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Rating Methodology

Financial Institutions

Global Criteria for Rating Finance and Leasing Companies

Updated March 2017

Related Methodologies

Global Master Criteria for Rating Banks and Other Financial Institutions, updated March 2017

Introduction

This report details GCR's approach to according ratings to finance and leasing companies ("FLCs"). In terms of this methodology, FLCs include all non-bank financial institutions that offer consumer or commercial finance, as well as factoring and leasing companies. These companies fall under GCR's financial institution ratings division, as a similar rating process and analytical framework is applied. This is justified, since the services of these firms are typically a subset of what larger banks do or could offer. This methodology therefore supplements GCR's Global Master Criteria for Rating Banks and Other Financial Institutions ("Criteria for Rating Banks and Other FIs") which is available on GCR's website, www.globalratings.net, and is to be read in conjunction with this report.

GCR's Criteria for Rating Banks and Other FIs illustrates the methodology primarily as it applies to banks, but there are key differences between banks and FLCs that must be considered for an accurate rating to be accorded. FLCs are largely unregulated (particularly in emerging markets), typically do not take deposits, and are mostly unlisted entities. This may be seen to constrain the availability of industry information and overall transparency, although this differs across the various jurisdictions covered by GCR.

While this methodology focuses largely on the rating of an FLC's ability to honour all of its general obligations (ie, borrowings and other liabilities) in a timely manner, it is also relevant to specific debt issues. Moreover, this methodology is intended to be applied globally, and covers institutions with solely domestic or regional operations in a single market, as well as those with a broad franchise operating in multiple countries.

This criteria report ("the Criteria") is an update to the version published in March 2016. There are no significant amendments to the Criteria. However, for ease of reference it is noted that Factor 3 'Market position' was renamed 'Competitive position', in order to emphasise the consideration of relative and absolute measures of competitive strength. This was done to be consistent with changes in the Criteria for Rating Banks and Other FIs. The update of this Criteria will not have an impact on any existing ratings. Going forward, this Criteria will be applied to all ratings of FLCs.

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Rating methodology

Given that there is a significant overlap in the services offered by FLCs and commercial banks, the methodology applied is similar. GCR's opinions are based on a clear understanding of the fundamentals of the rated organisation and the environment in which it operates. These guidelines are intentionally broad in scope, recognising that assigning credit ratings is a dynamic process and that each entity possesses unique characteristics and assumes varying levels of risk.

For FLCs, GCR's analytical process focuses on the following fundamental factors:

1. Economic risk
2. Industry risk
3. Competitive position
4. Asset quality
5. Funding and liquidity
6. Capital adequacy
7. Management quality and systems
8. Risk management
9. Financial performance

Although these areas are discussed in detail in GCR's Criteria for Rating Banks and Other FIs (which should be read in conjunction with this report), additional considerations should be taken into account in analysing FLCs, and these are discussed for each fundamental factor area below.

1. Economic risk

Economic risk is a significant factor in the evaluation of FLCs, which are generally small companies that lack significant franchise or brand value and financial flexibility. A weakening in economic fundamentals could therefore impact the operations of these companies to a greater degree. Since liquidity is typically a key constraint, defaults among FLCs therefore tend to be higher during times of economic stress, when funding costs are typically high and liquidity is low.

2. Industry risk

Unlike banking institutions, FLCs are generally less formally regulated, particularly in emerging markets. FLCs are also generally smaller, unlisted firms, and transparency and industry data are limited. A high degree of regulation provides a greater degree of confidence to GCR in terms of financial reporting (and the additional discipline required in general), whilst the regular reporting requirements result in industry data being more readily available. The general lack/lower level of formal regulation has further implications for corporate governance, which can be absent or limited. Since these companies generally do not take deposits and account for a negligible market share in terms of loan assets, sovereign support is unlikely.

3. Competitive position

Once the operating environment of a rated institution has been analysed, GCR determines the competitive position of the company, based on its market share and core competences. Advantages and vulnerabilities arising from its competitive position are examined, concentrating on diversification, strategy, management and systems. Cognisance may be taken of market share in relation to a specific, defensible niche even if the overall financial sector market position is low.

4. Asset quality

Credit risk (asset quality) and residual value risk are the key risks for most FLCs.

For credit risk, GCR analyses a FLC's policies and procedures from origination through the servicing and collection process, and ultimately resolution.

For leasing companies, this involves understanding residual value setting, depreciation methodology and asset disposal capabilities. Indications of poor asset quality or credit risk will generally lead to lower ratings, unless sufficiently countered through sustainably higher margins.

GCR focuses on identifying concentrations in the loan book by the type of loan, client, collateral, industry sector, geography and maturity. High exposures to individual clients (measured as a percentage of the FLC's capital base) are also reviewed. Loan and lease portfolios with high growth or significant concentrations require closer scrutiny, and these features may have a negative influence on asset quality.

5. Funding and liquidity

One of the main factors determining a FLC's ability to continue meeting its obligations in a timely manner is the stability of its funding. FLCs are typically funded via the wholesale capital markets, which are confidence sensitive. Defaults among FLCs internationally have more been due to a lack of liquidity, than poor capitalisation or earnings performance. Although liquidity is a key risk across most financial institutions, banks generally display a more diverse funding structure and are also constrained by tightening regulatory requirements across most jurisdictions. Banks are required to maintain a portion of assets in liquid instruments, measured as a proportion of both total assets and deposits. Although this does create a liquidity buffer, generally this would not be sufficient to counter a prolonged run on deposits should confidence in the institution diminish. In this respect, franchise value (reputation, market share, brand recognition, etc.) and support factors become key considerations.

Whereas larger banks may be able to rely on sovereign support due to the systemic impact of a bank failure, no such support would likely be available for a FLC. Furthermore, the financial flexibility for the majority of these firms would be limited, with funding generally highly concentrated and of a wholesale nature. There is no access to a lender of last resort or to the interbank market (as would be the case for banks). Wholesale funding is both expensive and highly volatile, meaning that asset yields typically need to be maximised through increased lending (while maintaining high lending rates), rather than retaining liquid balance sheets.

6. Capital adequacy

In general, a solid capital base provides a basis for growth, sourcing funding alternatives and creating loan loss provisions. A FLC's capital ratios are to a great extent determined by regulatory requirements, if any.

In addition to reviewing the standard capital metrics (such as capital to assets and capital to advances), GCR also considers the quality of a FLC's capital base, dividend policies, internal capital generation rates and asset growth rates. Although FLCs are not generally required to comply with risk-adjusted measures of capital, GCR prefers this measure which better aligns capital with risk. More comfort is derived from such analysis when it forms the basis for management decision making.

For leasing companies, GCR's analysis of leverage and capitalisation may take a corporate approach, where the focus is on cash flow coverage and debt service, rather than balance sheet analysis. GCR uses earnings before interest, taxes, depreciation and amortisation ("EBITDA") as a proxy for cash flow, with debt to EBITDA and EBITDA to interest expense considered.

7. Management quality and systems

One of the most important aspects of the rating process is the level of confidence GCR develops in management and its strategies. One of the focal areas in the analysis of a company's performance (across all sectors) is an evaluation of the quality of the strategic and financial planning. For this purpose, GCR uses a comparison of the FLC's financial results with management's plans and budgets. With regard to management succession planning, 'key man' reliance and strength of middle management are assessed.

Another of the focus areas which GCR evaluates is the level of sophistication and quality of the financial institution's information technology systems. In addition, risk management procedures enhanced by high quality information systems provide for better monitoring and lower risk.

8. Risk management

GCR obtains an in depth understanding of the institution's risk management policies and procedures, as well as overall corporate governance. The risk management structures (including the structure and authority of various risk committees and subcommittees) and policies with regards to credit and market risk, as well as asset and liability management, are particularly scrutinised.

Corporate governance is greatly determined by an institution's ownership structure, with most FLCs falling into two categories: independent (public or private), or a subsidiary of a larger corporate entity. Ownership of independent FLCs is often fairly diffused across a broad spectrum of shareholders, and control therefore largely rests with management and the Board of Directors ("Board"). As a subsidiary, the FLC typically has only one shareholder, being the parent company. As a result, the FLC's ratings may be closely linked to those of its parent, although the appropriateness of such a rating linkage is assessed on a case by case basis.

Key criteria for corporate governance are the composition (executive versus non-executive and independent directors) and experience of the Board. GCR considers whether Board members understand the risks faced, and whether an appropriate level of expertise is demonstrated given the firms strategy and target market. This is particularly relevant given the general lack of regulatory requirements. GCR would expect firms to be aware of and generally follow local requirements (if any) and international best practice.

9. Financial performance

One of the key factors in assessing the long-term viability of any organisation is profitability. The first step is to examine the split between interest and noninterest income and the FLC's relative dependence on certain types of income.

The absolute level, as well as quality of earnings, and volatility of results, are all factors in GCR's analysis and are highlighted in GCR's Criteria for Rating Banks and Other FIs. In addition, GCR may conduct additional assessments of a FLC's earnings over time. Earnings tend to be highly reliant on margin or spread income, with a limited ability to raise fee or other income. Due to a higher cost of funds, these institutions therefore operate at a disadvantage to commercial banks, which can source cheaper retail deposits and raise substantial transaction related fees. This is generally countered through faster turn-around times and better customer service when granting credit. Leasing is also a growing alternative to traditional asset finance. In evaluating the performance of leasing companies, GCR also considers operating costs relative to loans or leases, including the mix of variable and fixed costs.

Conclusion

While thorough quantitative analysis is important, the qualitative characteristics of GCR's analysis cannot be overemphasised. It is critically important to look "beyond the numbers" and to evaluate the intangible strengths and weaknesses of an entity. At the core of GCR's analysis is the understanding of the strategic characteristics of an organisation and the quality of management. Our emphasis is on determining how these strategic aspects will affect an organisation's flexibility and capacity to withstand adverse market circumstances.

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GLOSSARY OF TERMS/ACRONYMS USED IN THIS DOCUMENT AS PER GCR'S FINANCIAL INSTITUTIONS GLOSSARY

Amortisation	From a liability perspective, the paying off of debt in a series of instalments over a period of time. From an asset perspective, the spreading of capital expenses for intangible assets over a specific period of time (usually over the asset's useful life).
Asset	A resource with economic value that a company owns or controls with the expectation that it will provide future benefit.
Asset Quality	Refers primarily to the credit quality of a bank's earning assets, the bulk of which comprises its loan portfolio, but will also include its investment portfolio as well as off balance sheet items. Quality in this context means the degree to which the loans that the bank has extended are performing (ie, being paid back in accordance with their terms) and the likelihood that they will continue to perform.
Balance Sheet	Also known as a Statement of Financial Position. A statement of a company's assets and liabilities provided for the benefit of shareholders and regulators. It gives a snapshot at a specific point in time of the assets the company holds and how they have been financed.
Budget	Financial plan that serves as an estimate of future cost, revenues or both.
Capital	The sum of money that is invested to generate proceeds.
Capital Adequacy	A measure of the adequacy of an entity's capital resources in relation to its current liabilities and also in relation to the risks associated with its assets. An appropriate level of capital adequacy ensures that the entity has sufficient capital to support its activities and that its net worth is sufficient to absorb adverse changes in the value of its assets without becoming insolvent.
Capital Base	The issued capital of a company, plus reserves and retained profits.
Cash	Funds that can be readily spent or used to meet current obligations.
Cash Flow	The inflow and outflow of cash and cash equivalents. Such flows arise from operating, investing and financing activities.
Collateral	Asset provided to a creditor as security for a loan.
Corporate Governance	Refers to the mechanisms, processes and relations by which corporations are controlled and directed, and is used to ensure the effectiveness, accountability and transparency of an entity to its stakeholders.
Credit Rating	An opinion regarding the creditworthiness of an entity, a security or financial instrument, or an issuer of securities or financial instruments, using an established and defined ranking system of rating categories.
Credit Risk	The possibility that a bond issuer or any other borrowers (including debtors/creditors) will default and fail to pay the principal and/or interest when due.
Debt	An obligation to repay a sum of money. More specifically, it is funds passed from a creditor to a debtor in exchange for interest and a commitment to repay the principal in full on a specified date or over a specified period.
Default	Failure to meet the payment obligation of either interest or principal on a debt or bond. Technically, a borrower does not default, the initiative comes from the lender who declares that the borrower is in default.
Diversification	Spreading risk by constructing a portfolio that contains different investments, whose returns are relatively uncorrelated. The term also refers to companies which move into markets or products that bear little relation to ones they already operate in.
Dividend	The portion of a company's after-tax earnings that is distributed to shareholders.
Exposure	Exposure is the amount of risk the holder of an asset or security is faced with as a consequence of holding the security or asset. For a company, its exposure may relate to a particular product class or customer grouping. Exposure may also arise from an overreliance on one source of funding.
Financial Institution	An entity that focuses on dealing with financial transactions, such as investments, loans and deposits.
Industry Risk	The risk that defaults will arise in an industry because of factors specifically affecting that industry.
Interest	Scheduled payments made to a creditor in return for the use of borrowed money. The size of the payments will be determined by the interest rate, the amount borrowed or principal and the duration of the loan.
International Scale Rating LC	International local currency (International LC) ratings measure the likelihood of repayment in the currency of the jurisdiction in which the issuer is domiciled. Therefore, the rating does not take into account the possibility that it will not be able to convert local currency into foreign currency or make transfers between sovereign jurisdictions.
Lease	Conveyance of land, buildings, equipment or other assets from one person (lessor) to another (lessee) for a specific period of time for monetary or other consideration, usually in the form of rent.
Leverage	With regard to corporate analysis, leverage (or gearing) refers to the extent to which a company is funded by debt.
Liabilities	All financial claims, debts or potential losses incurred by an individual or an organisation.
Liquidity	The speed at which assets can be converted to cash. It can also refer to the ability of a company to service its debt obligations due to the presence of liquid assets such as cash and its equivalents. Market liquidity refers to the ease with which a security can be bought or sold quickly and in large volumes without substantially affecting the market price.
Long-Term	Not current; ordinarily more than one year.
Long-Term Rating	Reflects an issuer's ability to meet its financial obligations over the following three to five year period, including interest payments and debt redemptions. This encompasses an evaluation of the organisation's current financial position, as well as how the position may change in the future with regard to meeting longer term financial obligations.

Margin	The rate taken by the lender over the cost of funds, which effectively represents the entity’s profit and remuneration for taking the risk of the loan; also known as spread.
Maturity	The length of time between the issue of a bond or other security and the date on which it becomes payable in full.
Portfolio	A collection of investments held by an individual investor or financial institution. They may include stocks, bonds, futures contracts, options, real estate investments or any item that the holder believes will retain its value.
Provision	The amount set aside or deducted from operating income to cover expected or identified loan losses.
Risk	The chance of future uncertainty (i.e. deviation from expected earnings or an expected outcome) that will have an impact on objectives.
Risk Management	Process of identifying and monitoring business risks in a manner that offers a risk/return relationship that is acceptable to an entity's operating philosophy.
Shareholder	An individual, entity or financial institution that holds shares or stock in an organisation or company.
Short-Term	Current; ordinarily less than one year.
Short-Term Rating	An opinion of an issuer’s ability to meet all financial obligations over the upcoming 12 month period, including interest payments and debt redemptions.
Yield	Percentage return on an investment or security, usually calculated at an annual rate.

For a detailed glossary of terms please click here