital. If a bank is not profitable, losses will decrease its capital strength, which may ultimately affect the institution's overall safety, soundness and viability. Because of banks' multiple functions, the great degree of leverage they employ in carrying out their economic role, and their access to a safety net, society has a keen interest in the health and well being of the banking system. The level of government regulation and supervision, unique to insured depository institutions, has evolved over the years. KBRA SRS measures capital strength mainly through the institution's amount of regulatory capital (through combinations of equity, loan loss reserves, subordinated debt, and other accepted instruments) as compared to its risk-weighted assets (loans and securities, for example) and asset equivalent off-balance sheet exposures (such as loan commitments, standby letters of credit, and

obligations on derivative contracts). Analyzing a bank's capital level in this way increases the emphasis on common equity and restricts the amount of loan loss reserves that can be counted as capital. It also recognizes the relative degree of credit risk associated with various assets by setting different capital requirements for some assets that clearly have less credit risk than others.

Note: Regulatory capital requirements for international banks depend on local or regional central banks. Information for these minimum capital requirements may not be available for all countries or regions.

## Earnings

As described above, a bank's capital strength is of paramount importance to its overall financial condition and earnings are the primary means for banks to increase capital internally, specifically through retained earnings. Earnings help an institution; cover expenses, provide for loan and other losses, support growth, add to capital and pay dividends. Earnings also provide insurance against losses, are a means to support asset growth, and support the bank's ability to pay dividends to shareholders, which can improve its ability to raise capital externally. The institution's dividend policy is of importance since excessive dividends can weaken a bank's capital position. Banks located in rapidly growing markets must be attentive to their rate of earnings' retention so they may properly plan for new capital funds as needed.

For most banks, the loan portfolio comprises the majority of earning assets. Interest income can be derived from other earning assets and when analyzing the institution, the relative importance of each type of interest income to overall interest income should be taken into account. Noninterest income is typically the second largest source of revenue for a bank. It consists of fees and charges that are not interest related, such as; service charges on deposit accounts, trust income, other real-estate owned rental income, gains/losses on trading accounts assets, and fees and commissions for other services and activities.

<b>KBRA SRS FINANCIAL RATIO DEFINITIONS</b>	
<b>Abbreviation</b>	<b>Ratio Description</b>
<b>TOTAL ASSETS</b>	Total consolidated assets reported in dollars (millions or thousands depending on the service used).
<b>EQTY CAPT</b>	Total equity capital shown in dollars (millions or thousands depending on the service used).
<b>INC QTR (000)</b>	Net income reported for the current quarter; i.e., fourth quarter net income would only be for the final quarter and not for the full year.
<b>INC CUM (000)</b>	Cumulative net income; i.e., cumulative net income for the September rating period (September 30) would include income for the first nine months.
<b>NET INC/CAPT</b>	Annualized income divided by total equity, also know as return on equity, ROE.
<b>LIQUIDITY RATIOS</b>	
<b>LNS/ASTS</b>	Ratio of total loans, net of provisions for loan losses, to average assets.

<b>ASSET QUALITY RATIOS</b>	
<b>NONPERFORM ASTS / ASSETS</b>	Nonperforming assets include loans past due 90 days or more and still accruing and loans placed on nonaccrual divided by total assets. PCT is the bank's percentile ranking for its ratio within its peer group based on asset size in the specific country.
<b>NONPERFORM ASTS / CAPT.</b>	Nonperforming assets as defined in the above definition divided by total equity capital plus reserve for loan losses minus goodwill.
<b>LOSS RSRV. /AST</b>	The bank's reserve coverage ratio. The ratio of a bank's reserve for loan and lease losses to its total amount of total assets.
<b>CHG-OFF / ASTS</b>	Ratio of gross losses on loans charged to the loan loss reserves (annualized) to total assets.
<b>CAPITAL ADEQUACY RATIOS</b>	
<b>TIER 1 / R. AST</b>	Measures the bank's "tier one" capital relative to its risk-weighted assets.
<b>T.CAPT / R. AST</b>	Measures the bank's total capital in relation to its risk-weighted assets.
<b>T. CAPT / T.AST</b>	Ratio of an institution's total capital in relation to its total assets.
<b>EARNINGS PERFORMANCE RATIOS</b>	
<b>INT INC</b>	Annualized interest income placed on a tax-equivalent basis. Categories included in interest income are interest and fee income on loans in domestic and foreign offices, income from lease financing receivables, interest income on balances due from depository institutions, interest and dividend income on securities, income from assets held in trading accounts, and interest income on fed funds sold and securities purchased under agreements to resell.
<b>INT EXP</b>	Annualized interest expense. Categories included in interest expense are: interest on transaction and non-transaction accounts held in domestic and foreign offices, interest on demand notes issued and other borrowed money, interest on mortgage indebtedness and obligations under capitalized leases, interest on subordinated notes and debentures, and the expenses associated with fed funds purchased and securities sold under agreements to repurchase.
<b>NET INT INC</b>	Annualized net interest income placed on a tax equivalent basis.
<b>NON INT INC</b>	Annualized noninterest income includes deposit service charges, trading commissions, foreign exchange trading and other foreign transaction income, and other income.
<b>OVERHEAD</b>	Annualized total overhead expense includes personnel

	expense, occupancy expense, and other operating expenses.
<b>PROV LOAN RESER</b>	Provisions made to the loan-loss reserve as a percent of assets.
<b>PRE TAX INC</b>	Pretax income placed on a tax equivalent basis shown as a percent of assets.
<b>NET INCOME</b>	Annualized net income (cumulative) as a percent of assets as of the reporting period and for the last year-end period. D, M, J, and S stand for the reporting periods of December, March, June, and September, respectively.
<b>OTHER RATIOS</b>	
<b>NPA CHG</b>	Quarterly change in reported nonperforming assets.
<b>AST CHG</b>	Change in average assets from the year ago period
<b>EQTY CAP CHG</b>	Change in total equity capital from the previous quarter.

# **KBRA Subscription Rating Service's Methodology for Rating Country Exposure**

Version: November 1, 2010

Expanding financial markets and diversified investment possibilities in foreign countries leads to increased risks for investors. The KBRA Subscription Rating Service (SRS) uses a country exposure analysis to determine these risk factors that are outside an institution's control, and assign a rating to the country. The KBRA SRS rating provides an objective and subjective evaluation of the financial, economic, and political condition, as well as the banking industry of a given country, demonstrating how they all can have substantial impacts on an institution's financial soundness. The KBRA SRS provides the user with a means to quickly evaluate the overall risk environment of a country and thus the financial condition of institutions within the country without having to perform a lengthy financial analysis. The main criteria used by KBRA SRS to evaluate the risk exposure of a country are described below. Each factor is weighted on par with the others, making sure not to have a disproportionate effect on the overall country risk exposure; however changes in economic conditions or political stability may lead to a shift in which indicators of risk exposure are focused on.

## *Gross Domestic Product (GDP) Growth*

GDP growth is an indicator of the capability of the government to solve a balance of payments crisis without defaulting on external debt. The potential tax base widens as the GDP becomes larger, thus helping the government to fulfill external obligations. The GDP growth rate plays a vital role in indicating the pace at which the economy is growing or shrinking. A significant change, whether it is up or down, can have a significant effect on the economy. Negative GDP growth worries investors, because it is a main factor indicating the possibility of an economy entering into a recession.

## *Inflation Rate*

High inflation rates can imply problems within the country's finances and may lead to economic crisis, however deflation can be just as bad since it is generally a sign that the economy is not growing. It is important to consider inflation in part due to the close relation with interest rates.

## *Unemployment Rate*

When an economy is witnessing high growth, unemployment levels tend to be low, due to increasing levels of outputs creating more jobs. The unemployment rate is a well diversified indicator that covers many locations and industries and is considered one of the best indicators of the health of the economy due to the timeliness of the information.

## *Current Account Balance (% of GDP)*

The ratio of the current account balance (CAB) to GDP is used because the volume of a country's CAB is a good indicator of economic activity. A negative CAB indicates the country being a net debtor to the rest of the world, and is thus using resources from

other economies to meet its own domestic demand. A deficit might not necessarily be bad for the country if the economy is growing or under reform. Deficits usually coincide with a depletion of foreign exchange reserves, which can put pressure on the value of the country's currency. A CAB deficit can also stem from foreign investment in the local market. A surplus is not necessarily good for the economy; since it is becoming a net creditor to the rest of the world by giving those economies resources it could possibly use more productively at home. When analyzing the deficit or surplus of a country we must first consider what is fueling the extra credit or debit and what the country is doing to counter the effects.

### *Corruption Index*

To analyze a country's exposure to corruption, we first consult an index published by Transparency International. The Corruption Perception Index is a report reflecting the views of analysts and business people, not only locally but from around the world, that rates the countries by the extent to which corruption is perceived to be present among politicians and public officials. The index is not based on empirical data, but on perceptions from individuals that in some way have encountered the abuse of public office for private gain. Corruption is important to consider because it undermines economic growth and sustainable development. Corruption also impairs the economy by impeding on amounts of foreign investments contributed to the country, which in turn would help the country grow and prosper.

### *Gross National Income Per Capita*

Gross national income (GNI) is the sum of value added by all resident producers, including product taxes and net receipts of income from abroad. GNI per capita figures are calculated by dividing GNI by mid-year population for the country and then converting to U.S. dollars using the World Bank Atlas method. This measure estimates the standard of living across different countries, indicating the financial wealth of a population. The economy of a country with a rising standard of living can better support high public debt levels and withstand unforeseen economic and political shocks more readily than a country with a weak or stagnated economy.

### *Reserves/Trade Balance*

Foreign exchange reserves as a percentage of trade balance is important because it shows how much the country can afford to pay towards their trade balance deficit. The ratio gives an indication of the ability of an economy to meet its import obligations in the near term. There is a greater threat of an unexpected liquidity crisis, when the ratio is lower. Reserves can be used as a safeguard for the government during stages of balance-of-payments pressure.

### *Average Bank Rating*

The average rating for the banks rated by KBRA SRS within the country is used to better judge the soundness of the banking industry as a whole.

Along with the previous quantitative factors, KBRA SRS uses subjective considerations to come to the final country exposure rating. Subjective factors accounted for are the government's policies toward foreign creditors, the ability to execute stabilization

measures for the economy, and to meet external payments. Political risk is a major qualitative factor to be considered. KBRA SRS analyzes the transparency, predictability, and stability of the political institutions, evaluating how policies are developed and the timeliness to identify and correct errors that are made. KBRA SRS also considers the government's separation of powers and development of civil institutions. Furthermore, relations with neighboring countries are considered to account for posed internal and external security risks.

After all factors, subjective and objective, are evaluated the country is given a final comprehensive rating on a scale ranging from a high of "A" to a low of "D", with "C+" being the lowest investment rating given. A definition of the ratings follows:

#### Country Exposure Rating Definitions

- A** The country has a very strong economy, a stable government, a healthy trade surplus, and a very sound financial system.
- B+** The country has a strong economy, a stable government, a healthy trade surplus, and a sound financial system.
- B** The country has a stable government, a moderate or weak economy, a healthy trade surplus, and a sound financial system.
- C+** The country has some or all of the following characteristics: a stable government, a moderate or weak economy, enough foreign exchange available to meet trade agreements and foreign debt payments, and / or a moderately sound financial system.
- C** The country has some or all of the following characteristics: a stable government, weak economy, possible problems in raising foreign exchange to meet trade agreements and foreign debt payments, and a weak financial system.
- C-** The country has some or all of the following characteristics: a stable government, a weak economy, concern that the country may not be able to meet debt payments, and / or its currency could be devalued, and an unsound financial system.
- D** The country has some or all of the following characteristics: an unstable government, a weak economy, reserves may not be available to meet trade agreements or foreign debt obligations, and / or its currency could be devalued, and a very unsound financial system.

# **KBRA Subscription Rating Service's Methodology for Rating Corporate Institutions**

Version: November 1, 2010

## **Description**

The KBRA Subscription Rating Service (SRS) objectively rates approximately 1,000 of the largest publicly traded domestic corporations on a quarterly basis using a uniform set of criteria. Corporations then undergo a qualitative review (e.g. market-based data, enforcement actions, contingent liabilities, etc.), which may cause a change in the objective rating. By measuring and aggregating ratios representing liquidity, leverage, capital, earnings and solvency, corporate ratings are derived from "A+" to "E" four times a year. Data is obtained from the annual and quarterly condition reports filed with the Securities and Exchange Commission. This information may be purchased through third parties to expedite the rating process.

Very few institutions receive an "A+" rating with most ratings falling into the "B" range. A "C+" is the last investment grade rating. Institutions with "D" or "E" ratings have a higher than normal probability of failure and usually have negative earnings, very low or negative capital ratios, possibly very high debt levels and/or low interest coverage ratios. The size of the institution does matter in the assignment of ratings. Larger institutions have better access to capital markets and usually have greater diversification in their products. However, this does not mean that a small corporation cannot receive an "A" or "A+" rating when all the financial ratios that are used in the calculation of credit rating are extremely good.

KBRA SRS is designed so the user can intuitively understand the rating. The key ratios are presented along with the rating; an institution will usually have a good rating if it has strong financial ratios. There could be an exception because KBRA SRS analysts may be aware of some current event concerning a company or negative outlook we may have on an industry.

The Corporate Service is also designed for early detection of change in a corporation's financial condition. We do this by rating a corporation four times a year, based on its quarterly financial statements. A downward trend in the KBRA SRS credit rating is a likely indicator of deterioration in the corporation's financial condition and a steady increase in the rating generally signals an overall strengthening of the corporation's financial position.

Interim rating changes are made based on material changes in the company's financial condition or major concern about events that could affect the company. When this occurs, we will change the rating immediately, depending on how serious the event is or size of the company. Releases will be sent to our subscribers describing the rating change and the reason leading to the change.

## Rating Criteria

When evaluating the KBRA SRS criteria for U.S. Corporations, it is important to note that evaluations are performed on a peer basis, i.e. by type of industry. Some industries will be more leveraged than others, have higher capital requirement or lower earnings margins. Size is taken into consideration because larger companies have greater access to capital markets and are equally more diversified. When assigning credit ratings for corporations, the KBRA SRS analysts evaluate the following:

**LIQUIDITY** is measured by evaluating the company's cash flow, the amount of liquid assets the corporation currently has on its books, and the ability to borrow. The ability to borrow will depend in part on its size but most importantly, on its overall financial condition. Companies with low or negative earnings and capital (there are several companies with negative capital in this service), will find it difficult to borrow working capital. Of course, when credit conditions are tight, companies with poor overall financial conditions may not be able to obtain credit.

Cash Flow: KBRA SRS is interested in how well a company's cash from operating activities cover its current liabilities. A ratio greater than one shows the company is in a position to meet its commitments. A ratio lower than one, indicates that the company may have to borrow to meet its commitments, indicating a weaker financial position.

Quick Ratio: The Quick Ratio  $[(\text{Current Assets} - \text{Net Inventories}) / \text{Current Liabilities}]$  is used by KBRA SRS analysts to measure a company's short-term liquidity needs. The ratio has to be measured based on a peer basis because of operational differences among industries. KBRA SRS analysts in general like to see a ratio of 1.5 or better. Companies with a ratio of less than one may be penalized in its rating process.

**ASSET ALLOCATION**, product diversification and composition of assets will vary among companies within the same industry. Usually companies with more diversified products can better withstand economic slowdowns.

Debt: The amount of debt, relative to the company's capital is a major component of the KBRA SRS credit rating. Depending on the industry, a Debt-to-Equity ratio of 50% is acceptable and higher levels can affect the company's rating.

Composition of Assets: Companies with high cash positions can better withstand liquidity crises and can take advantage of adverse conditions by making acquisitions under attractive circumstances.

**CAPITAL**: Capital needs will vary considerably by type of industry and company size. Most companies have fairly high capital ratios ranging around 50% of their assets. Depending on the industry, companies with lower ratios may be penalized in their KBRA SRS credit ratings. Capital is the cushion needed to withstand adverse times and for expansion.

Retained Earnings: KBRA SRS believes that a major contributor to the financial soundness of a company are high levels of retained earnings; the level of retained earnings is taken into account in the assignment of the KBRA SRS credit rating.

**EARNINGS:** Earnings are not only an important determinant of financial soundness but can also provide an early warning concerning a change in a company's financial condition. Since KBRA SRS rates corporations on a quarterly basis, a major change in earnings from the previous period and/or the year-ago period, indicates there has been a change in the company's financial condition.

Interest Coverage: The inability to pay interest on debt can bring about insolvency. KBRA SRS analysts prefer a positive interest expense (EBIT/Interest Expense) ratio and the higher the better. The ratio is analyzed in conjunction with the Debt-to-Equity position of the company.

Price Earnings and Market Price Ratio: KBRA SRS's analysts review both the company's stock market price and it's relation to the company's earnings for two reasons. First, investors or traders may be aware of events that have yet to be shown in the company's reported financials. Second, market price, relative to earnings, is an investor's evaluation (expectation) of a company's financial condition. KBRA SRS analysts follow stock price trends; a very low stock price may indicate a company with a weak financial condition. These evaluations are performed on a peer basis and take into account market trends.