

# Non-Bank Financial Institutions Criteria

## Rating Criteria

### Scope of the Criteria

Lianhe Ratings Global Limited (“Lianhe Global”) applies the non-bank financial institutions criteria to non-bank financial institutions globally, including securities firms, finance companies and leasing companies. For some financial institutions offering a wide range of financial services (e.g., financial conglomerates), Lianhe Global uses the criteria corresponding to the institution’s main business activities and key risk features and may employ the other criteria to complement the analysis.

Securities firms’ business lines include securities brokerage, financial advisory services, investment banking and securities trading. Finance companies offer commercial and consumer financing, including loans for housing, automobiles, business ventures and individuals and debt purchases (i.e. companies that buy portfolios of defaulted assets or non-performing loans), as well as associated services. Leasing companies provide physical assets or services for use by commercial clients or individuals for a period of time (sometimes with provisions to purchase assets at the end of the contract) in return for regular payments. Leasing assets include passenger vehicles, office equipment, industrial equipment, ships and aircrafts.

Furthermore, the criteria do not represent a comprehensive coverage but only address key rating factors.

### Overview

The criteria report explains Lianhe Global’s general approach to assessing a non-bank financial institution’s standalone credit profile and the likelihood of external support that the entity will receive in case of need, i.e. to sustain the institution’s viability. We incorporate the availability of external support into the assessment of a non-bank financial institution’s standalone credit strength to assign a credit rating to the entity.

The most common form of support for a non-bank financial institution is the institutional support from the entity’s parent. Government support is not common for most non-bank financial institutions given the lack of systemic importance, although this may be available for an institution with a policy role.

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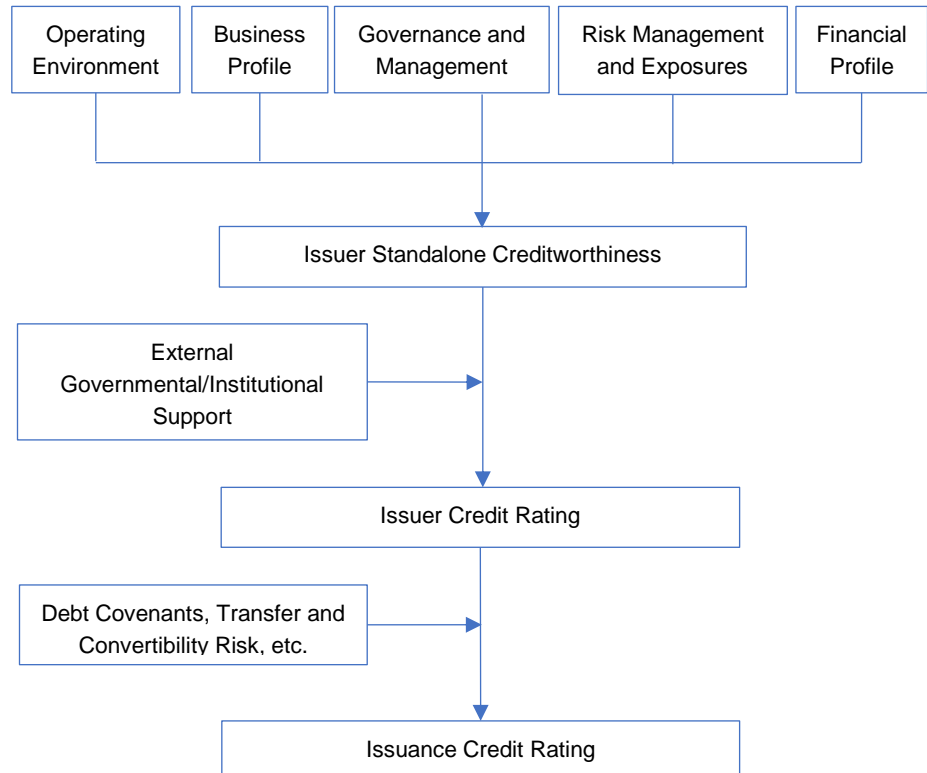
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The diagram below illustrates the topology of the criteria:



### Standalone Creditworthiness Analysis

The assessment analysis of a non-bank financial institution’s standalone creditworthiness is assessing the probability of the entity that will default or need to receive external support to avoid a default. We use a combination of qualitative and quantitative analysis to assess five key credit factors: the operating environment, business profile, governance and management, risk management and exposures, and financial profile.

The standalone assessment considers operational support, from which a non-bank financial institution benefits in the usual course of business, such as complementary product offerings, funding facilities and knowledge and information sharing from its parent and affiliates. In addition, ratings assigned are based on our forward-looking expectations. We assess a non-bank financial institution’s financial history as well as its strategy and business model to arrive at a forward-looking view of its credit profile.

Key Credit Factor	Sub Factor
Operating Environment	Sovereign Rating
	Macroeconomy
	Legal and Regulatory Environment
Business Profile	Industry Profile
	Franchise and Market Position
	Business Mix and Diversification
Governance and Management	Corporate Structure and Governance
	Management Quality
	Business Strategy and Execution
Risk Management and Exposures	Risk Policy and Framework

Key Credit Factor	Sub Factor
	Credit Risk Profile
	Market Risk Exposure
Financial Profile	Capital Adequacy
	Asset Quality
	Profitability
	Liquidity and Funding

## Operating Environment

The operating environment often has a significant influence on the other aspects of a non-bank financial institution's credit profile. Weakening sovereign strength can affect the credit quality of a non-bank financial institution operating in that jurisdiction as the deterioration usually relates to economic weaknesses or system-wide issues. A volatile economic environment may impair a non-bank financial institution's earnings stability and asset quality. Competition tends to be intense in a fragmented market, while concerns over corporate governance and transparency are usually more pronounced within an underdeveloped legal system and regulatory framework.

## Sovereign Rating

Sovereign strength often has a significant impact on a non-bank financial institution's credit profile domiciled in that country. In limited circumstances (such as with a strong overseas presence), a non-bank financial institution's rating may exceed the sovereign rating.

We use internal assessment to gauge sovereign ratings and believe our internal assessments on sovereign nations are not expected to be materially different from the market consensus. We apply both commonly accepted quantitative and qualitative metrics to conduct the sovereign analysis. In addition, we apply elements from recognised third-party indexes such as World Bank's Worldwide Governance Index, Human Development Index, Easy of Doing Business Index to maintain neutrality and objectivity in our analysis. We believe these indexes provide us with a platform to conduct our analysis in a non-ideologically biased setting.

## Macroeconomy

A country's economy usually affects a non-bank financial institution's operation through its impact on the business and financial environment. Factors taken into consideration include the stage of economic development, and the economic growth pace and expectations. We also consider other attributes that may affect the healthiness of the economic environment. This may include the aggregate indebtedness of the country and growth, the stability of interest rates and exchange rates, inflation rates and employment and demographic prospects.

## Legal and Regulatory Environment

A well-established legal system and regulatory framework contribute to the financial sector stability. We consider that a comprehensive and effective legal system should provide adequate protection to property and creditor rights, and have a reliable, efficient and independent justice system. A prudent regulatory system often requires a market-based regulatory and supervisory framework with an independent authority. The regulator has willingness and capability to intervene and enforce laws and regulations, including dealing with problematic financial institutions and potential contagion risk. Internationally

comparable accounting standards and proper auditing procedures are also important to ensure the reliability and integrity of financial information.

### **Industry Profile**

The market structure and competitiveness affect a non-bank financial institution's business strategy and development. An oligopolistic market may create an obstacle for new participants and protect existing institutions' franchise and market position. However, deregulation may encourage them to focus on capital adequacy and operating efficiency and to put emphasis on shareholder value. We analyse the industry profile by looking at the size and number of market participants, products and services provided, business growth, deregulation of financial services and opening up to international competition.

### **Business Profile**

A non-bank financial institution's business profile, franchise and competitive position influence its current financial performance and creditworthiness and the sustainability for a long run.

### **Franchise and Market Position**

A non-bank financial institution's franchise value is usually reflected in its resilient and sustainable market position, comprehensive product and service offerings, and wide market coverage. Large entities generally have a competitive advantage with business leadership and pricing power as well as the benefit of economies of scales. However, small market presences may be offset by a sustainable business model in a specific region or in niche product or client segments.

Being part of a larger (typically financial) group can be beneficial to a non-bank financial institution's franchise with the access to a larger clientele base and business synergies from other group members. Conversely, reputational and contagion risks may arise should its affiliates have weaker credit profile.

### **Business Mix and Diversification**

Diversified revenue streams from various business lines and regions can support a non-bank financial institution's earnings stability through economic and credit cycles. On the other hand, a concentrated business profile (e.g., a high reliance on volatile activities, such as securities trading, or a narrow product/client focus) can cause high earnings volatility and risk concentrations. Lack of business diversification is usually a credit weakness for non-bank financial institutions.

### **Governance and Management**

Prudent governance and professional management is essential for the achievement of a non-bank financial institution's business and financial objectives and ensuring good internal control and in compliance with regulatory requirements.

### **Corporate Structure and Governance**

Prudent governance practices support a non-bank financial institution to achieve long-term business success and financial stability. The board members (directors) are elected by the shareholders to oversee the institution's interest in the long-term health and the overall success of the business and financial strength. We examine features (including but not limited to) such as the ownership and organisational structure, reporting hierarchy, board

composition and independence, board committees, related party transactions, material litigations, and prior regulatory sanctions, etc.

A complex and opaque organisational structure, including layers of intermediate holding companies, may raise concerns over effective management, corporate governance and inappropriate intra-group transactions. Publicly listed entities usually have better disclosures and governance practices as they must abide by both listing and regulatory rules. However, private-owned institutions are not necessarily calls for concern.

### **Management Quality**

Professionalism and integrity are two important features in quality management. A solid management team shows good credibility and competence. It manages business in a professional and ethical manner and has a proven record of achieving an institution's business and financial goals. The remuneration scheme is established to ensure the alignment of the management's interests and risk preferences with those of the organisation and its stakeholders. Mitigations of key man risk (such as an established succession plan) are also essential especially for an institution with a reliance on a specific individual or a few individuals.

### **Business Strategy and Execution**

Business objectives give a non-bank financial institution a guideline and direction from where to start and where the organisation is going, while successful execution turns strategic objectives into performance. The objective setting should be clearly-defined, measurable, and achievable. It takes into account the entity's operating environment, business model, management expertise, and competitive position, and balances risks and rewards.

### **Risk Management and Exposures**

Concentrated risk profile due to a monoline focus or a narrow customer base and high reliance on wholesale funding are common risk features of non-bank financial institutions. Risk control is an integral part to support a non-bank financial institution's credit strength and resilience throughout an economic cycle. An effective risk management can help the institution identify, measure, monitor, and control or mitigate risks and protect the entity's capital base and earnings without hindering growth.

### **Risk Management Framework**

A sound risk management framework should be able to identify the risk universe and quantify specific and aggregate risk exposure, as well as potential loss. Risk mitigation mechanisms are well established to ensure the risk levels remain at an optimal threshold. Risk policies and governance clearly define and segregate duties and assign authority to employees, committees and the board for approval and execution of various risk limits and exceptions to limits.

### **Credit Policy and Profile**

Credit risk is the risk that a customer or counterparty in a transaction may default. It arises from the lending, leasing, trading and other activities undertaken by a non-bank financial institution. We examine a financial institution's credit policy and underwriting standards, including its lending criteria, collateral requirements, concentration limits and impairment and provisioning policies, as well as the soundness of its internal credit rating system, scorecards, or third-party databases such as credit bureaus. We pay additional attentions to residual value risk management (such as assets under lease monitoring and loan

recovery management) for those institutions which significantly rely on collateral disposals to secure their risk exposures.

Quantitative aspects mainly focus on the degree of borrower, sector and geographic concentrations of a non-bank financial institution's lending business, loan-to-value ratios, provision coverage, and off-balance-sheet exposure. A concentrated risk profile may increase a non-bank financial institution's vulnerability to deteriorations of a counterparty's credit profile or a relatively undiversified regional economy. A counterparty's loss of confidence in this institution may also significantly affect the entity's revenues and profits. We look into the nature of the institution's businesses to identify potential high asset and/or cash flow volatility.

### **Liquidity and Capital Management**

Liquidity is generally defined as the ability of a non-bank financial institution to meet its debt obligations without incurring unacceptably large losses. A healthy liquidity profile often requires effective liquidity analysis and projections to identify potential funding issues, diversified funding sources, sufficient liquidity cushion and contingency funding plans in place. Ability to secure investors' confidence is essential as most non-bank financial institutions lack deposit taking franchises and primarily rely on wholesale funding. Liquidity projections should be made under both normal conditions and a range of stress scenarios. Early warning indicators for liquidity shortages also help the institution take pre-emptive actions.

Effective capital management identifies a non-bank financial institution's capital needs for various business activities depending on the risks taken by each business division and in accordance with the requirements of relevant regulatory authorities. It helps ensure the institution's capital adequacy is commensurate with the risk involved and in compliance with relevant statutory limits, taking into account business growth, dividend pay-outs, potential capital market volatility and other relevant factors.

### **Market Risk**

Market risk mainly refers to the risk of incurring losses due to fluctuations in the value of a non-bank financial institution's assets and liabilities caused by market movements, including the changes in interest rates, prices of securities and exchange rates. We assess the scale of the risks relative to the institution's ability to absorb the impacts of sudden and substantial market movements and the entity's control mechanisms and hedging practices to monitor and mitigate the risks.

Quantitative measures usually include value at risk (VaR), stop-loss limits, concentration limits (by product, counterparty, industry and region), sensitivity analysis and stress testing. We also review policies with respect to collateral requirements and margin calls for securities firms as their brokerage business is heavily influenced by capital market dynamics.

### **Operational Risk**

Operation risk arises from employee misconduct, inadequate or failed internal procedures and processes, inadequate management of information and other systems, as well as unforeseeable external events. A non-bank financial institution should implement monitoring systems for operational risk exposures and losses for major business lines and enforce control or mitigation mechanisms through regular internal auditing. Infrastructure investments should commensurate with the nature of the business. Securities firms' trading and risk management systems need to cope with the increase in trading volume, speed and volatility in capital markets.

### Financial Profile

We examine a non-bank financial institution's financial profile by analysing key financial metrics, including their historical trends, stability and expectations. Financial metrics can be various depending on the institution's business model. We may reclassify items derived from the institution's financial statements to fit our standard spreadsheets and ratio calculations for greater comparability across regions and/or for better measurements of the entity's financial position. Common treatments may involve excluding nonrecurring gains/losses from operating profits, deducting intangible assets from eligible capital, or including restructured loans in impaired loans.

### Capital Adequacy

Capital serves as a buffer that absorbs losses and sustains a non-bank financial institution's viability. Stringent capital requirement prevents an institution from taking excessive risk and increases incentives for better risk management to safeguard shareholders' equity. Adequate capitalisation also helps maintain both public and regulatory confidence in an institution. Key financial metrics include the capital adequacy ratio and composition (core and supplementary capital), equity to assets ratio, and debt to earnings before interest, taxes, depreciation and amortisation.

### Asset Quality

Analysis of a non-bank financial institution's asset quality focuses on the loan portfolio and securities investments. We also inspect other on- and off-balance sheet credit exposures to have a sound understanding of the overall asset quality. Absolute and relative loan growth rates (compared with industry averages and the underlying economic growth) help assess an institution's risk appetite and asset quality trend. Key financial metrics include classification of loans according to their performance and provisions made against them, the ratio of impaired loans to gross loans, and loan impairment charges to gross loans.

### Profitability

Internal earnings generation capability is important to support a non-bank financial institution's capital adequacy and future business expansion as well as maintain investors' confidence for ongoing debt refinancing needs. We look at the level of profitability and earnings quality, diversification and stability. Key financial metrics include returns on assets/equity, profit margins, contributions of fee-based income, impairment charges to pre-provision profits, and the cost-to-income ratio. We may exclude nonrecurring income/expenses in the ratio calculations if deemed necessary.

### Liquidity and Funding

Wholesale funding can be very sensitive to changes in the credit risk profile of a non-bank financial institution or to interest rate movements. We assess the institution's readily available liquid assets, committed credit facilities and contingency funding plans to meet its debt obligations and potential funding needs. Key financial metrics include liquid assets to short-term debts, unencumbered assets to unsecured debt and interest coverage. We also analyse a non-bank financial institution's funding structure to assess its funding diversity and stickiness.

### External Support Assessment

External support typically comes from the governmental authorities of the country/region where the non-bank financial institution is domiciled or from the institution's shareholders.

Governmental authorities include the government of the nation, any political subdivision thereof, whether state or local, and any agencies and regulatory bodies pertaining to the government. We assess both the capability and willingness of the potential supporter to provide assistance to sustain the institution's viability.

### **Government Support**

We consider that the government's long-term rating best captures its capability to provide support to a non-bank financial institution. An institution's government ownership, systemic importance, and policy role are key considerations in assessing the public authority's willingness to provide support. The government statements on the intention to bail out failed non-bank financial institutions and track record of support also help gauge the propensity. That said, support from government authorities is usually less common for non-bank financial institutions than for banks, given their generally relatively smaller size and influence on the overall financial system.

### **Institutional Support**

The institutional parent's credit strength as reflected in its issuer rating, its relative size to the subsidiary, and relevant regulations governing the group's operations (particularly the capital and liquidity flows within the group) affect the parent's ability to provide support. In cases where the parent's rating has factored in potential government support, we assess whether this support would flow through to the subsidiary.

The strategic importance of the non-bank financial institution to its parent is usually the key factor in assessing the parent's willingness to provide support. The likelihood tends to be high should the subsidiary represent an essential part of the group's operation, carry the same brand name, and its failure may bring reputational risk to the group.

For a captive finance company belonging to a larger company and providing financing services associated with the parent's business, we may rate the entity primarily or solely on the basis of parental support. In these cases, the entity's strategic importance, its parent's credit strength and support agreements (if any), are key considerations for the rating.



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