

The imprint of Kingdom's economic transformation on banks' rating methodology design

How Vision 2030 and lower oil revenues necessitate wearing a finer lens when evaluating banking sector risk



The banking sector outlook in the Kingdom of Saudi Arabia (KSA) continues to be heavily influenced by crude oil fundamentals. However, as of late, Vision 2030 initiatives centering on digital innovation, economic diversification, and enabling the FinTech ecosystem have meant that banks take the center stage in orchestrating these developments as financial intermediary.

Axial Consulting's bank rating methodology for the KSA banking sector has been designed incorporating these essential themes. Axial's holistic approach to the methodology process is cognizant of the fact that banking institution performance and risk cannot be evaluated in silos.

That is why Axial's methodology stands apart from convention and is relevant to the KSA economy we see today. Additionally, and most importantly, our methodology incorporates overarching themes which essentially define the banking institution as a mobilizer of loans and deposits.

Skeletal Description of the Methodology

The methodology design is based on the assessment of credit risk from both a qualitative and quantitative perspective. To execute this design intent, our methodology has been split into a two-part process; the first part involves assessing the institution's credit risk with an end objective of assigning a Foundational (or base) Credit Rating (FCR) while the second part features an assessment of the level and probability of credit support provided by a parent or the State: Affiliate Support Rating (ASR). The latter process is a fundamental component

in the assessment of financial institutions given their dealings with public money and serves to notch the FCR with the direction and magnitude contingent on the strength of affiliate support.

To explain how Axial derives the FCR and ASR, our methodology identifies five major themes, which serve to define the broad forces influencing bank ratings. Each theme, in turn, hosts a combination of qualitative and quantitative factors. It is these factors which provide the context to the associated theme and directly contribute to the generation of the credit rating. We've created a total of 17 factors to facilitate the credit rating generation process.

Themes and Factors Outlay

Axial has identified the following critical themes: Macro economy and Industry Climate; Qualitative Factors; Business Risk; Financial Risk; and Affiliate/Parent Support Likelihood. The first four themes are classified under the FCR while the last theme, as its name suggests, is associated with the ASR.

Theme 1. Macro economy and Industry Climate

Here, Axial's factors dig deep into the competitive landscape of KSA's banking industry and evaluate the implication of the 66% cumulative market share on competitiveness. Additionally, Vision 2030's push for innovation and its impact on disrupting concentration is evaluated from a credit risk perspective. We also focus on whether the mandate driven Saudization

drive narrows the access to a diversified talent pool for each institution.

Theme 2. Qualitative Factors

Axial recognizes that as stewards of institutional activities and operations, the competence, skills, expertise, and integrity of a bank's management are imperative to credit risk analysis. Within this theme, we believe key person risk must never be disregarded. We also believe that the quality and strength of the corporate governance framework and degree of business complexity are important rating drivers.

Theme 3. Business Risk

The credit risk focus of this theme is on bank margins and their stability, the stability of cost structures with a special focus on loan provisions, and income diversification.

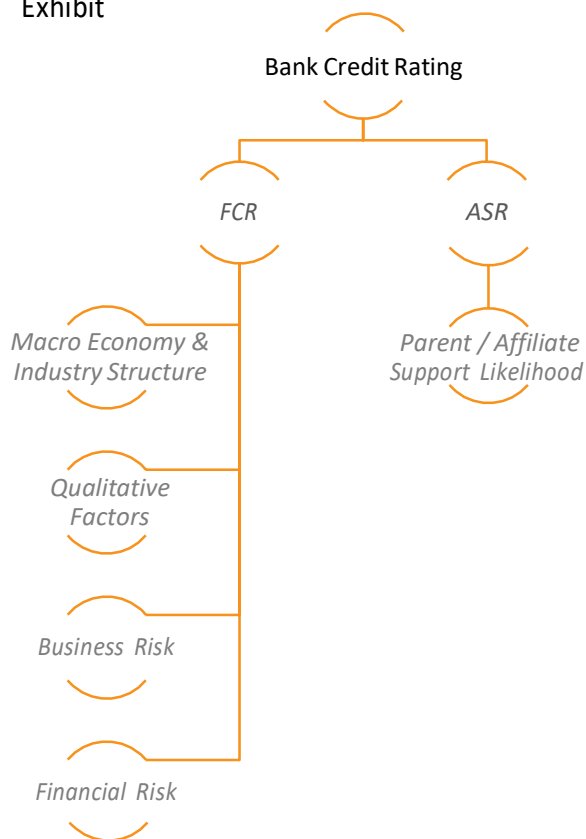
Theme 4. Financial Risk

Axial's main consideration factors include an evaluation of bank's funding resources. Here, we focus on depositor quality and diversification. We've also assessed the liquidity of a bank's funding resources (internal and external), the quality of the bank's loan portfolio and the capital adequacy.

Theme 5: Affiliate/Parent Support Likelihood

Given their systemic importance, banks are simply too big to fail and our methodology recognizes this. Under this theme Axial assesses the likelihood and level of support provided by the affiliate or parent.

Exhibit



Designing the Scoring Model

In order to establish uniform rating criteria during such progressive times, Axial has developed a credit scoring model based on FCR and ASR themes, enabling banks to be assessed using fair and applicable thresholds.

The model is populated using publicly available financial statements, as well as the rating questionnaire with the latter requiring vital non-public information. The provided data is processed in the form of financial statements and ratios, calculating the rating score based on established thresholds of financial performance and credit risk. The rating score is adjusted as per weightages assigned to each theme, resulting in a reliable credit rating of the subject bank.



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