

STANDARD  
&POOR'S

# New Zealand Relative Strength Ratings For The Finance Industry

Criteria Brief

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This brief seeks to lay out the general criteria that Standard & Poor's uses in its analysis of *New Zealand Relative Strength Ratings*.



# Index

<b>1. New Zealand Relative Strength Ratings.....</b>	<b>3</b>
<b>1.1 Ratings definitions .....</b>	<b>3</b>
<b>1.2 Measurement of probability of default.....</b>	<b>5</b>
<b>1.3 CreditWatch .....</b>	<b>5</b>
<b>2. Rating Criteria and Methodology .....</b>	<b>6</b>
<b>2.1 Business risk profile analysis6</b>	
(a) Market position .....	6
(b) Diversification/Concentration.....	6
(c) Management and strategy.....	6
<b>2.2 Financial risk profile analysis .....</b>	<b>9</b>
(a) Credit risk.....	9
(b) Market risk.....	9
(c) Funding/Liquidity risk.....	9
(d) Earnings.....	10
(e) Capital and financial flexibility.....	10
<b>2.3 Finance industry, country, and regulatory risk .....</b>	<b>10</b>
<b>2.4 Enterprise risk management.....</b>	<b>10</b>
a) Risk governance.....	11
(i) Culture .....	12
(ii) Risk appetite.....	12
(iii) Risk aggregation and quantification .....	12
(iv) Risk reporting and disclosure .....	12
(b) Credit risk management.....	12
(i) Underwriting process and portfolio management .....	12
(ii) Credit risk analytics .....	13
(iii) Loan/Asset administration .....	13
(c) Funding and liquidity risk management.....	16
(d) Operational risk management.....	16
(i) Definition and categorization of operational risk.....	16
(ii) Measurement and reporting of operational risk.....	17
(e) Market risk management .....	17
(i) Asset-Liability management/Interest rate risk .....	18
(ii) Trading risk .....	18
<b>3. Surveillance .....</b>	<b>18</b>

# 1. New Zealand Relative Strength Ratings

A Standard & Poor's *New Zealand Relative Strength Rating* for a finance entity is a current opinion of the overall creditworthiness of an entity over a two-year period, and is a relative measure of risk compared with other nonbank New Zealand finance entities.

*New Zealand Relative Strength Ratings* are measures of probability of default at the enterprise level, and are based on a holistic analysis of risk management; and financial and business profile attributes.

Like Standard & Poor's other credit ratings, *New Zealand Relative Strength Ratings* are not market ratings. That is, they are not buy, sell, or hold recommendations for any debt or equity security, and do not take into account yield, price, other market factors, or suitability for a particular investor. Ratings are based on current information furnished by the entity or obtained by Standard & Poor's from other sources it considers reliable. Standard & Poor's does not perform an audit and may, on occasion, rely on

unaudited financial information. Ratings may be changed, suspended, or withdrawn as a result of or the unavailability of such information, or based on other circumstances.

A Standard & Poor's *New Zealand Relative Strength Rating* should not be taken as an indication of any expected loss that may occur as a result of default of the entity ('expected loss' is commonly defined as the product of probability of default multiplied by loss given default). It is, therefore, important that investors and financial advisors form their own views of the likely recovery amount in the event of a default by the entity. The amount recovered on an investment will depend upon a number of factors, including but not limited to, the seniority level of the investment, the security, or collateral supporting the investment.

Ratings apply to the entities that Standard & Poor's has rated and not to any debt issues of the rated entity.

## 1.1 Ratings definitions

In conjunction with the preceding subsection, the specific ratings definitions are shown in the table below (see Table 1):

A Standard & Poor's *New Zealand Relative Strength Rating* for a finance entity is a current opinion of the overall creditworthiness of an entity over a two-year period and is a relative measure of risk compared with other New Zealand nonbank finance entities. The New Zealand nonbank finance sector has significantly higher risk attributes than those of the New Zealand banking sector, and as a consequence, is likely to exhibit greater volatility and default experience.

*New Zealand Relative Strength Ratings* are measures of probability of default at the enterprise level, and are based on a holistic analysis of risk management; and financial and business profile attributes.

**Table 1—Specific Ratings Definitions of *New Zealand Relative Strength Ratings***

<b>nzf1+</b>	An entity rated 'nzf1+' has EXTREMELY STRONG capacity to meet financial commitments relative to other New Zealand finance entities. 'nzf1+' is the highest risk rating assigned on Standard & Poor's <i>New Zealand Relative Strength Ratings</i> scale. Entities rated at this level are less susceptible to the adverse effects of changes in circumstances and economic conditions.
<b>nzf1</b>	An entity rated 'nzf1' has VERY STRONG capacity to meet financial commitments relative to other New Zealand finance entities. Entities rated at this level are less susceptible to the adverse effects of changes in circumstances and economic conditions.
<b>nzf2</b>	An entity rated 'nzf2' has STRONG capacity to meet its financial commitments relative to that of other New Zealand finance entities. However, the entity is somewhat more susceptible to the adverse effects of changes in circumstances and economic conditions than higher rated entities.
<b>nzf3</b>	An entity rated 'nzf3' has REASONABLY STRONG capacity to meet its financial commitments relative to that of other New Zealand finance entities. However, the entity is more susceptible to the adverse effects of changes in circumstances and economic conditions than higher rated entities.
<b>nzf4</b> <b>nzf5</b>	An entity rated 'nzf4' or 'nzf5' has ADEQUATE capacity to meet its financial commitments relative to that of other New Zealand finance entities. However, adverse economic conditions or changing circumstances are more likely to lead to a weakened capacity of the entity to meet its financial commitments.
<b>nzf6</b>	An entity rated 'nzf6' has REASONABLY ADEQUATE capacity to meet its financial commitments relative to that of other New Zealand finance entities. However, adverse economic conditions or changing circumstances are more likely to lead to a somewhat weakened capacity of the entity to meet its financial commitments.
<b>nzf7</b>	An entity rated 'nzf7' has REASONABLY WEAK capacity to meet financial commitments, although is less vulnerable than lower-rated New Zealand finance entities. However it faces ongoing uncertainties or exposure to adverse business, financial, or economic conditions, which could result in an inadequate capacity on the part of the entity to meet its financial commitments.
<b>nzf8</b>	An entity rated 'nzf8' has WEAK capacity to meet its financial commitments relative to that of other New Zealand finance entities. Adverse business, financial, or economic conditions will likely impair the entity's capacity or willingness to meet its financial commitments.
<b>nzf9</b>	An entity rated 'nzf9' is HIGHLY VULNERABLE to defaulting and is dependent upon favorable business and financial conditions to meet financial commitments.
<b>D</b>	An entity rated 'D' has either failed to pay one or more of its financial obligations when due, or it has been placed into receivership.

## 1.2 Measurement of probability of default

Standard & Poor's estimates that the corresponding median probability of default, over a two-year period, for each of the ratings is as follows:

**Table 2—Estimated corresponding range of probability of default over a two-year period**

<b>nzf1+</b>	0.05%-0.7%
<b>nzf1</b>	0.7%-1%
<b>nzf2</b>	1%-2%
<b>nzf3</b>	2%-3%
<b>nzf4</b>	3%-5%
<b>nzf5</b>	5%-10%
<b>nzf6</b>	10%-15%
<b>nzf7</b>	15%-20%
<b>nzf8</b>	20%-25%
<b>nzf9</b>	25%-40%

The above is derived from, but does not precisely reproduce, Standard & Poor's historical global pool of rated issuers for the period 1981 to 2005 inclusive. Users should be cautioned that past performance of default rates is no assurance of future performance and that actual performance of entities rated under the *New Zealand Relative Strength Ratings* could be substantially different from that shown above.

Because the estimated range for the probability of default is based on all industries globally, investors and financial advisors need to consider whether the New Zealand finance industry has a risk profile different from this. The different ranges of probability of default shown above are taken from the averages for the period 1981 to 2005 inclusive. This means that investors need to also consider the current economic cycle, as the probabilities of default may increase or decrease throughout the cycle.

## 1.3 CreditWatch

Standard & Poor's may place a rating on CreditWatch. A CreditWatch is defined as follows:

CreditWatch highlights the potential direction of a rating. It focuses on identifiable events and short-term trends that cause ratings to be placed under special surveillance by Standard & Poor's analytical staff. These may include mergers, recapitalizations, voter referendums, regulatory action, or anticipated operating developments. Ratings appear on CreditWatch when such an event or a deviation from an expected trend occurs and additional information is necessary to evaluate the current rating. A listing, however, does not mean a rating change is inevitable. CreditWatch is not intended to include all ratings under review, and rating changes may occur without the ratings having first appeared on CreditWatch. The "positive" designation means that a rating may be raised; "negative" means a rating may be lowered; and "developing" means that a rating may be raised, lowered, or affirmed.

Standard & Poor's will place a rating on CreditWatch if it is determined that there is at least a one-in-two likelihood of a rating change within 90 days. From time to time, there may be events that present such significant uncertainty to an entity's credit profile that a rating is placed on CreditWatch without the need to assess this threshold of potential change. It is important to reiterate that rating changes can occur without the entity appearing beforehand on CreditWatch. Whenever possible, Standard & Poor's communicates with an entity in advance of making a decision to place a rating on CreditWatch. However, once a decision has been made, an entity cannot appeal a CreditWatch listing. Absence of a CreditWatch listing on a rating indicates that the rating is unlikely to be changed in the near term.

## 2. Rating Criteria and Methodology

Credit analysis of a finance entity includes a wide range of quantifiable and qualitative factors. Standard & Poor's does not necessarily assign a fixed weight in evaluating each factor. This approach recognizes that the risk represented by any rating factor may vary depending on the circumstances. At times, a rating decision may be influenced strongly by financial measures. At other times, risk management or business risk factors may dominate. To the extent that a firm is strong in one respect and weak in another, the rating takes into consideration the different factors.

The *New Zealand Relative Strength Ratings* analytical approach encompasses four broad components:

- 1) Business risk profile;
- 2) Financial risk profile;
- 3) Finance industry and country risk; and
- 4) Enterprise risk management assessment.

It should be noted that the analytical approach used for Relative Strength Ratings is based upon Standard & Poor's criteria, which are used globally for any financial institution. Nevertheless, the enterprise risk management component has been specially incorporated for the specific characteristics of New Zealand's finance entities.

### 2.1 Business risk profile analysis

Standard & Poor's will assess and categorize the following business risk rating factors as 'extremely strong', 'very strong', 'strong', 'reasonably strong', 'reasonably adequate', 'adequate', 'reasonably weak', 'weak', or 'highly vulnerable', as a relative measure of risk compared with other New Zealand finance entities:

#### ***(a) Market position.***

Key aspects include the entity's market shares in key businesses and the size of those markets; real advantages stemming from the entity's market position (e.g., pricing power, funding base, quality of business, etc.); and vulnerability of market position.

#### ***(b) Diversification/Concentration.***

Diversification includes the diversity of products/business lines/customer base, geographical spread of the entity's business base, economic diversity of the entity's home market(s), quality and type of collateral supporting the loan book, and the size and extent of international diversification which adds real franchise value. Concentration includes the size and number of large counterparty loans, related party loans, concentration of liquid funds held with third parties, large individual depositors, and concentration of broker-introduced business.

#### ***(c) Management and strategy.***

In determining any rating, the past is important only as an indicator of the future. While many entities furnish forecasts of expected levels of profitability and capitalization, face-to-face discussions with senior management are even more valuable. These discussions cover economic conditions; the current and expected regulatory and competitive environments; and future diversification and acquisitions. The review also includes a discussion of the extent to which profitability levels will be maintained and how required capital and liquidity levels will be financed. Management's philosophy in each of these areas is covered.

As a subset of this area, Standard & Poor's will internally use qualitative descriptors of 'Excellent', 'Strong', 'Adequate', and 'Weak' to describe aspects of an entity's management and organization (see Table 3):



**Table 3 - Factors Considered In Evaluating Management And Strategy**

<b>Staff</b>	Management and staff experience, both within the industry and tenure within the entity, provides a “depth of knowledge” measurement of generally accepted industry procedures, regulations, and efficiencies in performing servicing activities. As a general guide, Standard & Poor’s believes that management should have at least seven to 10 years of industry experience, and that the overall staff should average at least three to five years of industry experience.
<b>Structure</b>	Operational structures should be designed to support the organization’s growth and continuation, segregation of duties, and monitor all aspects of performance. Levels of independent internal and external reviews, meetings, and analysis of performance and compliance best address the overall monitoring of the organization. Depending on the entity’s activity, a combination of transactional and functional departments - e.g. payment processing versus asset/portfolio analysis - usually results in lower per-loan costs. Outsourcing activities and certain functional-based activities also may result in lower costs, and may provide a level of experience not available within the organization.
<b>Training</b>	Training is also a key indicator of an entity’s commitment to improving staff knowledge of institutional procedures, industry techniques, and regulatory requirements. The method and level of training depends on two factors: the size of the institution (based on number of employees) and the level of industry experience. Smaller entities will often have less formal classroom-type instruction, while more experienced staff will have less of a need for “basic” types of courses. As a general rule, Standard & Poor’s expects a minimum of 20 hours per year per employee to be allocated toward mortgage banking education.
<b>Turnover</b>	Employee turnover is also an indicative measure of the stability and general management of an institution. High turnover is detrimental to performance efficiency and profitability, while excessively low turnover can indicate other issues. Turnover is generally higher for residential mortgage and other consumer product servicing than for commercial servicing. Standard & Poor’s has found average turnover ratios for residential/consumer servicing to range between 15% and 25%, while average levels for commercial products range between 5% and 10%. Standard & Poor’s defines the turnover rate as the total number of separations divided by the monthly average of employees at the end of each reporting period. Separations include all resignations, terminations, transfers to other departments/divisions outside of servicing operations, and retirements.
<b>Systems</b>	<p>This involves an analysis of how an institution utilizes automation in addressing its operating functions. Often, due to limitations within any one single system, an institution will employ ancillary systems/databases to support other functions.. A review of how effectively and efficiently the various systems are integrated to avoid manual re-handling of data is addressed. The system controls and administration of security functions within each system are also reviewed.</p> <p>An entity’s disaster recovery and business continuity plans are also evaluated as components of an entity’s technology. Standard &amp; Poor’s requires an entity to have documented procedures that are readily accessible to all staff, hot sites to resume computer operations, and alternate work location(s) to support business continuity with a minimum staff level necessary to process daily transactions on an interim basis. The alternate site location arrangement should be capable of maintaining operations for a minimum of several days to several weeks while the institution’s main facility is being repaired, or alternative long-term arrangements are being made. The plan should outline timelines for which each business function would be recovered. Ideally, the alternative system hot site and the business recovery site should be at least 25 miles away from an institution’s main servicing location to ensure adequate power and minimize inaccessibility or transportation disruptions. Both the system recovery and business continuity plans must be tested at least annually to ensure workability. The ‘Adequate’ entity must be able to recover the most time sensitive and critical functions within 48 hours (preferably within 24 hours) of the disaster event. Resumption of all key functions should be in place within three to five days of the disaster event.</p>

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**Internal controls** Standard & Poor's review of internal controls covers an entity's policy and procedures manual(s), the work performed by its internal operational audit department, including a review of audit reports, any independent self-monitoring quality control type programs, and a review of external audits.

**a) Procedure manuals**

Policy and procedure manual(s) should combine written statements of policy, detailed instructions on how to perform a particular task's procedures, and reference/exhibit forms or computer input screens used to accomplish the task at hand. Standard & Poor's analysts review the material for:

- Clarity of content, ease of understanding, and consistency of structure;
- Completeness in describing an operation and/or procedure; and
- Compliance with, and explanation of, regulatory/industry standards and requirements.

Standard & Poor's has found well-structured manuals to be a good source of training material for education and cross

straining of staff, and add to employee competence. Manuals can be in either paper or electronic form, with the latter being preferable due to ease of update and speed of dissemination. The institution should also have a stated policy and procedure for updating its manuals.

**b) Audit**

Internal audit, self-monitoring, and external audit programs and reports are reviewed for breadth and frequency of areas being audited, completeness of resulting reports, summary of findings, and management's response to proposed corrections. High credit-risk areas (cash, investor reporting, and default management) should be conducted within an 18-month frequency.

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**Additional items** Additional items include a review of an entity's adherence to industry standard insurance coverage for director and officer (D&O) policies, and errors and omissions (E&O) coverage.

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If an entity is a member of a larger group, Standard & Poor's will briefly analyze any parent or subsidiary operation to determine whether it adds to or detracts from the financial strength of the entity. In some instances, being part of a larger group can have advantages. Standard & Poor's attempts to determine whether the group is willing or legally capable of supporting the entity, if necessary. At the same time, if the other group members are weaker than the entity, it must be determined to what extent income may be diverted to less profitable group members or loans may be made to group members or related parties on an uneconomic basis, to the detriment of the entity's financial condition.

Standard & Poor's closely examines the accounting principles applied and the underlying assumptions utilized by an entity. The aim of this analysis is to determine its impact on measures used in the more quantitative aspects of the rating analysis, such as asset quality, profitability, liquidity, and capitalization, as well as qualitative aspects such as management, including its financial policy and internal information systems. Standard & Poor's analysis of accounting incorporates a study of the impact of national accounting principles and practices, which vary widely from country to country. Where appropriate, adjustments are made to financial statements to arrive at a more faithful representation of credit measures and improve comparability.



## 2.2 Financial risk profile analysis

Standard & Poor's will assess and categorize the following financial risk rating factors as 'extremely strong', 'very strong', 'strong', 'reasonably strong', 'reasonably adequate', 'adequate', 'reasonably weak', 'weak', or 'highly vulnerable', as a relative measure of risk compared with other New Zealand finance entities:

### **(a) Credit risk.**

A discussion of credit risk encompasses the entire spectrum of an entity's assets, including loans, debt securities, equity investments, and on and off-balance sheet counterparty exposures. The primary areas of concern are diversification and risk. Broadly speaking, Standard & Poor's analyses the entity's total credit exposure through breakdowns by geography, collateral, maturity, industry sector, and types of borrower (consumer, commercial, corporate, entity, or government). Standard & Poor's works with the entity's own internal information and reports, in order to understand how the entity manages credit risk and the loan portfolio.

Concentration of risk is an important factor when reviewing the loan portfolio. Where there is concentration of a significant portion of assets, a request for additional information would be made, along with the rationale as to the entity's reason for concentration. To gauge the importance of individual borrowers, Standard & Poor's will review the entity's largest credit exposures.

The history of arrears, impaired assets, nonperforming assets, loan losses, and provisions is of extreme importance. In assessing the true level of problematic assets and adequacy of provisions, Standard & Poor's looks beyond the regulatory or entity's definitions of problem loans to determine the level of assets on or off the entity's balance sheet that the entity is exposed to,

and assesses the appropriateness of the methodologies that the entity uses to determine its provision levels.

Standard & Poor's will review the reasons and extent of any rewritten or restructured loans, and the entity's internal risk grading trends to determine the extent to which the quality of the lending book is changing.

Credit risk also takes into account how effectively an entity manages its growth.

### **(b) Market risk.**

Standard & Poor's examines in detail the level of market risk over the entire range of a financial entity's activities, whether on- or off-balance sheet, for example, in its asset and liability structure, trading activities, securities underwriting business, etc. The analysis of an entity's asset and liability mix includes an assessment of both external and internal factors affecting interest, maturity, and currency matching. The entity's general philosophy of asset and liability management and the systems for monitoring exposures are then discussed.

### **(c) Funding/Liquidity risk.**

The analysis of liquidity focuses on both the nature and sources of an entity's funds, as well as the character of the entity's assets. Retail deposit-funded entities, with a large and diversified customer base offering a variety of deposit products, contrast with wholesale entities, which access their funds from the capital markets. Both types of entities are examined in terms of the stability of their sources of funds, as well as the maturity structure of liabilities, and assessed as to their ability to meet obligations as they come due. The liquidity review also focuses on the ability to turn assets into cash, either through the natural maturation of the assets or sale in liquid markets, which is another important dimension of an entity being able to meet its obligations.

#### ***(d) Earnings.***

In assessing profitability, key considerations are the spread of income between interest and noninterest income, earnings levels, timing of recognition of income and expenses, trends, quality, and stability—that is, the long-term, core earnings power of an entity. Standard & Poor's computes the ratio of earnings according to various definitions: operating, pretax, net income, etc., to average total assets, earning assets, and risk-adjusted assets. Additionally, net interest and net income margins are examined as measures of efficiency. Reasons for performance in specific periods are analyzed and discussed, and a determination is made as to whether historical results are an accurate indicator of future performance. These same ratios are, with appropriate accounting adjustments, compared with those of entities of similar size and type in other countries.

Loan loss practices differ; thus, the loan loss provision may sometimes be considered a discretionary item, as opposed to an actual operating expense. Specific provisions are usually treated differently from general provisions. Specific tax treatment may also have a major impact on "bottom-line" net income.

#### ***(e) Capital and financial flexibility.***

While it is important that an entity meets the capital requirements of its regulators, Standard & Poor's looks at an entity's capital structure in a broad context, including the types and components of capital. The judgment of capital adequacy is also greatly influenced by the perception of relative profitability, risk profile, and asset quality.

Standard & Poor's also looks at the group structure, if any, to assess the reliance on, or support from parent and subsidiary entities, including any contractual relationship.

## **2.3 Finance industry, country, and regulatory risk**

The environment in which an entity operates is key to understanding the individual entity's operations. Experience shows that even the best entity in a country may undergo severe stress if the country in which it operates suffers a painful economic slowdown or recession, and the finance system's health declines substantially. This is true in mature as well as less developed markets.

Industry risk contains many elements, and for any system there will be both positive and negative factors. Standard & Poor's gauges the dynamics of the financial service industry and to what extent those dynamics lead to more or less risk from the debt-holder's or counterparty's point of view.

The New Zealand nonbank finance sector has significantly higher concentration risk attributes, typically narrow business lines, higher credit risks, narrower funding products, and comprises smaller organizations than registered banks. As a consequence, it is likely to exhibit greater volatility and higher default experience.

Regulatory changes can have positive or negative impacts on entities. Standard & Poor's considers the impact of any regulatory changes on the entity and participants in the industry, such as loan brokers and financial advisors; and on borrower or investor habits that may occur as a result of such changes.

## **2.4 Enterprise risk management assessment**

Standard & Poor's evaluates five key components of enterprise risk management (ERM) namely (i) risk governance; (ii) credit risk; (iii) funding and liquidity; (iv) operational risk; and (v) market risk.

Qualitative descriptors of 'Excellent', 'Strong', 'Adequate', and 'Weak' [NA3] are used to describe an entity's overall ERM practices compared with other New Zealand finance entities. The broad characteristics of these evaluations are given below:

#### **a) Risk governance.**

In respect of risk governance, Standard & Poor's assesses the entity's (i) risk culture; (ii) risk appetite; (iii) risk quantification and aggregation; and (iv) risk reporting and disclosure.

**Table 4 Factors Considered In Enterprise Risk Management Assessment**

<b>Descriptor</b>	<b>Characteristics</b>
<b>Excellent</b>	Excellent ERM practices share all the criteria for structures considered Strong, but are more advanced in their development, implementation, and execution effectiveness. An entity with Excellent ERM practice will have developed its processes more fully over time, may have implemented it throughout a higher percentage of its group, and/or may be executing the process more effectively. Excellent ERM practices are more likely to have a positive impact on an entity's ratings.
<b>Strong</b>	Entities with Strong ERM practices would have exceeded the Adequate criteria for risk control and have a vision of their overall risk appetite and tolerances. There would be a sound risk governance process with a well-established operational risk structure that is tied to the risk-adjusted returns for the various alternatives, and a goal for optimizing risk-adjusted returns. In addition, Strong programs would have robust processes to identify and prepare for emerging risks. Standard & Poor's expects the ERM practices of such entities to be a strategic and competitive advantage over time. The process of selecting choices that have the best risk-adjusted returns should result in lower losses per unit of income over time, allowing such institutions to choose between offering lower prices, retaining higher capital, and obtaining funding at a lower net cost than competitors without such a strategic ERM practice.
<b>Adequate</b>	Adequate ERM practices have fully functioning risk control systems in place for all major risks. The risk management process in entities with Adequate ERM practices is solid, conservative, and has established governance structures, although primarily silo-based. However, these entities often lack a clear and holistic vision of their overall risk appetite. Risk limits for various risks have usually been set independently, and systems for each risk element usually function completely separately, without significant coordination across silos of its risks. Entities with Adequate ERM practices also lack a robust process for identifying and preparing for emerging risks. Since neither cross-risk views nor overall risk tolerances exist, no process to optimize risk-adjusted return is present either. Standard & Poor's does not expect these entities to experience any unusual losses outside of their separate risk tolerances unless a rapid, major change occurs in the environment related to one or more of their major risks. Entities can also have Adequate ERM practices if they have developed a cross-risk view, and an overall risk tolerance that uses risk-return considerations for its business decisions and have a process for envisioning the next important emerging risk, but do not have fully developed controls. Standard & Poor's does not view Adequate ERM practices as a negative factor in the ratings process.
<b>Weak</b>	Entities with Weak ERM practices cannot consistently control all of their major risks. Control processes are incomplete and these entities have limited ability to fully identify, measure, or manage major risk exposures. Weak ERM practices may have an adverse effect on the ratings of the entities.

**(i) Culture**

In assessing the risk culture of an institution, Standard & Poor's evaluates the stature of the risk function within the organization and its role and relationship with the business units.

**(ii) Risk appetite**

Standard & Poor's assesses how the risk appetite at the aggregate level is established for the firm and the role that risk management plays; whether it is consistent with the entity's business strategy and how the entity translates that appetite into a tangible quantitative metric.

**(iii) Risk aggregation and quantification**

Standard & Poor's assesses if, and how an institution employs metrics at a firmwide level to understand the aggregate exposure to the firm. Do these metrics capture nonfinancial risks as well? How are these firmwide risk measures established, and what is the level and quality of the interactions between risk management, the board, and the business in establishing these metrics? Is the firm in a position to monitor and aggregate risks across the organization? Can risk management describe in a coherent manner how this process works and whose responsibility is it to aggregate risks across the various business lines? Is risk adequately controlled in smaller/remote offices?

**(iv) Risk reporting and disclosure**

Standard & Poor's assesses how well informed are senior management and the board of the financial and nonfinancial risks. How often does the risk committee of the board meet to discuss the risks? Who participates in these meetings and how involved is the board in understanding the ERM initiatives within the organization? How frequently are internal audits of the risk management function conducted and what is the process for resolution? Administratively, what is the reporting structure of the audit function?

***(b) Credit risk management.***

The process of credit risk management includes (i) approval/underwriting process and portfolio management; (ii) credit risk analytics; and (iii) loan and asset administration.

**(i) Underwriting process and portfolio management**

In assessing the underwriting process, Standard & Poor's evaluates the clarity of an entity's underwriting policies and the process for establishing the relative risk appetite. Is there an adequate degree of segregation between origination and underwriting staff/processes? What are the criteria and internal approval structures that the entity has adopted in the delegation of its underwriting processes? What is the structure of on- and off-balance sheet exposures? What is the process for monitoring outstanding exposures for early warning signals of potential problems? What is the level of diversity in the portfolios (by geography, collateral, maturity, borrower type, etc) and what is the tolerance for large exposures to individual names and/or sectors and the process for collections and recoveries?

Factors that are viewed as favorable to the assessments would be where entities:

- Have well-articulated policies governing types of exposure they are willing to accept, with effective procedures to ensure that underwriting criteria/processes are consistent with that policy. Underwriting policies and processes would be reviewed on a periodic basis to ensure that during times of low yield, standards are not compromised. Recalibration of underwriting standards to historical experiences would be undertaken;
- Have clearly documented criteria that establish the delegation of the underwriting processes throughout the organization. They would allow for sufficient detail by product type and customer groups; and

- Establish clear guidelines that tie in with the entity's broader credit strategy on the monitoring of its exposures. The delegation of the monitoring and reporting of exposures would be well articulated within the organization.

Factors that are viewed as less favorable to the assessments would be where entities:

- Have inadequate policies governing the types of exposures they are willing to accept;
- Compromise on underwriting policies during times of low yield, with minimal to no recalibration of underwriting standards to historical experiences;
- Lack clear criteria for the delegation of the underwriting processes within the organization; and
- Lack clear guidelines for monitoring and reporting of its exposures.

## (ii) Credit risk analytics

Standard & Poor's assesses the quality of an entity's ability to quantify its credit exposures on a stand-alone basis as well as on a portfolio basis. Is there a strategic view to credit risk management? Does the entity have a global credit exposure management system?

To what extent does the entity use internal credit rating and scoring applications, and/or behavioral systems in its pricing decisions? How does the entity gain comfort that it is not underpricing credit risk? To what extent has the entity stress tested these parameters?

Factors that are viewed as favorable to the assessments would be where entities:

- Have the technical infrastructure to quantify their credit exposure on a single-name basis as well as on a portfolio basis. There would be a strong support from senior management to manage exposures based on portfolio analytics and quantitative methods;

- Have in place robust exposure management systems that are updated continuously so that exposure and pricing can be monitored in near real time;
- Have sound internal credit rating models built on well-tested behavioral assumptions. They would have robust and granular internal data warehousing and systems infrastructure to extract customer-related information and market rates on demand; and
- Are in a position to calculate several risk measures.

Factors that are viewed as less favorable to the assessments would be where entities:

- Have limited to no support from senior management that would encourage the use of advanced portfolio analytics and quantitative methods to manage their exposures;
- Lack the technical support and systems infrastructure to update and monitor exposures on a continuous basis. Most often exposure aggregations and monitoring would be conducted on a weekly basis;
- Have spotty to no internal data relating to defaults, losses, and other customer-related information;
- Employ rudimentary or crude risk measures to manage the credit exposure in their portfolios; and
- Lack a risk-based approach to capital allocation with no performance measurement metrics.

## (iii) Loan/Asset administration

The functions reviewed for the loan (or asset) administration ranking cover procedures employed after an asset's acquisition or loan's closing.

**Table 5 - Factors Considered In Evaluating Loan/Asset Administration**

**New loan setup** New loan setup involves establishing the loan record on the servicing system after funding, including controls for testing correctness of all data fields, appraising borrower information, and instructing the borrower on their responsibilities.

<b>New Loan Setup</b>	<b>'Adequate' Ranking Criteria</b>
Recorded on system	Within 48 hours of funding or purchase.
Cash control	Funding account reconciled daily to system's new loan report by different personnel.
Miscellaneous data fields	System error reports test principal and interest payment, term amortization, and missing, incomplete or erroneous data (i.e. tax and insurance) fields, reviewed by different personnel.
Borrower communication	System "Hello" letter for customer contact, confirmation of payment, and other loan information.

Manual boarding of new loan data to the servicing system is acceptable, however, at higher volume levels, automated boarding from file downloads are preferable

**Document tracking** Review procedures for document tracking. Check completeness of information (loan file tracking versus document tracking), vault security, and storage procedures. Effectiveness of system used for monitoring and follow-up of missing documents.

<b>Document Tracking</b>	<b>'Adequate' Ranking Criteria</b>
Post closing and documents area	Setup/reviews closing checklist.
File/Records department	Restricted access, crosschecks closing list to actual documents, and data input to tracking system for loan file location.
Document completion	Established written procedures for ordering/obtaining trailing documents, updating tracking system, and dual signoff controls. Respond to trustees/custodians for securing missing documents within prescribed timelines.

**Payment processing** Operations are tested to ensure separation of duties, appropriate controls regarding the movement of funds, timely reconciliation of balances, and explanation/resolution of suspense items. Adequate cash controls and procedures for handling live checks, secured in a fireproof and controlled access area, are tested.

A lockbox vendor should be used at higher volume levels (usually 10,000 accounts for residential institutions and 1,000 accounts for commercial institutions), with electronic file uploads to the servicing system. Funds transfers between the payment clearing, investor custodial, and general ledger accounts are balanced and reconciled daily. Suspense/reconciling items should not be older than 90 days.



<b>Property insurance</b>	The insurance function should provide collateral protection against fire, flood, earthquake, and terrorism[NA4], depending on collateral type; and maintain acceptable procedures for monitoring property insurance policies, coverage levels, and carrier ratings. This includes having force-placed coverage available through a carrier with an acceptable Standard & Poor's financial strength rating. Insurance policies should include adequate loss draft processing procedures to protect against loss of collateral value, and maintain acceptable escrow analysis and in-force (nonescrowed) procedures to ensure policies are current. Proper procedures are followed for advance and recovery of insurance disbursements for accounts with escrow shortages.
<b>Taxes</b>	The tax function, depending on collateral type, includes real estate and personal property taxes imposed by various state and municipal authorities. The institution must maintain acceptable procedures for ensuring non-encumbrance of collateral due to non-payment of those obligations. Servicing systems should handle advancing and recoveries.
<b>Investor reporting</b>	Maintain an investor reporting function that has proper segregation of duties among reporting, remittance, and reconciliation tasks. This includes proper bank account titling, appropriate investor reporting formats, payment remittances, separation of duties, and reviewing appropriate controls and reconciliation. Overlap of duties between reporting, remitting, and reconciling presents a risk of loss due to fraud. Reconciliation of investor bank accounts must be completed within 45 days of bank statement date, and signed by two individuals (prepared by and reviewed by). Unreconciled items should be resolved within 90 days. The institution should also have adequate procedures for reconciling unpaid principal balances to scheduled security balances.
<b>Customer service</b>	Maintain a dedicated and adequate customer service function with response times to customer needs that adhere to regulatory or industry standards.
<b>Advances</b>	Procedures for advancing and recovery of delinquent principal and interest (P&I), and tax and insurance (T&I) are reviewed. Procedure manuals should outline conditional tests, levels of required authorization for advances, and describe the recovery process. The servicing system should support automated advancing and recovery reporting; and detail tracking entries at the loan, investor, and general ledger levels.
<b>Early stage collections</b>	For accounts up to 30 days delinquent, institutions are expected to, at a minimum, generate late notices and attempt borrower telephone contact prior to the 30-day delinquency period. Delinquency levels for 30-, 60-, and 90-plus days should generally be in line with applicable industry averages.
<b>Asset/Borrower credit reviews</b>	These are critical and required at least annually, to support an 'Adequate' ranking in this area.
<b>Default management</b>	Covers the collection efforts on 30-plus day delinquents through the liquidation of collateral. The process and procedures utilized by the institution, and the results achieved, should be tailored for the particular assignment.

***(c) Funding and liquidity risk management.***

In assessing the quality of an institution's liquidity and funding practices, Standard & Poor's evaluates how well established and documented the funding policies are, and the extent to which the institution places a premium on maintaining diverse funding sources (by product, investor type, geography, etc).

actors that are viewed as favorable to the assessments would be where institutions:

- Maintain a diverse funding profile without over-reliance on any single product/source;
- Generate Asset-Liability Management Committee (ALCO[mma5] reports that include gap analysis and similar techniques to analyze the expected maturity profile of its assets and liabilities over future periods;
- Undertake extensive stress testing and/or contingency planning to demonstrate their ability to source sufficient liquidity to survive a reasonably modeled worst-case scenario; and
- Can demonstrate their ability to survive a reasonably modeled worst-case liquidity stress scenario without damaging their franchise.

Factors that are viewed as less favorable to the assessments would be where institutions:

- Would rely significantly on a couple of sources/products for their funding needs and would maintain inadequate documentation on funding policies;
- Would have undertaken limited stress testing and/or contingency planning to demonstrate their ability to source sufficient liquidity to survive a reasonable worst-case scenario; and
- Would lack the ability to adequately demonstrate their ability to survive a reasonable worst-case liquidity stress scenario without damaging their franchise.

***(d) Operational risk management.***

Standard & Poor's examines how an entity defines its operational risk, measures such risk, manages and reports such risk, and the quality of back office infrastructure and operations. The process has five key components: define (what is operational risk), measure (establish the risk indicators and relevant metrics), analyze (assess the results and whether decision making is facilitated), improve (entity iteratively improves the process through robust enhancements), and control (entity manages the process).

***(i) Definition and categorization of operational risk***

Factors that are viewed as favorable to the assessment would be where entities:

- Have a clear definition of what is categorized as operational risk;
- Would ensure that there is adequate education across the organization to ensure that there is a disciplined process toward establishing a consistent operational risk framework across the organization;
- Have granular mapping of loss events, in terms of their cause and impact. The institution would also be in a position to clearly articulate the cause and effect of legal/compliance liabilities and reputational liabilities across business lines; and
- Clearly highlight the key causes of an operational risk impact, and view the fact that any event could have a reputational impact (i.e., lead to foregone future income).

Factors that are viewed as less favorable to the assessments would be where institutions:

- Have a fuzzy definition of what is categorized as operational risk. The categorizations would not necessarily be consistent across business lines and would not be part of the broader ERM vision within the organization;

- Have inadequate support from senior management with very limited opportunity to educate personnel across the organization on what a consistent operational risk management framework would entail;
- Have a limited understanding toward assessing the impact of an event, with spotty mapping of loss events in terms of their cause and impact; and
- Are not in a position to coherently prioritize the operational risk.

#### **(ii) Measurement and reporting of operational risk**

In assessing how institutions measure and report on operational risk, Standard & Poor's looks at the process that the institution employs to collect operational risk loss data. Is this process consistent across business lines and does the institution use external/internal data or a combination of the two to measure and monitor its operational risks? Does the firm coordinate its efforts across business lines to capture and track event and risk indicator information? How does the institution classify its key risk indicator information? What is the quality of the operational risk reporting of the institution? Is there a heat-map process that exposes the risk profile of each of the business unit, and how is this used by senior management to manage the operational risk exposure of the institution and to improve the operational risk control processes?

Factors that are viewed as favorable to the assessments would be where institutions:

- Track operational loss data by business lines using parameters that are consistent across the organization. If institutions use external data in their analysis, measurement, and control of operational losses, it should be done with appropriate adjustments (i.e., external data sources may not be relevant to the institution in question and hence may need to be scaled or adjusted);

- Would coordinate its efforts across the organization in identifying and tracking predictive indicators and drivers of operational risk. There would be an effort to capture both qualitative and quantitative data on risk drivers; and
- With sound practices would have established a heat map or operational risk dashboard that highlights the operational risk exposure of each of the business units in a way that would provide for effective decision making by senior management.

Factors that are viewed as less favorable to the assessments would be where institutions:

- Tracked operational loss data for a limited number of business lines not necessarily consistently across the organization. There may be a substantial dependence on external data sources with minimal or no adjustments to reflect the institution's characteristics;
- Have allocated minimal resources and effort to capture both qualitative and quantitative data on risk drivers; and
- Have not established a heat map or operational risk dashboard that highlights the operational risk exposure of each of the business units in a way that would provide for effective decision making by senior management.

#### **(e) Market risk management.**

Standard & Poor's is interested in management's record of reacting to changing circumstances. An entity that takes an interest rate or currency position and maintains the exposure regardless of subsequent events, is viewed more negatively than one that quickly liquidates or closes open positions when markets move adversely. With respect to trading risk management, Standard & Poor's due diligence process involves reviewing with management its policies, practices, and organizational structure in all areas of risk management, as well as

an analysis of its results. In reviewing management policies and procedures, Standard & Poor's has found that most management teams are aware of what proper policies should be and will purport to have such policies in place. The real issue is how well and consistently these policies are practiced.

**(i) Asset-Liability management/Interest rate risk**

In assessing asset-liability management (ALM) or interest rate risk, Standard & Poor's evaluates an entity's assumptions made about the maturity structure of the balance sheet and how the firm models the duration and price sensitivity of the various classes of deposits with indeterminate maturities and/or administered pricing.

**(ii) Trading risk**

In assessing the quality of market risk management, Standard & Poor's looks at both trading risks and the process for managing interest rate exposure. For trading risk, Standard & Poor's assesses how the market risk tolerance for the firm is established. Is it consistent with the business strategy and is there a well-defined process for the approval of new products?

### **3. Surveillance**

*New Zealand Relative Strength Ratings* are, like all long-term ratings, subject to ongoing surveillance.

As such rated entities are required to advise Standard & Poor's of any material changes when they occur. Standard & Poor's position is that ongoing communication is required to assure quality and timeliness of the ratings.

Standard & Poor's will review interim and annual financial information, regulatory returns, and other key trends or statistics, and may re-evaluate a rating based on new information whenever such an action is warranted. A regular dialogue is maintained and each entity is subject to a formal review, including a meeting with management, at least annually.

On a monthly basis, rated entities will generally be required to provide the following financial metrics:

- \* Monthly liquidity positions (including amount of liquid assets held);
- \* Aggregate cash inflows and outflows:
  - Inflows, including debentures, deposits; draw down on bank loans and funding; and
  - Outflows, including loans and advances made, and dividends paid.
- Details of inter- or related-company transactions;
- Interest rate on borrowings (deposits/debentures) and interest charged on lending;
- Loan portfolio metrics:
  - Arrears (30 days, 30-59 days, 60 - 89 days, and 90 past due);
  - Movement in impaired loans (nonperforming, partly performing and restructured loans, and foreclosed assets); and
  - New large loan exposures (that fall with the top 10 exposures).
- Key financial information:
  - Summary profit and loss items;
  - Capital ratios; and
  - Relevant Trust Deed ratios.
- Details on any material changes:
  - Business activities (acquisitions/divestments);
  - Ownership profile; and
  - Key personnel.
- Notification of any regulatory action or investigation.

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