Rating Methodology

Supranational Institutions Rating Methodology

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This report describes TRIS Rating's criteria for rating supranational institutions. The criteria supersede the "Rating Methodology for Supranational Institutions" published on 24 July 2014.

SCOPE AND OVERVIEW

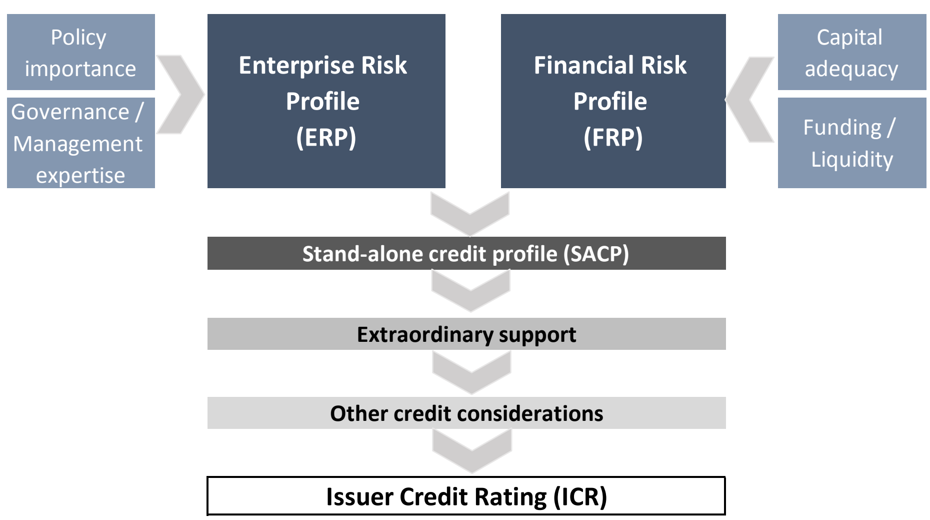
The criteria apply to supranational entities encompassing multilateral lending institutions (MLI) and other supranational institutions (OSI), but center on the analysis of MLIs. Supranational institutions are defined as institutions jointly owned by a group of sovereign governments of two or more countries and established by international treaties or their equivalent with public policy mandates. The mandates mainly focus on economic and social development or specific objectives achieved through the provision of loans, concessional loans, financing, guarantee, grants, or credit enhancement to debt issues.

METHODOLOGY

In evaluating the creditworthiness of MLIs, the criteria start with an assessment of Enterprise Risk Profile (ERP) and Financial Risk Profile (FRP). ERP is evaluated based on two key credit factors: policy importance coupled with governance and management expertise. FRP is assessed by considering capital adequacy as well as funding and liquidity profile.

After combining ERP and FRP to derive a stand-alone credit profile (SACP), we assess the likelihood of shareholder extraordinary support that may be incorporated to enhance the SACP. Extraordinary support can include callable capital, guarantee, and group support. After factoring in the support element and other credit considerations, we then finalize the Issuer Credit Rating (ICR). For short-term rating assignment, refer to TRIS Rating's "Short-Term Ratings Methodology".

RATING FRAMEWORK FOR MULTILATERAL LENDING INSTITUTIONS



CHARACTERISTICS OF SUPRANATIONAL INSTITUTIONS

Supranational institutions include mainly multilateral lending institutions (MLI) and other supranational institutions (OSIs). Both MLIs' and OSIs' principal objectives and mission include but are not limited to economic, social, and environmental development, infrastructure project investments, promotion of capital markets particularly bond markets, provision of assistance to developing or financially stressed member countries, or financial support for the private sector, particularly micro and small- and mid-sized enterprises. The objectives are achieved through the provision of loans, financing, guarantees, credit enhancement, and private equity investments.

Supranational institutions are not subject to any domestic or international regulations. They are governed and controlled by their own prudential rules and policies that are established by the member states or shareholders, which are mostly sovereign governments. If the institution is a subsidiary of a larger institutional group, it is administered by the group.

For MLIs, funding comprises paid-in capital from shareholders but there is no dividend distribution. Several MLIs may also raise debts through bond markets as they are non-listed and cannot acquire deposits. Certain MLIs may also have callable capital (see 'Extraordinary Support' section for details). OSIs may or may not have capital. If they do, it is generally in the form of grants or development aid from donor countries.

ENTERPRISE RISK PROFILE (ERP)

For ERP assessment, we combine our assessment of 'policy importance' and 'governance and management expertise' to derive the ERP.

Policy Importance

Policy importance encompasses three key factors: (1) roles and public policy mandates; (2) strength and stability of the relationship with shareholders; and (3) preferred creditor treatment (if relevant).

- **Roles and public policy mandates**

The two major determinants include: sustainability of roles and track records of fulfilling public policy mandates. We assess sustainability of roles by reviewing the importance of the institution's policy mandates and whether its role can be performed by other entities. We also review the track record of the institution in meeting its objectives or mandates based on the length of time and geographical scope of its operation.

An entity will receive a favourable assessment if it has a long track record (20 years or longer) of fulfilling its public policy mandates and its role is considered important and cannot be fulfilled by any private or public institution. The assessment is less favourable in the case of a shorter track record of operation, or if the role may be diminishing or can be partially performed by other entities.

- **Strength and stability of the relationship with shareholders**

The first consideration is whether the institution is established by an international treaty or equivalent. Other evidence which demonstrates the level of shareholder support includes track record of capital increase and payment of new share subscriptions and whether shareholders, specifically major shareholders, have withdrawn from the institution.

For this factor to be assessed favorably, the institution should be established by an international treaty or equivalent. There should also be a long track record of shareholders providing capital on schedule to support ongoing operations and no withdrawal of major shareholders. If the establishment was not backed by a treaty or equivalent and there is evidence of uneven capital support or a history of major shareholder(s) withdrawing even though the institution has been established by a formal treaty, the institution could be viewed as having weak shareholder support.

- **Preferred creditor treatment (PCT)**

The institution can benefit from PCT in the form of lower probability of default or enhanced recovery when it is treated as the most senior creditor of sovereigns or when financial obligations towards supranational institutions are resolved before commercial creditors. This is because such preferential treatment can be in the long-term interest of sovereigns. During sovereign stress, loans from supranational institutions may be the main source of external financing.

PCT is generally applied to both ERP and FRP assessment. In the ERP, PCT is part of the policy importance assessment. However, when the institution's exposure to the private sector is greater than 75% of total exposure, PCT will be excluded from the ERP assessment and only applied to FRP through adjustment of risk weight for sovereign exposure.

Governance and Management Expertise

Supranational institutions are not subject to regulations. They are governed by their own prudential governance and risk management rules which are set by the member states. Therefore, governance principles are crucial in analyzing ERP. Management expertise and risk policies are also important.

- **Governance**

We evaluate governance by focusing on shareholding structure, governance standard and earnings retention. We would view positively institutions with balanced and diversified shareholding structures, with no material shareholders from the private sector as it could weaken its public policy role. We would also expect governance standards, such as audit, to be strong, while all or most of the earnings should be retained for development purposes. Conversely, we would take a negative view if the institution is controlled by very few shareholders or borrowing members with great influence on decision making and capital is eroded due to earnings distribution through dividends.

- **Management expertise**

Management expertise is analyzed in four aspects: strategy, risk management, personnel management, and track record of the management team's capability. We expect the management to have the capacity to execute strategic plans and attain operational targets. Financial policies and the risk management framework should also be appropriate for the institution's objectives and operations. Personnel management must be effective such that the institution is able to handle the loss of key personnel without a material impact on operations. Lastly, we expect the management team to have extensive experience and expertise as well as a track record of successful operations.

FINANCIAL RISK PROFILE (FRP)

'Capital adequacy' and 'funding and liquidity profile' are the focal points, which are combined to derive the FRP assessment.

Capital adequacy

For MLIs, capital adequacy forms a vital part of the FRP assessment. The assessment starts with an initial estimate of the capital adequacy ratio, which is then adjusted by risk position assessment and other risk adjustments.

- **Capital adequacy ratio**

We estimate the initial capital adequacy ratio by calculating 'equity to risk-weighted assets', where assets mainly consist of investment portfolio and loans and/or off-balance sheet guarantees. The risk weights, which are in line with the standardized approach for credit risk under the Basel capital accord adopted by the Bank of Thailand, are applied according to the average rating of each type of asset. We may also consider the capital ratio reported by the institution as part of our assessment.

- **Risk position assessment**
  - ***Portfolio performance*** is analyzed based on loss experience, e.g., non-performing loans or guarantee calls. The initial capital adequacy assessment can be enhanced by one notch (positive), unchanged (neutral), or diminished by one notch (negative).
  - ***Risk management*** in general can raise or lower the initial capital assessment by up to two notches. However, if we have greater concerns over its risk management policies and implementation, it may result in further downward adjustments.

    For risk management to be viewed positively, we expect the institution to have appropriate levels of risk tolerance and prudent credit policies or underwriting standards. There should also be limits imposed on credit concentration and policies that mitigate credit risk (e.g., conservative provisioning), counterparty risk (e.g., reinsurance), and operational risk. Positive risk management also means the institution stays focused on core activities and moves into new businesses or countries cautiously.
  - ***Other risk adjustments*** may include interest rate risk, currency risk, market risk, concentration risk and other risks.

Funding and Liquidity

- **Funding assessment**

For MLIs that are permitted to use debt funding, the funding is generally made up of unsecured borrowings through the capital market. Thus, the focus on funding assessment is on funding structure and market access. We assess the funding structure by looking at the diversity of the funding mix. If the institution raises funds through the capital market, we assess the extent to which it is a regular benchmark issuer and whether it overly relies on a single market. An entity will receive a favorable assessment if it has a conservative funding profile with a diversified funding mix. Conversely, an unfavorable assessment could reflect worsening funding conditions such as limited market access and overreliance on bank funding or weak funding profile with excessive use of short-term debt, large negative funding gap, or high cost of funds.

- **Liquidity assessment**

Liquidity assessment starts with an estimate of the initial 12-month liquidity ratio, defined as 'liquid assets' to 'liquidity needs within 12 months'. The assessment may be modified by liquidity adjustment factors, where relevant.

Liquid assets primarily include cash and investment portfolios. For supranational institutions, investment portfolios comprise largely treasury assets, which are generally of high quality and low credit risk and can be liquidated on a timely basis without material impairment.

For liquidity needs, potential cash outflows include on- and off-balance sheet financial obligations within the next 12 months. Off-balance sheet obligations include contingent guarantee calls projected over the 12-month period.

Liquidity adjustments take into consideration alternative liquidity sources that are available on a timely basis. Our concerns over immediate liquidity risk could result in multiple notches of downward adjustments to the SACP.

EXTRAORDINARY SUPPORT

After we derive the SACP by combining our assessment of ERP and FRP, the next step is to assess whether there is a possibility of a rating uplift due to extraordinary support. For MLIs, the support generally takes the form of callable capital, which is defined as committed capital that can be called during financial stress to avoid default on debt obligations or guarantee calls. Each shareholder is responsible for a certain amount of the capital call to which it has agreed to subscribe, generally from the time of establishment. However, not all supranational institutions have callable capital in place even though it is a common attribute of MLIs. If available, only callable capital from shareholders with ratings at or above the SACP of the institution should be considered.

The enhancement from callable capital only uplifts the FRP assessment. The uplift is mainly triggered by the reassessment of capital by adding callable capital to equity in the calculation of initial capital adequacy ratio. The enhanced FRP combined with ERP can raise the SACP by no more than three notches. This is due to uncertainty in the legal and administration procedures of the payment of capital. The magnitude may be determined by a few factors:

(1) Policy importance of the institution influences our view on the willingness of the shareholders to make payments in times of financial stress.
(2) Track record of shareholders' payment of paid-in capital for the capital increase needed for operational expansion influences our view on the shareholders' ability to provide support.

Other forms of support include guarantees, e.g., a joint guarantee by shareholders on non-performing loans, or parent or group support when the institution is a subsidiary of a larger institutional group a supranational institution. If the group support is expected to improve the liquidity position of the institution materially, the three-notch above SACP cap may be overruled, depending on the Group Credit Profile (GCP) and group status assigned to the institution. For group support, refer to our 'Group Rating Methodology'.

OTHER CREDIT CONSIDERATIONS

Before deriving the ICR, we may review other credit considerations for a more comprehensive viewpoint. This may include industry-based analysis, peer comparison, notable positive or negative attributes that have not been captured in the rating factors, or forward-looking view of operations or financials. The adjustment could be up or down by one notch.

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