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Impact of accounting and prudential rules on Moody's ratings and research

AEFR Webinar

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Expertise
A comprehensive view of the global markets through our ratings and research

Credibility
Over 100 years of experience delivering forward-looking, independent, stable and transparent opinions

Engagement
Meaningful interactions across multiple channels between our analysts and market participants

Agenda

1. Accounting vs. prudential standards
2. Moody’s use of accounting and prudential metrics
3. Moody’s adjusted metrics
4. New risks entail new challenges
5. Q&As

1 | Accounting vs. Prudential Standards

Why accounting & prudential standards matter ?

> Regulatory and accounting rules are important determinants of bank behavior

From BCBS – Working Paper 28 The interplay of accounting and regulation and its impact on bank behaviour: Literature review (2015)

Accounting and prudential rules complement each other

“In many respects, banking supervisors and external auditors face similar challenges and, increasingly, their roles are being perceived as complementary”

BCBS “The relationship between banking supervisors and banks’ external auditors” (January 2002)

Accounting and prudential approaches do not always fit together

1. "accounting rules – fair value - have fueled the great global crisis"

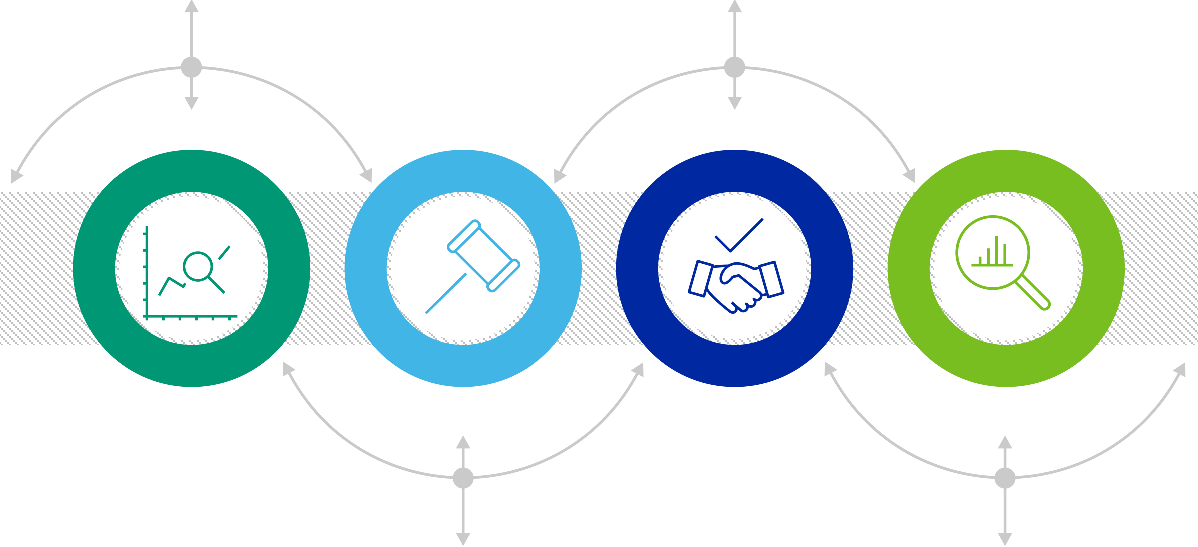
2. "accounting rules are overly procyclical"

3. "accounting rules on loan loss provisions are (were) backward looking"

Prudential authorities' policies vis a vis accounting standards (setters)

Regulators rely on accounting standards and derive prudential metrics from banks' accounting

Regulators express views on accounting standards (e.g., replacement of IAS39 by IFRS9 to address concerns about "too little too late" re. loan loss provisions)



Regulators add specific prudential rules (e.g. EU provisioning backstop, IFRS9 first time application) to meet their own objectives

Supervisors are keen on reviewing banks' implementation on accounting (recent EBA report on IFRS9)

2

Moody’s Use of Accounting and Prudential Metrics

Implications of non fully harmonized and complex information

Credit analysis requires an in-depth understanding of accounting and prudential rules

Prudential rules have become more complex over time (e.g. Basel 4, CRR-CRD, BRRD, EU “quick fix”, etc.)

Implementation of principle-based accounting rules and IRB models has become more opaque (black box) hence the need to gauge how banks interpret and enforce them

Moody’s rating and research activities mostly rely on banks’ public disclosures

Information is not fully harmonized /identical

As a global organization Moody’s is eager to use global standards for ease of comparing and contrasting banks’ creditworthiness and assign ratings

Moody’s relies on banks’ public disclosures which are based on numerous accounting frameworks (e.g., IFRS, local GAAP)

Prudential norms also vary between jurisdictions even if most of them are influenced by, and derived from BCBS guidance

In short Moody’s uses all the available and meaningful information

Both accounting based metrics and prudential metrics are factored in banks’ analysis

ACCOUNTING METRICS	PRUDENTIAL METRICS
» TBA (adjusted assets)	» CET1
» TCE (adjusted capital ratio)	» Buffer over SREP
» Impaired loans	» LCR/NSFR
» IFRS 9 provisions/cost of risk	» MREL/TLAC
» Pre-Provision Income	» Provisioning back stop
» Accounting based Liquidity/funding	

Banks' financial profile captured in Moody's scorecard

Financial Factors			Assigned Scores and Drivers			
	Financial Ratio	Current Macro Adjusted Score	Credit Trend	Assigned Score	Key Driver #1	Key Driver #2
Asset Risk (25%) *Problem Loans / Gross Loans*	3.0%	a3	↔	a2	Expected trend	Long-run loss performance
Capital (25%) *Tangible Common Equity / RWA*	17.2%	aa2	↔	aa2	Expected trend	Capital retention
Profitability (15%) *Net Income / Tangible Assets*	0.4%	ba1	↔	ba1	Earnings quality	Loan loss charge coverage
Combined Solvency Score (65%)		**a3**		**a2**		
Funding Structure (20%) *Market Funds / Tangible Banking Assets*	25.9%	baa2	↔	baa2	Term structure	
Liquid Resources (15%) *Liquid Banking Assets / Tangible Banking Assets*	32.4%	a2	↔	a3	Asset encumbrance	
Combined Liquidity Score (35%)		**baa1**		**baa1**		
Financial Profile		**a3***		**a3**		

Note: * The Macro Adjusted Financial Profile (a3) is sensitive to a deterioration and an improvement of the Weighted Macro Profile
Source: Moody's Investors Service

Moody's "Loss Given Failure" as a follow-up to BRRD

The adoption of BRRD (and other resolution regimes in other jurisdictions) along with the "bail-in" framework were reflected in banks' ratings

Risk of losses (or expected losses) in case of "resolution" informed by resolution authorities' powers and new creditor hierarchies

Non-compliance with prudential rules could have direct implications for investors/ratings

Breaching SREP requirement could prompt coupon suspension on AT1 hence losses for investors

Resolution scenario could trigger “bail-in” hence losses for both junior and senior creditors

3 Moody’s adjusted metrics

Moody’s Global Standard Adjustments

Financial Statement Adjustment
1. Hybrid Securities
2. Defined Benefit Postretirement Plans
3. Noncontrolling Interests of Minority Shareholders
4. Operating Leases*
5. Fair Value of Own Debt Affected by a Change in Credit Risk
6. Balance Sheet Netting of Financial Assets and Liabilities
7. Reclassification of Certain Deferred Tax Assets
8. Deferred Tax Liabilities Associated with Tax-Deductible Goodwill and Other Intangible Assets
9. Goodwill and Other Intangible Assets Attributed to Noncontrolling Interests of Minority Shareholders
10. Risk Weightings of Sovereign Debt Securities**

* Operating leases adjustment does not apply to banking entities
** RWAs of sovereign debt securities adjustment applies only to banking entities

Sovereign exposures are not 0% risk-weighted

The bulk of banks' data/information is taken as is

Moody's considers banks' RWAs with no adjustments (with one exception)

» Moody's capital analysis assumes even relatively highly rated sovereign exposures are not risk free

» As a reminder 0% risk weight on sovereign exposures is permitted in BCBS guidance under certain conditions

CET1 vs. TCE

Both metrics are useful

Our TCE is less "distorted" than CET1, the definition of which varies between jurisdictions (prudential filters/ IFRS 9 first time impact)

Our TCE better reflects banks' risks (sovereign risk is not 0% risk weighted)

Banks' CET1 targets have a bearing on their activities/performance

Failure to observe CET1 could trigger supervisory action and possibly losses for investors

Deferred Tax Assets

Reporting Problem

Deferred tax assets are low-quality assets, with no significant value during a bank resolution (similar to intangibles)

How We Adjust

Analytical response to banks only:

- DTAs capped at 10% of TCE

Adjustment applicable to banks only:

- If certain DTAs are convertible into government claims, enhancing the quality of the asset -- partial or full amount included in TCE (subject to Moody's eligibility criteria)

4

New risks entail new challenges on disclosures

Banks’ risks have evolved over time

Accounting and prudential rules address a large array of banks’ risks

Other risks have emerged which necessitate new standards about how they are measured, managed and disclosed

Such risks include: Environment, Social, Cyber, etc.

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Questions and Answers

Moody's award winning expertise in credit ratings, research and risk analysis

For more information, visit:
awards.moodys.io

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Best Credit Ratings Agency

Credit Ratings Agency

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