RATING CRITERIA

Criteria for Rating Financial Institutions

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Related publications

[Consultation Report: General Rating Framework (9 July 2018)]

25 July 2018

This criteria report updates and replaces the previous report dated 10 July 2017.

Changes compared to the previous version:

1. Incorporation of an Individual Financial Strength Assessment (IFSA) based on historic and forecasted data to support the forward-looking approach related to the assigned IFSA.
2. Definitions of the 7-scale opinions for qualitative factors.
3. Definitions of accounts included in the calculation of ratios.
4. Change in the Corporate Governance assessment, expanding the notching from '-1 notch' and '-3 notches' to a range that goes from '-1 notch' to '-6 notches' adjustment.
5. Change in the assessment of capital ratios. Elimination of the classification of banks into different groups, replaced by only one assessment for capital and leverage.
6. Incorporation of a potential cap of the IFSA for banks with capital levels too close to regulatory limits and for banks with strong penalisation for Corporate Governance.
7. Additional details on the framework for the stress test applied to the IFSA.
8. Additional details on the External Support Assessment (ESA) and the application of notching and examples.
9. Additional details on factors analysed to assess the Level of Support.
10. Inclusion of potential support for multilateral / development financial institutions.
11. Additional details on notching analysis for debt obligations.

OVERVIEW

A key analytical highlight of Dagong Global's rating criteria is the overall emphasis on the long-term business sustainability of a rated entity. A thorough understanding of the main drivers and factors that underpin a sustainable business strategy is fundamental in our view to assess the financial strength and therefore the credit profile of an entity. Our assessment includes a comprehensive understanding of the fundamentals of long-term business strategies, goals and plans to support the analysis that combines historic and forecast/projected data based on specific assumptions. This allows Dagong to include not only historic data but also to include performance assumptions for the short-medium term and provide a forward-looking view of the credit profile of a rated entity.

I SCOPE

This criteria report describes the analytical framework used by Dagong for assigning credit ratings to financial institutions. It is applicable to institutions with different business models, with and without banking license, and both for regulated and unregulated entities. The definition of 'bank' is broad and includes larger broker-dealers, mortgage lenders, consumer finance companies, trust banks, credit unions, building societies, custody banks and multilateral/development banks.

The criteria report is not applicable to asset managers, exchanges, clearinghouses, regional securities brokers or insurance companies.

The criteria is used to assign new ratings and monitor existing ratings.

The analytical approach described in the criteria is implemented via Dagong's proprietary rating model.

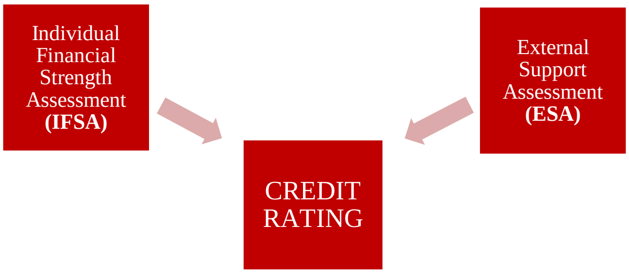
All Dagong's rating criteria and associated models are subject to regular validation and review in accordance with Dagong's internal procedures and regulatory requirements.

II SUMMARY

Dagong has developed a comprehensive analytical approach for rating financial institutions. The analysis follows a flow from macro to micro level. It starts with the analysis of the operational environment of the entity and then progresses to the particularities of its financial profile. Finally, any potential support from an identified support provider is evaluated.

Dagong's ratings of financial institutions consist of two components, which are:

Exhibit 1: Components of Dagong's credit ratings for financial institutions



Source: Dagong

Individual Financial Strength Assessment (IFSA)

The IFSA is the result of Dagong's opinion on the stand-alone and individual financial health of an entity. This opinion represents Dagong's analytical view of the entity's financial strength based on its financial information, business model and strategy. The IFSA does not under any circumstances represent a rating, a default indication of the debt issued by the entity or a deposit rating. Nevertheless, the opinion provided by Dagong through the IFSA is helpful to perform direct comparisons between entities, and is the main driver of the entity's credit rating. Details of the analytical approach applied for the IFSA are explained later in this document.

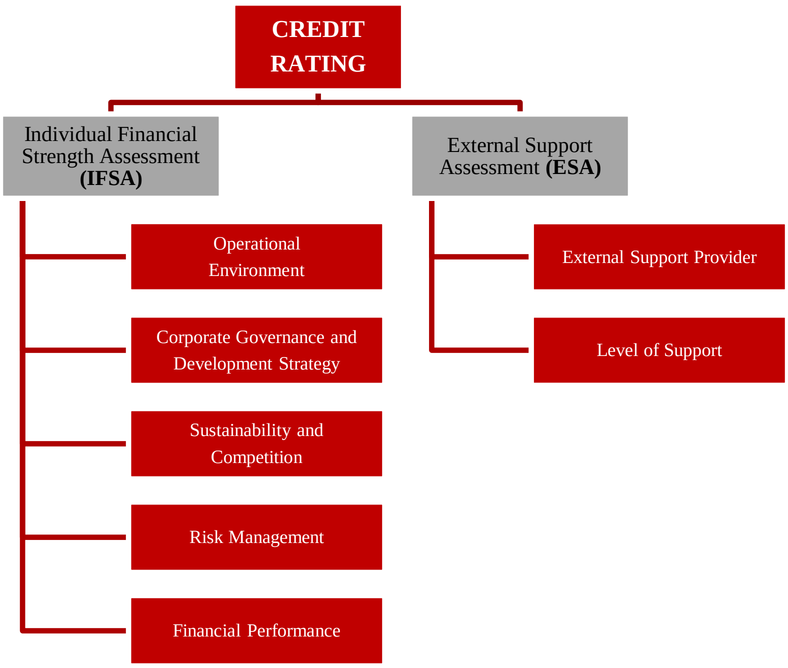
External Support Assessment (ESA)

The ESA represents Dagong's view on the likelihood of the external support (from a parent entity, government or other support providers) that an entity could receive, to prevent default when in financial distress.

When financial institutions find themselves in depressed economic conditions (e.g. liquidity shortfalls, large losses or capitalisation concerns), external support could be the only immediate solution to overcome financial stress or rebuild market confidence. The ESA is based on Dagong's view of different sources of support available for each entity; it may come from a parent company, a group, mutualist groups, central or regional/local government, multilateral or international organisations. The opinion on external support completes the overall analysis when assessing a financial institution's credit rating. The detailed analytical approach for the ESA is addressed later in this document.

The sections that comprise the analytical framework applied by Dagong for the IFSA and ESA are detailed in the diagram below:

Exhibit 2: Credit rating



Source: Dagong

III INDIVIDUAL FINANCIAL STRENGTH ASSESSMENT (IFSA)

The IFSA reflects Dagong's evaluation of the stand-alone, intrinsic financial health of an entity based solely on its financial fundamentals, business model, strategy and operational environment. The IFSA is directly comparable with other entities within the financial industry since it does not include any assessment related to external support (government, parent company or any other source of support).

The IFSA is built to suit the business model of traditional commercial banking (defined as a balanced combination of corporate and retail banking business as main earnings generators). Nevertheless, the IFSA takes into consideration the differences in business models, evaluating the complexity and target markets of each entity. Dagong assesses whether the business nature of the entity is accurately represented by standard metrics. If this is not the case, adjustments to certain financial metrics may be applied to reflect the actual financial profile and risks.

The IFSA is the first step in Dagong's process of assigning a credit rating. It is worth noting that the IFSA does not, under any circumstances, represent an ultimate indication of default risk or loss severity. The IFSA is the weighted average result of all factors used in the IFSA framework. This result is then translated into an IFSA scale, similar to the credit rating scale, in order to visually present the assessment in a form that can be easily interpreted.

The IFSA is presented in lowercase letters to distinguish it from the credit rating, which is presented in uppercase letters. The IFSA uses the scale detailed below; except the IFSA of 'aaa' and 'cc/c/d', each IFSA can be modified by adding a plus or a minus, indicating a stronger (+) or a weaker (-) IFSA within each category.

Exhibit 3: Definition of IFSA - Individual Financial Strength Assessment

aaa	**'aaa'** denotes the highest score of the individual financial strength assessment, with excellent indicators in all the factors that comprise the IFSA. Represents entities with solid and recognised successful business models supported by an excellent risk management framework. An excellent capital base and financial performance to support organic growth is also available. Entities are located in stable economic environments with highly efficient and predictable legal and regulatory frameworks.
aa	**'aa'** denotes very strong individual financial strength, with a combination of excellent and sound indicators within the factors that comprise the IFSA. Represented by entities with solid and recognised successful business models supported by a very good risk management framework. A sound capital base and financial performance to support organic growth is available. Entities in this category are located in stable economic environments with highly efficient and predictable legal and regulatory frameworks.
a	**'a'** denotes a strong individual financial strength assessment with a mixed combination of good indicators within the factors that compose the IFSA. It represents entities with stable business models supported by good risk management frameworks. A healthy capital base and financial performance to support organic growth is available. Entities are typically located in stable economic environments with efficient and fairly predictable legal and regulatory frameworks.
bbb	**'bbb'** denotes a strong individual financial strength assessment with a combination of strong performance indicators within the factors. It represents entities with stable business models supported by an adequate but still-requiring-improvement risk management framework. An adequate capital base and financial performance to support organic growth is available while capital strengthening is still expected. Entities would be typically located in economic environments with some level of stability; however some deficiencies in the level of development of legal and regulatory environment exist.
bb	**'bb'** denotes a satisfactory individual financial strength assessment with a combination of satisfactory indicators within the factors that compose the IFSA. Represents entities with business models that face tough competition and with risk management frameworks that require improvement. The capital base to support organic growth is highly sensible and should be strengthened to provide more stability. Entities are typically located in economic environments with deficiencies in the level of development of legal and regulatory frameworks.

b	**'b'** denotes a moderate individual financial strength assessment with a combination of moderate performance indicators within the factors that compose the IFSA. Represents entities with limited business models that face tough competition and with basic risk management frameworks that require material improvement. The capital base does not support organic growth. Entities are typically located in economic environments with evident deficiencies in legal and regulatory development and with unpredictable behaviour patterns.
ccc/cc/c/d	**'ccc/cc/c/d'** denotes a very weak individual financial strength assessment, with a combination of poor and very weak indicators within the factors that compose the IFSA. Represented by entities with limited business models that face tough competition and with extremely deficient risk management frameworks. The capital base is weak and should be increased. Entities would be typically located in economic environments with evident deficiencies in legal and regulatory development and also with extremely unpredictable behaviour driven by individual objectives.

Source: Dagong

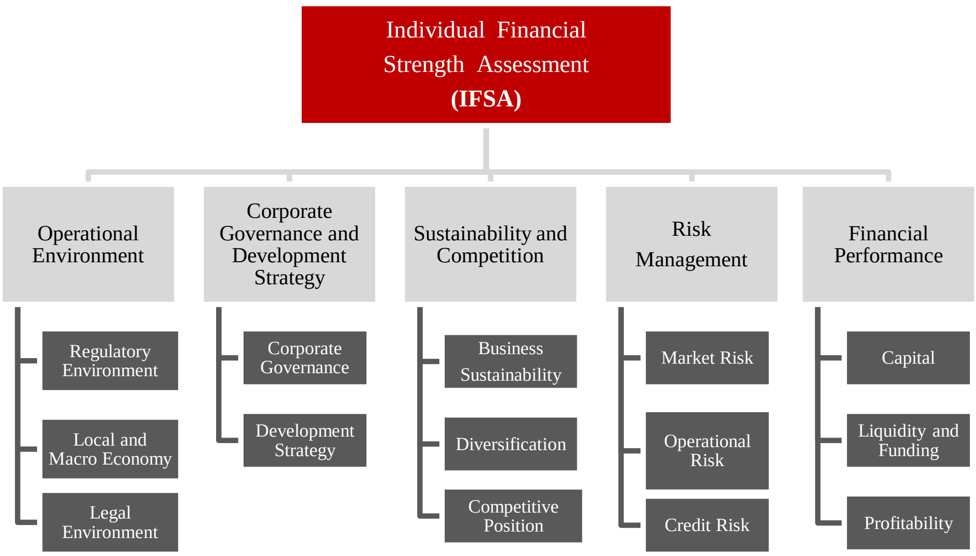
The IFSA is the result of five key analytical components that Dagong believes represent the main drivers that determine a financial institution's intrinsic financial profile.

The IFSA is determined based on historic financial data for the purpose of obtaining a Historic IFSA, as well as based on assumptions, projections and forecasts defined by the analyst in order to obtain a Forecast IFSA. The assigned IFSA will be the combination of the Historic IFSA and the Forecast IFSA. The Historic IFSA is derived using annual financial data for the preceding 3 years together with current year-to-date data (if available), which allows to avoid cyclicality that could trigger a biased analytical conclusion. The forecast IFSA is obtained over a 3-year time horizon. However, the time horizon could change depending on the nature and characteristics of the rated entity.

The five key factors include both qualitative and quantitative assessments. Factors and sub-factors are expressed following a seven-scale opinion: 'Excellent', 'Very Strong', 'Strong', 'Satisfactory', 'Moderate', 'Weak' and 'Very Weak'. This scale is then translated into rating equivalents and will then be used to calculate a weighted average rating equivalent.

Quantitative factors are compared to a range of possible outcomes tested by Dagong over a specific period of time, based on public available information from reliable data sources.

Exhibit 4: IFSA – Sub-Factors



Source: Dagong

III.1 Operational Environment

The analysis of a financial institution starts with an assessment of the operational environment. The international and domestic macroeconomic climate is crucial to the financial performance of individual entities, setting the starting point for any fundamental analysis and credit risk evaluation.

Dagong includes three sub-factors within the ‘Operational Environment’ which group the key elements that determine the economic, legal and regulatory environment where a financial institution sets and develops its business model.

In case of geographically diversified businesses, the sub-factors are assessed considering the major countries in which the entity has relevant businesses.

III.1.1 Regulatory Environment

The Regulatory Environment provides the base in which an entity develops and sets its business practices. A sound and transparent regulatory environment, with a framework set by a fully independent and credible regulator that shows evidence of empowerment and has control over entities with best practices, promotes a healthy financial industry with adequate incentives.

The Regulatory Environment ranges from multilateral agreements (e.g. Basel accord, ECB) to customised regulations based on country specifications (mainly concerning reporting standards). Dagong expects that the main objective of the regulator is to promote a healthy financial system, protect bank depositors and support competition. Following on from this, Dagong expects that the regulatory framework should be aligned with the best interests of market participants.

As a consequence of the 2007-2008 financial crisis, Dagong strongly focuses on the regulatory standards for liquidity and capital management and the minimum standards required by regulatory authorities (Basel III for example). Dagong places a high value on the implementation of strict liquidity and capital supervision within the regulatory framework.

Financial institutions with an approved banking license are subject to more specific regulatory standards and on-going supervision. Ready access to central bank lending or refinancing facilities provides a certain level of protection to creditors. Nevertheless, financial institutions without a banking license can have similar control mechanisms and advantages depending on their regulatory status and country-specific enforcement, which have been considered in the analysis.

For financial institutions that have operations or business lines in more than one country, the regulatory framework that applies for the purpose of analysis is taken from the country in which the entity has its home operations. If operations in other countries are relevant (in terms of earnings contribution, assets or loan portfolio, depending on disclosure), the analysis includes an assessment of the secondary country’s regulatory framework as well. Dagong notes that for certain financial institutions (typically large and systemically important institutions), a more consolidated analysis of the regulatory framework can be applied.

The Regulatory Environment is determined following the seven-point scale opinions detailed below:

Regulatory Environment Assessment	Definition
Excellent	Applies only to entities regulated at a global level (Globally Systemically Financial Institutions - GSFI). Fully developed and highly transparent regulatory framework with long track-record of consistent, predictable and independent decisions. Regulation is standardised with no exceptions in its application.
Very Strong	Developed and transparent regulatory framework, with long track-record of consistent, predictable and independent decisions. Regulation is standardised with no exceptions in its application.
Strong	Well-developed framework with adequate transparency, reliability and predictability; track- record of consistent, predictable and independent decisions. Some exceptions in the application of the regulatory framework are applied, mostly following the framework applied by national authorities in the best interest of the characteristics of the domestic market to migrate to a standardised approach in the medium term.
Satisfactory	Regulatory framework that is moving to a consistent application of industry best practices, with average level of transparency, reliability and predictability. Track-record of consistent and independent decisions. Exceptions in the application of the regulatory framework are in place applied by national authorities in the interest of the characteristics of the domestic market.
Moderate	Regulatory framework that is in the process to apply industry best practices and promotes stricter self-regulation for entities. However shows evidence of some inconsistency or lack of track-record or transparency.
Weak	Regulatory framework that applies a flexible approach with a high degree of inconsistency or significant lack of transparency. Exceptions to the application of the regulatory framework are easy to be identified.
Very Weak	Undefined or unclear regulatory framework with strong political interference and track-record of inconsistent and hostile decisions.

III.1.2 Local and Macro Economy

Local and macroeconomic conditions are typically strongly correlated with the performance of the financial industry. Due to the nature of the financial industry, the state of the local and macro economy has direct effects on the demand for financial services and available credit and thus the ability of market players to generate healthy earnings.

For Dagong, in the case of banks with operations or credit exposures to different countries, a weighted average is used in terms of loan portfolio composition, annual revenues, credit exposures or total assets (if available, depending on the disclosure of information) to assess the specific local and macro economy factors.

The analysis and assessment of a country's economy is a key driver for the expected performance of a financial institution. In addition, economic cycles can have a strong effect on asset evaluation, with an impact on the valuation of financial institutions' balance sheets. Dagong evaluates the health of the economy through the following macro indicators:

Local and Macro Economy Factors	Definition and data used
GDP change	GDP change at constant prices, full preceding year data or most recent y-o-y data; Data sources are public organizations such as IMF, Eurostat and other local statistical bureaus.
CPI average	Average CPI full year change or most recent y-o-y average; Data sources are public organizations such as IMF, Eurostat and other local statistical bureaus.
Unemployment rate	Official full preceding year unemployment rate available or most recent quarterly data; Data sources are public organizations such as IMF, Eurostat and other local statistical bureaus.

We assess sovereign risks within the local and macro economy analysis. However, sovereign caps are not automatically applied neither are the driver to the operational environment assessment.

III.1.3 Legal Environment

The Legal Environment is a key factor in setting the operational framework of financial markets. A well-established and proven legal framework, with clear legal procedures, ability to enforce contracts and predictable foreclosure times is vital to provide a smooth operating environment for financial market participants. During times when financial assets are non-performing, the legal framework that characterises a country directly affects the business model developed by any financial institution, for the recognition of non-performing assets and charge-offs.

Dagong evaluates and compares the strengths and weaknesses of each country's legal framework with the aforementioned characteristics based also on the 'Ease of Doing Business Ranking' from the World Bank, specifically the 'Enforcing Contracts' and 'Resolving Insolvency' factors if available.

The Legal Environment is determined following the seven-point scale opinions detailed below:

Legal Environment Assessment	**Definition**
Excellent	Well-established and proven legal framework, with clear, objective and transparent legal procedures that allow very fast and very cost efficient foreclosures. Degree of predictability is very high and very swift contractual enforcement.
Very Strong	Well-established and proven legal framework, with clear legal procedures that allow fast and cost efficient foreclosures. Degree of predictability is very high and very swift contractual enforcement.
Strong	Well-established and proven legal framework, with clear legal procedures. Degree of predictability is high and swift contractual enforcement and foreclosure times.
Satisfactory	Adequately established and proven legal framework, with standard legal procedures and adequate transparency. Degree of predictability is satisfactory and contractual enforcement and foreclosure times are adequate.
Moderate	Adequately established and proven legal framework, with rather complicated and not fully transparent legal procedures. Degree of predictability is moderate and contractual enforcement and foreclosure times can be very lengthy.
Weak	Developing legal framework, with complicated legal procedures and low transparency. Degree of predictability is low and contractual enforcement and foreclosure times is rather slow.
Very Weak	Developing legal framework, with very complicated legal procedures and very low transparency. Degree of predictability is very low and contractual enforcement and foreclosure times is very slow.

III.2 Corporate Governance and Development Strategy

III.2.1 Corporate Governance

The assessment of a financial institution's governance framework is an important factor in determining the quality of management, track record of fulfilling the strategic plan and long-term performance. It therefore affects the financial stability of an entity. Since the approach to Corporate Governance can be very different depending on the ownership structure of an entity, the qualitative judgment made by Dagong takes into account also the complexity of the ownership structure.

The assessment includes an opinion on how the entity manages its relationship with all stakeholders including shareholders, financial markets, regulatory entities, employees and any other relevant parties. A review of the entity's own definitions, procedures, internal policies and business practices is crucial to understand and identify potential risks from lack of governance or management vulnerability.

Dagong's opinion on Corporate Governance is defined as a qualitative score that is 'Neutral', or a notching adjustment that goes from '1 notch down' to '6 notches down' applied to the IFSA. The rationale to assess it as neutral or to apply a notching adjustment is based on the fact that Corporate Governance should be a minimum standard of best practices in every financial institution. Dagong gives no credit to strong Corporate Governance frameworks, since it represents a required level of professionalism and responsibility for each analysed entity. However, if we perceive some weaknesses or lack of governance, Dagong can apply notching adjustments. A comprehensive list of questions and topics when evaluating Corporate Governance include, inter alia:

- Composition of the board of directors/supervisory board, background and independency.
- Concentration of power of decision making processes.
- Are strategy and objectives communicated within the organisation and are those aligned within the organisational structure?
- Is risk tolerance appetite clearly determined and communicated?
- How is the risk management function structured and managed?
- How experienced is senior management and what is their track record?
- Are internal procedures and practices clearly defined, communicated and applied?
- What has been the outcome of the last inspection by the regulator/central bank?
- Are there any issues with the ownership structure?
- Structure of the management compensation packages. Are the incentives for management compensation aligned with a sustainable long-term perspective of the institution?
- Is there any evidence of moral hazard risks?
- Quality of reporting, controls and monitoring of the board to management level.
- Evidence of any legal or regulatory disputes that can affect the reputation of the entity.
- Any compliance breach, exception, or fine from a regulatory institution.
- Sizable related-party lending or concerns that it could be present.
- Other relevant aspects.

As an example of notching adjustment, Dagong assesses financial reporting as a best practice based on quality, transparency and timing. The disclosure of incomplete financial information of poor quality that lacks transparency or is not published timely, is negatively viewed and could lead to notching down based on Corporate Governance.

Dagong may apply an adjustment from '-1 notch' up to '-6 notches' based on the Corporate Governance; this adjustment is applied to the IFSA (Historic or Forecast). As mentioned above, a 'Neutral' assessment does not have an impact on the IFSA. In the particular cases that banks receive an assessment on Corporate Governance of '-5 notches' or '-6 notches' , Dagong could apply a cap to the IFSA to a level below investment grade, because the risk of Corporate Governance is too high and is not aligned to an investment grade type of entity.

III.2.2 Development Strategy

The assessment of the Development Strategy of any financial institution ranges from a basic review of the organisational structure to a more in-depth analysis of the management skills and ability to fulfil the strategic plan and focus on the long-term sustainability of the business model without jeopardising the financial profile.

In any business model, the business philosophy and strategy play key roles in determining the long-term objectives and risks that the management is willing to undertake to achieve its strategic goals. It is important that the management's philosophy and actions provide realistic strategies that reflect the real competitive advantages and disadvantages of an entity. Unrealistic expansionary strategies may lead to pressure, relaxing credit risk controls and unnecessary increase of the entity's overall risk appetite and therefore misalign the real performance from approved policies. On the other hand, an overly conservative management strategy may result in missed business opportunities and reduced competitive strength in the long-term.

A comprehensive analysis of management's ability to implement the business strategy and its competency in achieving it are fundamental to Dagong. As a key tool to analyse the quality of management, Dagong requests access to the entity's management reporting system and reports to address the soundness of the information and data shared for decision-making purposes and successful execution.

The analysis of the growth strategy also includes any merger and acquisition (M&A) process put in place. It is well known that M&A involve risks that are sometimes difficult to identify. The success and value creation through M&A depends heavily on an adequate strategic fit between/among the merging entities.

Management's business decisions and plans for poorly performing business units or those that no longer make strategic sense represent another relevant area for analysis. Objective appraisals and disciplined approaches in dealing with underperformers (divestiture, restructuring, discontinuation etc.) are reviewed.

The Development Strategy is determined following the seven-point scale opinions detailed below:

Development Strategy Assessment	**Definition**
Excellent	Thoroughly defined business strategy and goals, fully aligned with core competencies and market developments; excellent track-record of exceeding strategic goals and targets; successful and constant organic growth utilising market opportunities and mitigating risks.
Very Strong	Very well-defined business strategy and goals fully aligned with core competencies and market developments; very strong track-record of consistently fulfilling strategic goals and targets; successful organic growth utilising market opportunities and mitigating risks.
Strong	Strong business strategy and goals aligned with core competencies and market developments; strategic goals and targets met; organic growth strategy outperforming industry averages and balanced in terms of opportunities and risks.
Satisfactory	Adequate business strategy and goals aligned with core competencies and market developments; strategic goals and targets mostly met; organic growth strategy aligned to industry averages and balanced in terms of opportunities and risks.
Moderate	Business strategy and goals relatively aligned with core competencies and market developments; strategic goals and targets generally met; organic growth strategy balancing opportunities and risks.
Weak	Business strategy and goals not thoroughly defined, overly ambitious or not aligned with company or market developments; some underperformance against targets in the past; high risk appetite for organic growth and M&A.
Very Weak	Poorly defined or unrealistic business strategy and goals not aligned with company or market developments; track-record of consistent underperformance against targets; aggressive organic growth and M&A with significant uncertainties and risks involved.

III.3 Sustainability and Competition

The section related to Sustainability and Competition assesses the ability of an entity to develop a successful and sustainable business strategy and gain/maintain a stable market position as a basis for long-term success.

Sustainability and Competition factors include quantitative and qualitative evaluations that help to support and confirm the ability of an entity to maintain its long-term solvency and competitive position. For Sustainability and Competition, Dagong analyses the following sub-factors:

III.3.1 Business Sustainability

The sustainability of the business model sets a base for any projection and predictability of performance. The ability of an entity to overcome market distresses is based on its sustainability and stability of earnings generated through a healthy business model. It is noted that traditional banking models have proven to be more stable, with a more predictable performance throughout cycles. They have demonstrated to be better positioned to face event risks and large one-off extraordinary expenses. Dagong's values the 'simple' or so called ‘traditional banking’ model, with e.g. high net interest earnings proportion and loan and deposit dominant balance sheets. In Dagong’s view a sustainable and traditional banking model could provide a higher level of protection to creditors in the long-term.

Dagong evaluates the business sustainability through the following ratios:

Business Sustainability Factors	**Definition and data used**
Revenues Structure: Net Interest Income to Operating Income	The ratio is calculated using a 3-year average including year-to-date data; Net interest income is used as reported and operating income includes only income from operating activities and could be adjusted if non-recurring items are included.
Stable Funding: Stable Funding to Total Funding	The ratio is calculated using a 3-year average including year-to-date data; Stable funding typically includes deposit and long-term market funding facilities (with more than 7 years residual maturity) and other stable funding sources (for example central bank funding if it is viewed as a stable source). Total funding includes customers’ deposits, interbank funding and market funding. If additional funding sources are available and are considered material, they could be added to the calculation of total funding.
Asset Structure: Net Loans to Total Assets	The ratio is calculated using a 3-year average including year-to-date data; Net loans are gross loans less loan loss reserves. Total assets are total assets as reported.

III.3.2 Diversification

Diversification is an important factor in the analysis of any financial institution. Regional, industrial and income diversification can decrease dependence on the performance of a specific market and improve the entity’s ability to face any distressed conditions of isolated markets or business segments.

Diversification can add more stability and therefore represent a strength or, add volatility and represent a weakness. This is related to the nature of the diversification, the entity’s ability to manage it and finally, the overall contribution to the entity’s consolidated business model.

Developing business segments that are not of the entity’s expertise, or entering markets where high investment or large business intelligence are required to be successful, could be viewed as a potential weakness instead of an advantage/strength.

On the other hand, a reasonable or strong diversification rationale and model would be one in which an entity is able to either develop a franchise simultaneously and successfully in a different country (or countries), or develop different business lines. This is proven as a factor of mitigation in terms of financial performance helping to overcome different economic cycles or specific business risks.

Dagong analyses and reviews in detail the nature of the diversification and the expertise of the entity in terms of market and business model, to fairly assess the diversification effect.

To analyse diversification, Dagong separates it into **'Geographic Diversification'** and **'Business Diversification'**:

Geographic Diversification is determined following the seven-point scale opinion detailed below:

Geographic Diversification Assessment	Definition
Excellent	Significant presence in major well-diversified and developed geographic regions or continents, single market concentrations below 60% and not material exposure to underperforming regions.
Very Strong	Large presence in major well-diversified and developed geographic regions or continents, single market concentrations below 65% and limited exposure to underperforming regions.
Strong	Presence in one or more well-diversified geographic region or continents; single market concentrations below 70% and limited exposure to underperforming regions.
Satisfactory	Presence in one well-diversified geographic region or continents; single market concentrations below 80% and limited exposure to underperforming regions.
Moderate	Presence in one relatively diversified geographic region or continents; single market concentrations are above 80% and exposure to underperforming areas exists.
Weak	Presence in one geographic region/area/continent; single market concentrations above 90% and exposure to underperforming local regions/ areas regions affects performance.
Very Weak	High concentration in local areas and/or underperforming local areas/regions affects performance.

Business Diversification is determined with an opinion that could be 'Neutral', 'Weak' or 'Very Weak'. The rationale behind the assessment is based on the fact that, despite that business diversification can be very positive for some entities, it is more reasonable to adjust the IFSA for the lack of diversification than give benefit from it. Dagong applies a '-1 notch' adjustment for 'Weak' diversification and a '-3 notches' adjustment on 'Very Weak' diversification on the final IFSA. As mentioned above, a 'Neutral' assessment does not alter the IFSA.

Business Diversification Assessment	Definition
Neutral	There is a balanced business composition, with business units adequately contributing to the overall results. It can apply to assets or to liabilities.
Weak	Some concentration of business units as main contributor to results is present. It can apply to assets or to liabilities.
Very Weak	Concentration of one business unit as a main contributor to results.

III.3.3 Competitive Position

The ability of a financial institution to develop a competitive advantage provides a basis to generate stable profits and above-average returns. In that context, an entity should carefully manage and monitor the competitive environment to foresee the effects that any competitive change would have on its business model and eventually, competitive position. The competitive advantages can be a result of an internal strength or an external factor that allow the entity to provide a distinctive product or service. A sound and recognised franchise is more stable in times of financial stress, benefitting from the loyalty and preference of customers and debt counterparties. However, this depends on the level of financial or economic stress that affects the market or the entity in particular.

The Competitive Position is determined following the seven-point scale opinions detailed below:

Competitive Position Assessment	**Definition**
Excellent	Global or multimarket dominant market position; excellent client and brand recognition; among top players in the majority of the markets.
Very Strong	Dominant regional market position; very strong client and brand recognition; among top players in the majority of the markets or leader in a niche market position with extremely strong protections/competitive advantages.
Strong	Dominant regional or target markets position; strong client and brand recognition; among top players in the majority of the target markets or among the top players in a niche market position with strong competitive advantages.
Satisfactory	Regional or target markets player with an adequate competitive position; satisfactory client and brand recognition in its target markets; among largest players in the majority of the target markets or among the largest players in a niche market position with average competitive advantages.
Moderate	Modestly positioned regional or local market player with average or below average competitive advantages; moderate client and brand recognition in its target markets.
Weak	Limited regional or local market position; high competition pressure with weak competitive advantages; weak client and brand recognition in its target markets.
Very Weak	Very weak regional or local market position; high competition pressure with very weak competitive advantages; unclear client and brand recognition in its target markets; long-term viability at risk.

III.4 Risk Management

For Dagong, the ability, expertise and proven record of a successful risk management is a key qualitative factor for the IFSA. The ability of a financial institution to generate revenues under a solid risk management framework is analysed and challenged. The business model that financial institutions undertake carry credit, market and operational risks that need to be managed well in order to provide profitability -which needs to be properly adjusted based on the identified risk appetite. Since the overall profitability, achieved by financial institutions is mostly determined by the level of risks accepted and rejected, the management of risks is expected to be economically profitable and controlled accordingly.

The analysis of the management framework to monitor and control risks is assessed in the business context the entity is set for. The coherence of the risk management framework with the business model is the starting point for the analytical opinion. In this context, Dagong assesses the complexity of Market, Operational and Credit risk components and the risk management approach of the financial institution.

III.4.1 Market Risk

The potential consequences of poor market risk management on an entity’s balance sheet and financial profile can be significant. Dagong follows a comprehensive approach to understand and analyse each specific market risk framework and risks from a qualitative to a quantitative perspective.

The importance of the assessment of risk appetite, incentives and review of the practical application of the framework is vital in assessing the complexity and management of market risks. In addition, a relevant source of returns obtained from activities with market risk is a driver in determining the importance of these risks on the entity's overall IFSA.

The entity's reporting of market risk, sensitivity analysis, stress testing tools and results is data upon which the market risk complexity is assessed. The opinion is based on a qualitative score of seven categories from 'Excellent' to 'Very Weak'. There are no quantitative ratios applied to market risk, due to the vast diversity of models and tools used by entities depending upon their complexity levels.

The Market Risk assessment is determined following the seven-point scale opinions detailed below:

Market Risk Assessment	**Definition**
Excellent	Excellent and best in class market risk management practices; very high or very low complexity of operations managed through no history of related losses and sounds controls; Very proactive and independent approach to balance risks and returns from market risk.
Very Strong	Very strong market risk management practices; high or low complexity of operations managed through no history of related losses and sound controls; Proactive and independent approach to balance risks and returns from market risk.
Strong	Strong market risk management practices; high or low complexity of operations managed through no history of related losses and strong controls; Proactive and independent approach to balance risks and returns from market risk.
Satisfactory	Satisfactory market risk management practices; average complexity of operations managed through limited history of related losses with no material effects on profitability neither capital; relatively proactive and independent approach to balance risks and returns from market risk.
Moderate	Moderate market risk management practices; high or low complexity of operations managed through history of related losses weakening profitability or capital.
Weak	Weak market risk management practices; high or low complexity of operations managed through history of related losses materially weakening profitability or capital.
Very Weak	Very weak market risk management practices; very high or very low complexity of operations managed through history of related losses largely and persistently weakening profitability or capital.

III.4.2 Operational Risk

Due to the complexity of services provided by financial institutions and the volume and amount of transactions involved, operational risk can cause great damage to the financial profile, in both monetary and non-monetary terms. Operational risks could not only lead to unexpected losses in financial statements but also regulatory fines, credibility loss, legal litigations or other brand damage. These could in turn result in a decrease in customer base and also debt counterparties being reluctant to provide funding.

There are no quantitative ratios applied to operational risk, due to the vast diversity of models and tools used by entities depending on their complexity levels, regulatory frameworks and specific business needs. Nevertheless, the approach takes into account the amount of capital available (buffer) to cover any unexpected losses from operational risk and any other internal measure that the management uses for that topic. In addition, the operational risk assessment is evaluated in the context of the business model complexity.

The Operational Risk assessment is determined following the seven-point scale opinions detailed below:

Operational Risk Assessment	Definition
Excellent	Excellent and best in class operational risk management practices; very high or very low complexity of operations with no history of related losses and sounds controls; Very proactive and independent approach to balance risks and returns from operational risk.
Very Strong	Very strong operational risk management practices; high or low complexity of operations managed through no history of related losses and sound controls; Proactive and independent approach to balance risks and returns from operational risk.
Strong	Strong operational risk management practices; high or low complexity of operations managed through no history of related losses and strong controls; Proactive and independent approach to balance risks and returns from operational risk.
Satisfactory	Satisfactory operational risk management practices; average complexity of operations managed through limited history of related losses with no material effects on profitability neither capital; relatively proactive and independent approach to balance risks and returns from operational risk.
Moderate	Moderate operational risk management practices; high or low complexity of operations managed through history of related losses weakening profitability or capital.
Weak	Weak operational risk management practices; high or low complexity of operations managed through history of related losses materially weakening profitability or capital.
Very Weak	Very weak operational risk management practices; very high or very low complexity of operations managed through history of related losses largely and persistently weakening profitability or capital.

III.4.3 Credit Risk

For financial institutions, the key driver of recurrent earnings comes primarily from lending activities, which commonly represent the largest portion of assets. The large size of loan portfolios gathers a variety of credit counterparts in nature, industries, loan specifications etc. In that context, the quality of the loan portfolio represents a key driver on the financial profile and earnings prospect of any entity.

An entity’s credit risk appetite represents the starting point of the analysis. Dagong discusses and reviews an entity’s credit risk policies in order to understand the rationale of its lending practices. The analysis of credit operations and risk management processes provides a basis for comparison with peer and industry benchmarks. This allows Dagong to identify whether an entity follows the industry best practices, regulation or has any other business approach in its development of credit activities.

The analysis includes a review of the entity’s credit policies and standards, collaterals, management of recoveries and other related matters on loan write-offs policies.

Recent events in several European countries have shown how high borrower or industry concentration can cause large charge-offs and finally a deterioration of capital. Therefore, an adequately diversified and granular credit portfolio is an indicator of reasonable credit risk management that can help to reduce and mitigate credit losses. This is also related to large exposures to specific industries, countries or any other niche that is heavily dependent on market trends or economic conditions.

It is worth noting that although credit risk diversification can reduce the effect of a deterioration of specific counterparties on the loan portfolio, in cases of economic downturn, typically the loan portfolio as a whole is adversely affected. In those cases, it is necessary to carefully analyse the macro context and the ability of each entity to successfully overcome the economic scenario with limited shocks on asset quality. Understanding the cause of credit losses is a powerful tool in evaluating the expected performance of an entity’s asset quality.

Benchmarking and peer comparison allows Dagong to identify the complexity and specific characteristics that apply for each entity and therefore the expected asset quality stresses under different economic scenarios.

In order to evaluate the composition of the loan book in more detail, Dagong requires detailed information on the most relevant large credit exposures (or borrowers) including ratings, guarantees (and some transaction specific conditions if applicable), data on industry exposure, concentration by lending products and any other additional data the agency considers relevant for analytical purposes.

The Credit Risk assessment is determined following the seven-point scale opinions detailed below:

Credit Risk Assessment	**Definition**
Excellent	Very conservative credit risk policies with clear commitment to highest credit quality; very low risk appetite and very long and consistent track record of balanced risk and return from credit risk; very low single name and sector concentration; fully independent risk and business functions.
Very Strong	Conservative credit risk policies with clear commitment to highest credit quality; low risk appetite and very long and consistent track record of balanced risk and return from credit risk; low single name and sector concentration; fully independent risk and business functions.
Strong	Relatively conservative credit risk policies with clear commitment to strong credit quality; relatively low risk appetite and consistent track record of balanced risk and return from credit risk; some single name or sector concentration is present but manageable; fully independent risk and business functions.
Satisfactory	Credit risk policies aligned with the industry standard, with clear commitment to benchmark to industry average credit quality; risk appetite aligned to industry averages and track record of balanced risk and return from credit risk without material effects on profitability or capital; Single name or sector concentration is present but manageable; independent risk and business functions.
Moderate	Credit risk policies relatively more aggressive than the industry standard, with commitment to benchmark within a higher range compared to industry average credit quality; risk appetite relatively above industry averages and track record of risk / return from credit risk losses with effects on profitability or capital; Single name or sector concentration results in higher risks.
Weak	Credit risk policies focused on shareholder returns and more aggressive than the industry standards; risk appetite above industry averages and track record of risk / return from credit risk losses weakening capital or profitability; Single name or sector concentration results in large risks; not independent risk and business functions for major transactions with sometimes not transparent, non-consistent or modest credit decision governance structure.
Very Weak	Credit risk policies focused on shareholder returns and aggressive compared to industry standards; risk appetite above industry averages and track record of risk / return from credit risk losses largely weakening capital or profitability; Single name or sector concentration results in material risks; not independent risk and business functions for major transactions with sometimes not transparent, non-consistent or modest credit decision governance structure.

In addition to the qualitative assessment on Credit Risk, Dagong uses quantitative measures to enhance the comparability of the analysis between entities. The ratios used are:

Credit Risk Factors	**Definitions and data used**
NPL Ratio: Non-Performing Loans to Total Gross Loans	Since the definition on non-performing loans could vary across jurisdictions and regulatory bodies, we use the definition of non-performing exposures provided by the European Banking Authority (EBA) as a benchmark; This includes 90 days past-due and unlikely to pay loans; for non –EU banks, the calculation is done using 90 days past-due, impaired (if available) and unlikely to pay (if available). The ratio is calculated using most recent year or year-to-date data.

Coverage Ratio: Loan Loss Reserves to Non-Performing Loans	Loan loss reserves related to credit risk only; Non-performing loans using the EBA definitions as a benchmark; The ratio is calculated using most recent year or year-to-date data.

III.5 Financial Performance

The last component of the IFSA is focused solely on financial performance, and includes a detailed view on Capital, Liquidity and Funding and Profitability. This analysis provides a set of ratios to assess the financial soundness of each entity, which is then used also for peer comparison.

A sound financial profile which can withstand economic cycles is the basis for an entity's healthy and sustainable overall profile. Operating performance, balance sheet strengths and weaknesses, capital and liquidity positions represent the key drivers for long-term solvency prospects. Thus, Dagong has divided the analysis into three sections: Capital, Liquidity and Funding and Profitability.

III.5.1 Capital

Capital is fundamental to the financial stability of any financial institution. It is the most certain source of funds to absorb potential and unexpected losses (generated from credit, market or operational risks), when earnings are weak or non-existent, independent of their origins. It represents the sole source of funding which is completely reliable in supporting any organic growth expansion.

Dagong reviews the composition of an entity's capital base, the tools the management has in place to control and review capital needs and the internal limits and minimum capital levels that it tolerates within its business cycles. Dagong regards an entity's minimum internal capital limit as an important indication of risk tolerance and ability to manage the capital adequacy under tight financial scenarios.

In addition to the Tier 1 ratio to assess an entity's capitalisation, Dagong analyses also the Leverage ratio. The risk weighting of assets can vary significantly, even between institutions with similar risk and asset profile. This can be due to different regulatory frameworks on risk-weighting applications, or, for example, variations in business sophistication of the institution. In order to compare institutions true capital base – available to cover for losses – the Leverage ratio appears for Dagong as an effective measure.

Capital is an immediate buffer to mitigate financially distressed scenarios, but if management does not prospectively identify the risks held in the balance sheet, no matter the capital level kept by an entity, the effect on the financial profile can be material.

On the other hand, in periods of economic growth and subsequent expansion of assets, financial institutions are usually tempted to finance this growth through debt, increasing leverage. In that context, the analysis of balance sheet growth in terms of quality, stability and funding mix is addressed carefully.

The ratios that Dagong uses to assess the capital strength of any financial institution are:

Capital Factors	**Definitions and data used**
Tier I Capital Ratio	Tier I capital ratio (Basel III phased-in or fully loaded when implemented) as reported using most recent year or year-to-date data; In cases entities do not report/calculate Tier I Capital ratios, Dagong can make assumption based on the information available and calculate a proxy.
Leverage Ratio: Total shareholders' equity to total assets	Total shareholders' equity as reported and total assets as reported; Adjustments to total assets could be done if intangible assets are material; The ratio is calculated using most recent year or year-to date data.

In the particular case that banks show a Tier I Capital ratio too close to regulatory minimums (for example 8.0%), which could jeopardise the financial profile if no remedial actions are taken, Dagong applies a cap to the IFSA based on the potential risk of rapid capital erosion, with consequent effects on the financial profile of the entity.

III.5.2 Liquidity and Funding

Solvency is highly correlated with liquidity and funding risks, including the concept of 'market contagion' that could result from the financial instability of even a small and isolated entity, affecting larger and more solid franchises. Dagong requires entities to demonstrate their ability to manage liquidity and funding shortfalls under stressed economic scenarios.

Dagong gives special attention to the Liquidity Management framework (promoted by Basel III), including not only a qualitative analysis of liquidity plans (under contingency and normal scenarios), but also gaining an understanding of the historical liquidity dynamics that an entity has faced during economic cycles.

The liquidity scenario at a market or country level, is key to determining the ability of financial institutions to manage their funding structure, moving from more liquid positions in the short term to more stable funding structures targeting the long-term.

In addition, it is important to identify regulatory measures put in place to prevent financial institutions (particularly banks) to face uncontrolled liquidity stresses. The analysis includes the differentiation and special conditions available (central bank funding) for specific entities (banks in most cases) and for other non-banking institutions. Also, the availability of liquidity measures like the Liquidity Coverage Ratio (LCR) and Net Stable Funding ratio (NSFR) provides additional information to assess liquidity and funding risks.

The access to central bank funding or any other liquidity sources, is analysed accordingly and in the context of economic conditions. For Dagong, sound liquidity management is supported by a reasonable and equilibrated funding structure, with no overdependence on specific funding sources that cannot be reliable.

To complement the assessment, Dagong also considers the structure of funding and how an entity maintains on-going renewal. The analysis is focused on reviewing the deposit base, inter-bank loans, capital market funding, central bank funding and any other sources of funding available, if relevant.

Market access for financial institutions and respective pricing continues to be linked across most jurisdictions, given the on-going market perception of consolidated financial institutions and country specific risk. As such Dagong's Liquidity and Funding analysis is complemented with an indicator of market liquidity that can refer to the benchmark of a government 10-year bond rate or the specific entity's 10-year bond rate.

The ratios that Dagong uses to assess Liquidity and Funding are:

Liquidity and Funding Factors	**Definition and data used**
Gross Loans to Customers Deposits	Gross loans as reported; customers' deposits include households and non-financial corporations; the ratio is calculated using a 3-year average including year-to-date data.
Customers Deposits to Total Funding	Customers' deposits include households and non-financial corporations; total funding includes customers' deposits, interbank funding, market funds and subordinated debt issuances; the ratio is calculated using the average of customers' deposits and average total funding for a 3-year period including year-to-date data. Quality and stability of deposits is evaluated and adjustments to the customers' deposits base could be done if needed.

Market Access Benchmark	The data used is the average of the government bond 10-year rate for the most recent full year or year-to-date if deemed more representative. If the entity demonstrated to have a market access ability substantially better from the benchmark of the government bond 10-year rate, the entity's representative 10-year bond rate could be used instead.

III.5.3 Profitability

The ability of an entity to generate and maintain strong, sustainable and stable earnings is key to the continuity of the operation and long-term solvency. A detailed analysis of profitability, including key business activities, sources and composition, allows to identify the stability and predictability of earnings. Dagong puts particular attention to those entities with business models that lead to volatile earnings. In addition, the strength of a traditional lending model with a high component of earnings from interest (mainly from the loan book) is viewed as positive. Depending on the business model, core earnings are identified and analysed. A business model that lacks stable core earnings is more exposed to market and economic volatilities and therefore compares poorly with peers with more stable core earnings.

A deviation from the defined business model, to obtain 'one-off' earnings or to take advantage of market momentums is not viewed as positive in the profitability analysis. In fact, Dagong on a case-by-case basis may adjust net income for extra-ordinary items.

The ratios used by Dagong to assess profitability are:

Profitability Factors	**Definition and data used**
Income before Provisions to Loan Loss Provisions	Income before provisions including only recurrent income sources; loan loss provisions related to credit risk (loans and financial instruments); the ratio is calculated using a 3-year average including year-to-date data.
Return on Average Risk Weighted Assets	Net income as reported, adjustment for non-recurrent items could be made if deemed suitable; total risk weighted assets as reported; the ratio is calculated using a 3-year average including year-to-date data.
Income before Provisions to Average Total Assets	Income before provisions including only recurrent income sources; total assets as reported; the ratio is calculated using a 3-year average including year-to-date data.

Exhibit 5: Summary of Dagong IFSA Framework

Level 1 Indicators	Weight	Level 2 Indicators	Weight	Level 3 Indicators
I. Operational environment	25%	I.1. Regulatory Environment	25%	Regulatory Environment
		I.2. Local and Macro Economy	45%	GDP Change
				CPI average
				Unemployment Rate
		I.3. Legal Environment	30%	Legal Environment
II. Corporate Governance and Development Strategy	5%	II.1. Corporate Governance	Notching adjustment	Corporate Governance
		II.2. Development Strategy	100%	Development Strategy
III. Sustainability and Competition	20%	III.1. Business Sustainability	60%	Net Interest Income to Operating Income
				Stable Funding to Total Funding
				Net Loans to Total Assets
		III.2. Diversification	20%	Geographic Diversification
			Notching adjustment	Business Diversification
		III.3. Competitive Position	20%	Competitive Position
IV. Risk Management	15%	IV.1 Market Risk	15%	Market Risk Assessment
		IV.2 Operational Risk	15%	Operational Risk Assessment
		IV.3. Credit Risk	70%	Credit Risk Assessment
				Loan Loss Reserves to Non-Performing Loans
				Non-Performing Loans to Total Gross Loans
V. Financial Performance	35%	V.1 Capital	40%	Tier 1 Capital Ratio
				Shareholder’s Equity to Total Assets
		V.2 Liquidity and Funding	30%	Gross Loans to Customers Deposits
				Customers Deposit to Total Funding
				Market Access Benchmark
		V.3 Profitability	30%	Income before Provisions to Loan Loss Provisions
				Return on Average Risk Weighted Assets
				Income before Provisions to Average Total Assets

IV. Stress-Tests for the IFSA

To evaluate the resilience of any financial institution (mainly banks) to withstand difficult macroeconomic scenarios or market shocks, Dagong subjects the rated entities to specific stress tests which can be represented either by a change in a single factor (sensitivity analysis) or by a change in multiple factors simultaneously (scenario analysis).

Typically, the IFSA incorporates the resilience of an entity to a Dagong standard scenario, with a macro and microenvironment in line with general market expectations. In cases where Dagong expects a fair likelihood of a more severe scenario in the medium term, the IFSA incorporates the effects of this more severe scenario.

The stress-test and scenario analysis of the IFSA takes into account idiosyncratic financial stress, system wide financial stress and the combination of both. The stress-test and sensitivity analysis are built to assess the impact of unexpected events or material changes in economic trends on a financial institution's capital, asset quality, liquidity and profitability. While the risks which particular financial institutions and systems face can vary significantly (country specific factors for example), Dagong stress-test and sensitivity analysis are built as detailed below:

i. **RWA Sensitivity Analysis and effects on capital and profitability**: Indication on the level of vulnerability of capital and profitability ratios if the risk weighting on assets increases proportionally, given for example regulatory interference or regulator instructed calculation changes.

ii. **Asset Quality Stress and effects on capital, asset quality and profitability:** Default of large exposures, increase in LLR coverage to historic peak, historic maximum of cost of risk. Assessment of the effects on capital and profitability.

iii. **Customised asset quality stress test on the loan portfolio and securities portfolio and effects on capital, asset quality and profitability:** Increase in defaults or NPL for specific loan portfolios and investment securities, Assessment of the effects on capital asset quality and profitability.

iv. **Profitability Volatility:** Reduction on net interest income, operating income and net profit and effects on profitability ratios.

v. **Liquidity Stress:** Ability to face debt maturities and run-off of deposits under a base and adverse scenario. The assessment will evaluate the result of the gap (positive or negative) and size of the gap.

Dagong applies the scenarios depending on the nature and base characteristics of each operating environment and also on the unique characteristics of the financial institution being analysed (e.g. business model, size, funding structure, interconnectedness). In addition, special attention is given to the evolving context (e.g. business cycle, geographic and operational environment, regulatory changes, industry specifications) in order to identify the strength of each entity to manage its financial position.

The scenario outcomes obtained help to analyse the level of resilience of each entity to face financial distress and is therefore used in conjunction with the above described IFSA framework. The clear rationale and fundamentals of any IFSA is disclosed. If the stress test and scenario analysis lead to a perception of evident weaker financial position compared to the historic or forecast IFSA, the assigned IFSA will incorporate the assessment resulting from the stress-test.

V EXTERNAL SUPPORT ASSESSMENT (ESA)

For Dagong, the External Support Assessment (ESA) combined with the IFSA result in the final credit rating. The ESA is the analysis of the likelihood of support from an identified 'External Support Provider'. The support providers identified and used by Dagong are:

1. Cooperative / Mutualism
2. Parent / Holding Company / Group
3. Regional / Local Government
4. National Systemic
5. Supranational
6. Multilateral / Development Financial Institutions

After the identification of the 'External Support Provider', Dagong assesses the potential 'Level of Support'. Dagong applies a set of criteria to determine the potential level of support through a scoring system in which four levels of support could be obtained:

1. Low
2. Moderate
3. High
4. Very High

In certain cases, more than one support provider can be identified. Given the parallel assessment of support, this typically does not result in an addition of support. As such, the credit rating results from the most suitable 'External Support Provider' identified, matched to one of the four Levels of Support assessed. Based on that analysis, the IFSA may or may not receive notching uplift. It should be noted that the notching up is not automatic but subject to the Rating Committee discussion. The final combination of the 'External Support Provider' and the 'Level of Support' is disclosed in Dagong's Credit View.

Exhibit 6: Level of Support

Low	Moderate	High	Very High
Unlikely to receive notching uplift.	Notching uplift could be at maximum to the middle point (or rounded to) between the credit strength of the support provider and the IFSA of the rated entity.	Notching uplift could be in between the middle point from the IFSA and the credit strength of the support provider and to a level close to the credit strength of the support provider but not at the same level.	Notching uplift could reach the same level of the credit strength of the support provider.

Source: Dagong

For each 'External Support Provider', Dagong sets a specific list of conditions that are evaluated and if existing, will add or reduce the potential of support from the identified support provider.

Example:

IFSA	bbb
Support provider financial strength	AA+
Level of Support	Moderate
Support Provider	Parent
Maximum potential LTCR	**A+**
uplift in notches	**4**

V.1. Cooperative / Mutualism

Cooperative banking groups and mutualism mechanisms represent a very special type of external support since damages to one entity within the cooperative/mutualism structure can cause contagion to the overall group of entities under the cooperative/mutualism umbrella. In the case of cooperative banks, the support comes from other members of the cooperative. Support coming from other members of the cooperative is mainly a sort of intervention to avoid any reputational/business risk.

The support received can range from any sort of informal support to a more formalised and structured legally binding support, which is assessed accordingly to determine the level of support in each case. Dagong evaluates the legal framework and the specifications of the cooperative or mutualism mechanisms in place. The set of factors evaluated to assess the Cooperative/Mutualism support will be considered strengths if they add support and weaknesses if they reduce the level of support.

The factors evaluated are as follows:

Factor	Adds support or subtracts support
Reporting	Are accounts audited, consolidated and periodically reporting?
Branding	Are they identical?
Organisational structure	Do they have highly centralised or highly standardised operations?
Legal structure	1) Charter
	2) Sanction rights
Explicit support due to	1) Legal guarantee
	2) Fully paid-in sizeable support fund
Operational dependence	Is there any funding dependence, shared investments, other services?
Bail out or intervention history	Existing?
Geographic correlation	Existing?
Business correlation	Existing?
Relative size (of the analysed entity)	Important?

V.2. Parent / Holding Company / Group

In cases in which the financial institution is part of a group, with a parent entity or holding company, Dagong firstly evaluates the existence of any form of guarantee or legal obligation to support the analysed entity. In that case, due to the nature of the obligation to support, the notching up of the entity's credit rating could be up to the level of the parent/holding company/group.

It is worth noting that even though the parent/holding company/group may not have any formal or explicit commitment to support the operations of a subsidiary, Dagong evaluates the strategic importance of the subsidiary and the effects on the parent/holding company/group's reputation and market confidence if a potential default affects the analysed entity. In that context, Dagong uses the concept of 'strategic importance' and considers giving uplift to the analysed entity's IFSA based on the financial strength of the parent/holding company/group. Although Dagong evaluates prospectively the eventual support from parent/holding company/group entities, the track-record and past examples of support highlighted during past crisis is considered a key element.

The factors evaluated are as follows:

Factor	Adds support or subtracts support
Bailout history	Existing?
Ultimate parent financial strength	Above investment grade?
Ownership structure	1) Government / State Owned
	2) Branch
	3) Subsidiary
Financial reporting	Consolidated financial statements?
Guarantees in place	1) Implicit
	2) Explicit
	3) In other jurisdiction / regulatory environment / or monetary union
Strategic Importance	1) Brand sharing
	2) Important source of revenues
	3) Assets relevant for the parent
	4) Region relevant for the parent
Operational integration	Existing?
Reputational risk	Existing?

In special cases in which the analysed entity has a stronger IFSA than the parent/holding company/group the support provided by the parent/holding company/group is evaluated carefully and on a case-by-case basis. In these cases, Dagong applies a judgment to evaluate the degree of connection and dependence of both entities and therefore the relation of both credit ratings.

V.3. Regional / Local Government

In regions in which the financial system has a very specific role within the local economy, there is empirical evidence of support from the regional/local government. This is not recognisable in all countries, but some examples of regional/local government support exist. The factors evaluated are as follows:

Factor	Adds support or subtracts support
Bail out history	Existing?
Public sentiment	Favorable?
Legal capacity	Existing?
Reputational risk	Existing?
Guarantee	Existing?
Ownership	Sizeable?

V.4. National Systemic

Support from government has been historically proven. When the stability of the domestic financial system is at risk, governments are willing to support financial institutions. However, a government may be more willing to support those entities in which it has direct investment, through different mechanisms such as direct cash and capital injections, liquidity facilities, long-term debt, subordinated debt, guaranteed debt programs etc.

For systemically important financial institutions (mostly banks), the incentive for the government to provide support is driven by the catastrophic consequences of a bank facing a scenario of insolvency, with a direct effect on depositors and investor confidence, possible contagion to the financial system and the real economy. In those cases, the support to systemically important financial institutions comes from a desire to avoid any further damage to capital markets and therefore macroeconomic and social stability. It is worth mentioning that in those cases in which Dagong considers that the government does not have a sound financial profile or enough resources to provide support if needed, the level of support expected is adjusted accordingly.

In that context, Dagong identifies those financial institutions (mostly banks) that can be defined as systemically important and which are very likely to receive support in case of financial distress. However, in cases in which resolutions regimes are in place (for example the Bank Recovery and Resolution Directive – BRRD – applicable for the European Union), banks' shareholders and creditors are deemed to be the first layer to pay their share of the costs through a "bail-in" mechanism in case of failure. Therefore, national systemic support would be unlikely.

It is worth noting that Dagong's opinion on national systemic importance could differ from the definition of systemic importance that a country could set for its domestic banks. The factors evaluated are as follows:

Factor	Adds support or subtracts support
Importance of the banking system	Banking assets as % of GDP are sizeable?
Bail out history	Existing?
Legal capacity	Existing?
Public sentiment	Favorable?
Banking operational environment	Assessment of the rated entity should be at least 'Satisfactory'
Bank importance / substitutability	1) Deposit share sizeable
	2) Lending share sizeable
	3) Extra national deposits sizeable
	4) Extra national lending / business sizeable
Geographic diversification	Assessment of the rated entity should be 'Moderate', 'Weak' or 'Very weak'
Payment, settlement services and similar	Dominant player?
Business activity	1) Traditional bank or important monopolistic position
	2) Important national interbank player / market maker
Support due to	1) Capital short fall from regulatory/EBA requirements
	2) Loan losses
	3) Fraud
	4) Extra-national problems (lengthy procedure/complex)
	5) Issues from non-core operations
Resolution regime	Existing?
Guarantee	In place?
Ownership	In place?

V.5. Supranational

The interconnection and globalisation of financial markets highlights the critical importance of globally and systemically important financial institutions (banks and non-banking financial institutions) and the effects that liquidity, capital erosion and lack of market confidence could cause to the overall financial system. In addition, when governments are facing tight fiscal balances and deep crises in the real economy, the ability to provide funds to support the needs of a stressed financial system are fairly limited.

Dagong evaluates the supranational systemic importance of those entities and assesses the support based on their importance. However, since the supranational support is mostly triggered after evidence of support no longer / not available from other support providers, the assessment for the recognition of supranational support follows a dynamic approach. Dagong expects to apply the supranational support as an ultimate source of notching up, mainly to stabilise the credit rating of the affected entity. Therefore, the supranational support sets the floor until the rated financial institution recovers to a relatively stable solvency level to continue operating.

The factors evaluated are as follows:

Factor	Adds support or subtracts support
Corruption index	Low?
Non-natural sector distribution / GDP	Low?
EU / IMF program in place	Existing?
Central bank cooperation through liquidity	Existing?
Country financial strength	Low?
Bank importance / substitutability	1) Deposit share sizeable
	2) Lending share sizeable
	3) Extra EU (or monetary union) deposits sizeable
	4) Extra EU (or monetary union) lending / business sizeable
Geographic diversification	Assessment of the rated entity should be Moderate, Weak or Very Weak
Business activity	1) Traditional bank or important monopolistic position
	2) Important supra national interbank or capital markets player
Support due to	1) Capital short fall from regulatory requirements
	2) Loan losses
	3) Fraud
	4) Extra-national problems (lengthy procedure / complex)
	5) Issues from non-core operations

V.6. Multilateral / development financial institutions

In the case of financial institutions created with the purpose of providing financial support to help economies and engage in social development policies, which are owned by a group of governments, Dagong assesses the support based on their public role and the ability of the owners (so called ‘member states’) to provide support to these entities. Generally, those entities are not subject to specific banking regulation and they are governed by their own policies and benefit from special features as preferred creditor status, do not distribute dividends, do not have profitability targets, and keep callable capital available in case the entity faces financial difficulties.

The factors evaluated are as follows:

Factor	Adds support or subtracts support
Callable capital available	High?
Additional support available	High?
Willingness of support from shareholders	High?
Importance to shareholders	1) Economic interest
	2) Political interest
	3) Other interest
Financial strength of shareholders	1) High
	2) Medium
	3) Low
Relation between shareholders	1) Economic
	2) Geographic
	3) Political interest
	4) Other

VI OTHER CONSIDERATIONS FOR FINANCIAL INSTITUTIONS' CREDIT RATINGS

VI.1 Reporting and Information Risk

Dagong's analysis and ratings rely on a wide range of information sources including audited historical financial reports and legal documentation of credit facilities. In addition to this, management information such as preliminary financial data, projections, scenario analyses, liquidity and cash flow figures are also evaluated. Dagong uses an entity's internal and external data – the latter provided by valid publicly available sources of information, to complement and verify validity, consistency and the rationale of the information provided by the entity.

Dagong always relies on audited financial statements and does not implement any further audit or verification of the already-audited financial accounts. Consistency in accounting policies and financial strategies is, however, always assessed in a critical manner by the analytical team. Dagong understands the importance of the information risk as it significantly influences decisions on rating, including assignment, maintenance or withdrawal. In cases where the information risk is so significant that it prevents a meaningful analysis, Dagong will decline to assign a Credit Rating, or where a Credit Rating is already assigned, withdraw it.

Transparency and thorough reporting standards are fundamental to Dagong's credit analysis and ratings. Dagong recognises that lengthy reporting delays, material restatements, inconsistencies and related investigations that indicate poor quality of reporting. Close attention must be given to any adverse development such as regulatory challenges, lawsuits, changes in capital markets, or frequent substitution of auditors. Management's approach to resolution of these matters is also a pivotal part of the analysis. It is worth to mention that under Dagong's rating criteria, the quality of reporting is part of the Corporate Governance assessment.

VI.2 Financial Institutions Holding Companies

In the cases of pure holding companies within a group of financial institutions, for which cash flows are represented mainly by dividends received from the operating subsidiary (a rated financial institution), Dagong analyses the holding either on a non-operating or operating basis.

In the case of a non-operating holding, the IFSA is anchored at the level of the operating financial institution and then notched down due to the lack of independent earnings generation and dependency on dividends as the only income source. Further notching down applies depending on the level of leverage and any lack of financial flexibility present in the holding company.

An operating holding could have the same IFSA as the operating subsidiary, if it has proven additional sources of earnings or cash e.g.:

- Significant investment assets (real estate, marketable securities) that can be easily liquidated and transformed into an immediate source of cash.
- Other important and significant earning generator businesses that contribute stable cash flows and help the holding company to keep a very flexible and healthy financial position without over-dependency on one subsidiary only.

VI.3 Subsidiaries, Branches and other Vehicles

Large financial institutions usually keep some operations in non-core countries for special purposes such as alternative booking units, debt issuance or other reasons. In those cases, the subsidiary (vehicle or branch) is highly integrated with the parent, sharing IT, funding, risk management operations and most core services. This makes the IFSA or credit rating of the subsidiary (or branch) highly dependent on the IFSA/credit rating of the parent entity. Therefore, the IFSA/credit rating of the subsidiary (or branch) is mostly likely at a similar level to the one of the parent entity, considering that these subsidiaries (or branches) have a limited independence and that decision-making processes and operations are concentrated at the parent level.

The IFSA/credit rating can instead be different from that of the parent when the subsidiary (or branch) is located in countries where the jurisdiction differs substantially from that of the parent.

It is worth noting that Dagong assesses these subsidiaries on a case-by-case basis in order to clearly identify the potential risks or weaknesses that debt-holders could face within those specific jurisdictions and will assign a different credit rating if deemed necessary.

VI.4 Foreign Currency and Local Currency Ratings

Dagong assigns ‘Foreign Currency’ ratings in cases where the entity issues debt instruments in a currency different from the local currency. There ratings are not independent and are obtained through the ‘Local Currency’ rating. The debt obligations that an issuer committed to in a ‘Foreign Currency’ are subject to notching adjustments (up or down) based on the entity’s access to the specific foreign currency. Dagong defines notching as ‘the practice of assigning different ratings to the different sets of liabilities included within an entity’s financial statement.’ The adjustment also takes into account the specific features of the foreign currency issuance and any other factor that Dagong considers could constrain the access to foreign currency and therefore reduce the ability of the entity to fulfil its obligation accordingly.

In addition, a ceiling on ‘Foreign Currency’ would be applied if Dagong believes that the entity’s access to that currency is considerably restricted within its operating country, or if there is a government restriction on foreign currency access in events of financial distress. In those cases, the ‘Foreign Currency’ rating would mostly follow the external restrictions applied by that country and therefore would not be in alignment with the ‘Local Currency’ rating. The difference in notching is analysed on a case-by-case basis, depending on the rated entity’s strength and ability to ring-fence the specific ‘Foreign Currency’ debt obligation.

VI.5 Debt Obligations

The implementation of resolution regimes has led banks to prepare recovery plans to overcome any potential financial distress. In addition, it has set a comprehensive and effective arrangement to deal with failing banks at country level. In the case of the Bank Recovery and Resolution Directive (BRRD) applicable for the European Union, it is established that in case of failure, banks' shareholders and creditors must be the first layer to pay their share of the costs through a "bail-in" mechanism. If that is still not sufficient, the national resolution funds set up under the BRRD can provide the resources needed to ensure that a bank can continue operating while it is being restructured. The shareholders and creditors have to partially bear the losses of the failing institution; they cover the losses up to at least 8% of the total liabilities (debts or obligations) of the bank undergoing a restructuring plan. If there are still losses to cover, the resolution fund can intervene. Other powers in the hands of national authorities include the possibility to sell the institution undergoing restructuring or merge it with another one.

Therefore, with the implementation of resolution regimes (in general), banks are now able to default on certain instruments in order to continue operating while in the process of restructuring. The difference for each debt obligation to default or not will be if they are part of the loss absorption capacity and how far are they from the capital buffer to eventually be 'bailed-in'. Considering the different debt instruments available to be bailed-in, our rating approach will be as detailed below:

VI.5.1 Senior Unsecured Debt Obligations

In our opinion, senior unsecured debt obligations usually have a credit rating aligned to the bank's long-term credit rating (LTCR). Senior unsecured debt obligations are directly related to the overall credit risk of the bank, therefore we assess that the likelihood of default of any senior unsecured obligation is equal to a default of the bank.

However, with the incorporation of resolution mechanisms, when a bank approaches default, the balance sheet becomes tranched following the different characteristics of the obligations with or without loss absorption capacities or under the 'bail-in' structure and those that are not falling under the 'bail-in' structure. Therefore, in order to differentiate further the credit rating of senior unsecured debt obligation, Dagong will require to have detailed information of the resolution measure applied and consequently the instruments that will be absorbed as part of the action (e.g TLAC/MREL/senior-non preferred), allowing the bank to leave untouched the senior unsecured tranches. The general approach would be that senior unsecured debt obligations that are subject to bail-in would be notched down from senior unsecured debt obligations in cases the level of CET1, AT1, T2 and other subordinated debt available subject to bail-in is limited and could be highly likely to be triggered. In cases in which the buffer for bail-in is large enough to prevent any absorption of senior unsecured debt obligations, a notching differentiation between senior non-preferred and senior unsecured would be less likely.

In specific cases in which information on detailed balance sheet break-up for liabilities and assets is available in scenarios of financial distress, Dagong could assign LTCR to senior unsecured obligations that are above or below the LTCR of the bank. In cases in which we see that the balance sheet has a high encumbrance of assets, or there is depositors' preference, the probability that the credit rating of the senior unsecured debt obligations will be lower than the LTCR of the bank is high.

VI.5.2 Subordinated Debt Obligations

The base credit rating for subordinated and hybrid securities is in most cases the bank's IFSA because we see that additional support mechanisms, as well as the implementation of resolution regimes that promote burden sharing cannot be relied upon to extend to a bank's subordinated debt. However, in particular cases for certain jurisdictions where the probability of external support is likely to be high or very high (e.g. state ownership or guarantees, development or policy banks and/or high systemic importance), the security rating will be notched down from an issuer's LTCR.

The guidelines discussed above apply to traditional debt structures within a financial institution. However, Dagong notes increasing use of asset-backed instruments and higher collateralisation (so called 'asset encumbrance'). Asset encumbrance has benefits for investors in asset backed debt, but can have adverse implications for investors of unsecured debt (e.g. given structural subordination, lower recovery rates). For entities where asset encumbrance provides a certain level of threat to creditors of unsecured debt, Dagong increases the notching of subordinated debt described above.

VI.5.3 Hybrid, Convertible Debt Obligations

To evaluate the scope of debt- or equity-like character of any hybrid issuance, Dagong focuses on the timing and cumulative versus non-cumulative character of coupon suspension, the structural ranking of the hybrid security and its maturity. The proportion of equity versus debt recognised by Dagong within an issuer's capital structure is assessed on case-by-case basis, depending on the structure of the specific security and it is evaluated for stress test purposes only.

In general, high equity proportion is recognised for deeply subordinated hybrid securities that represent the most junior instrument in the issuer's capital structure, including strongly protective and non-cumulative coupon suspension conditions, 'can't default' or cross default other debt, and long (if any) maturity. Hybrid securities with weak loss absorption features, higher priority of claim in liquidation or short maturity (generally less than 30 years) would be treated as debt-like instruments with low or no equity proportion assigned.

Dagong might, however, limit the equity content of hybrid securities to the overall capital structure in cases when the equity proportion represents a larger share of the overall issuer's equity. Therefore, ratings of any hybrid security are assessed on case-by-case basis and, in general, notched down from the IFSA. Securities with high equity proportion tend to be subject to higher notching difference, compared to debt-like cases.

The notching differential is based on Dagong's assessment of the specific debt instrument, detailed below:

Subordination	**Regulatory Treatment**	**Coupon Skip Mechanism (Self-imposed or by the regulator)**	**Notching from IFSA**
Pain Vanilla Subordinated Debt	Lower Tier 2 or Tier 2	None	-1 to -2
Hybrid Subordinated	Tier 2 and Tier 3	Mandatory, cumulative;	-1 to -2
Junior Subordinated Debt	Upper Tier 2	Optional / mandatory, cumulative;	-1 to -3
Contractual Non Viability-Subordinated Debt	Tier 2	None	-1 to -3
Dated, Junior Subordinated Debt with Principal Write Down	Upper Tier 2	Optional / mandatory, cumulative;	-1 to -3
Contractual Non Viability-Preferred Stock	AT1	Optional / Non-cumulative	-2 to -3
Preferred Stock	Tier 1	Optional / mandatory, cumulative/non-cumulative;	-2 to -4

For financial institutions with IFSA equal to or higher than 'bbb-', cumulative coupon suspension and weaker triggers (e.g. balance sheet loss, or restricted deferral option), a less conservative notching than indicated could be applied.

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