中誠信(亞太)
CCX

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Rating Methodology for Finance Companies

Summary

This rating methodology adopted by China Chengxin (Asia Pacific) Credit Ratings Company Limited (“CCXAP”) applies to Finance Companies (“FCs”), which is inclusive of a wide range of non-bank finance companies that are active in provision of commercial and consumer financing, lending and other associated financial services. The finance company universe includes a variety sub-sectors. CCXAP currently classifies FCs into three broad sub-sectors: lenders, leasing companies, and services providers. Services providers includes companies that provide services related to financing but typically do not retain loans or leases on their balance sheets. Banks and securities firms are rated under our rating methodology for commercial banks and securities industry respectively, while their subsidiaries, which are classified as a finance company, are rated under this rating methodology. The rating methodology introduces the key determinants for rating FCs, and CCXAP assigns credit ratings to them using its rating scale.

This new rating methodology replaces the “Rating Methodology for Finance Companies” published by CCXAP in October 2018. The new version follows the core rating principles of the previous version with some amendments, which helps the users to better understand our methodology. No rating changes will be resulted from the implementation of this new rating methodology.

Introduction of Rating Methodology

The key rating determinants are divided into qualitative determinants and quantitative determinants. The rating methodology provides a summarized guidance for the important factors used in assigning ratings, but it does not include all aspects of rating factors that influence the determination of final rating of a rated company. As a result, the mapped rating may not match the final rating of each company.

Since a wide range of finance companies are covered under this rating methodology, CCXAP may weight and score differently on rating factors to reflect the particular characteristics of each sub-sector.

In this rating methodology, there are 9 rating factors comprising 20 sub-factors as follows:

Rating Factors	Sub-factors
Operating Environment	Economic and Industry Environment
	Legal and Regulatory Environment
	Financial and Capital Markets

Business Profile	Market Position Business Diversification
Company Management	Management Quality Corporate Governance
Risk Management	Risk Appetite Risk Control
Operating Scale	Net Capital Net Operating Income
Profitability	Pre-Tax Net Income/Average Assets Return on Average Equity
Capital Adequacy and Leverage	Capital Adequacy Ratio Debt/EBITDA
Asset Quality	Problem Loans/Gross Loans Asset Impairment/Tangible Assets
Cash Flow and Liquidity	Realizable Assets/Short-Term Debt Secured Debt/Tangible Assets FFO/Total Debt

Key Rating Determinants

Rating factors and sub-factors are discussed in detail in this section, including their rating rationale, their measurements and how they will affect the credit ratings of FCs.

1. Operating Environment

A Finance company's performance is fundamentally influenced by its operating environment (i.e., the economic, judicial, regulatory, institutional and general operating conditions). Severe economic condition, weak legal or regulatory implementation, and ineffective financial system can impede a finance company's business plan execution and impair its financial performance. CCXAP starts the credit analysis from macro perspectives by evaluating the operating conditions where the company operates. These include economic and industry environment, legal and regulatory environment as well as financial and capital markets.

(1) Economic and Industry Environment

The intrinsic economic strength where a finance company operates makes a significant impact on its business prospects and performance. By intrinsic economic strength we consider economic measures such as GDP per capita, diversification, scale, industrial cycle, and long-term trends. Countries with robust economies have greater resilience against market fluctuations and have higher shock-absorption capacities. The industry development cycle and competitive landscape where the FCs operates are also important. If a finance company operates within highly cyclical business, it could be subject to high levels of asset volatility, which can result in a negative impact on its credit rating. In the case of FCs operating in a number of business lines/industries or across multiple countries or regions, CCXAP typically uses a weighted average approach, with the weights corresponding to the proportion of each business line in each country or region.

(2) Legal and Regulatory Environment

The legal and regulatory environment is the basis of business operations. Well-established legal system and clear regulatory environment can help stabilize regional financial system and reduce business risks, thus increasing the creditworthiness of FCs. A well-regulated market environment requires FCs to maintain a good management system and to avoid taking excessive risks. A prudent regulatory system has the following characteristics: high degree of transparency, independent regulator, and effective regulatory implementation and supervision. While finance companies are less regulated relative to banks, they are often subject to leasing, lending or consumer protection rules, and they may be vulnerable when regulations change or new regulations are introduced. Therefore, a stable regulatory environment has a positive bearing on the credibility of FCs.

(3) Financial and Capital Markets

Effective financial and capital market can help facilitate FCs' operation and reduce its cost of business. CCXAP takes into consideration of the maturity of the regional financial infrastructure and the quality of market participants. A mature financial and capital market has the following characteristics including well-established financial infrastructure, diverse and experience market participants, effective market liquidity and execution, and good regulatory enforcement.

2. Business Profile

Business profile reflects the non-financial aspects of the company and is measured from a qualitative perspective. CCXAP considers how a particular finance company's business profile affects its creditworthiness. The factors identified are market position and business diversification/business stability of the rated company.

(1) Market Position

Market position is a vital factor that makes a finance company success. It is the robustness and resilience of a finance company's market standing based upon the strength of its competitive advantages. This is also underpinning the capability of a finance company to generate and sustain core earnings. A finance company with strong market position not only helps it sail through difficult market conditions, but also seize business opportunities. In assessing a finance company's market strength, we consider the company's market positions relative to its peers, e.g. market share. FCs with a leading market share is deemed to have stronger market strength than those with only a marginal market share.

(2) Business Diversification

Business diversification reflects the breadth of a finance company's business activities. This factor addresses whether a finance company depends on a single business line or has geographic concentration with limited coverage. In general, a finance company with operation concentration in a single geographic area or relatively undiversified economy undertakes higher credit risk profile and becomes more vulnerable to potential adverse changes in market condition. Conversely, if a finance company has good diversification with multiple business lines and geographic coverage, it can be more resilient to regional economic cycles, contributing to greater consistency in earnings.

3. Company Management

In the evaluation of company management, CCXAP will consider the rated company's management quality and its corporate governance. This has a direct impact on the creditworthiness of a finance company.

(1) Management Quality

The management team profile and management track record of companies are the considerations of the company's management quality and their expertise. These represent the management's strategic positioning and execution ability, which directly influence the direction of a finance company's future business development and its daily operations. CCXAP will consider different aspects of management quality to evaluate the ability of a finance company to achieve its long-term performance. The assessment includes the breadth and depth of management experience, management continuity, key person risk, succession planning and execution, management culture as well as their balance of the trade-off between business growth and risk. Good management quality and expertise are not only leading to good business performance, but are also able to maintain its creditworthiness in a changing business environment.

(2) Corporate Governance

Corporate governance represents the group structure, practices and processes by which the company is controlled and directed. Although FCs is less regulated relative to banks, corporate governance is still an important factor for financial institution. FCs has high exposure to confidence-sensitivity funding and customers. High-quality corporate governance can reduce the likelihood and severity of future operating challenges and speeds remediation when problem occur. Conversely, weak corporate governance can deteriorate the company's operation effectiveness and create business risk. In the evaluation of corporate governance, CCXAP considers various factors including but not limit to: board independency, executive compensation packages, ownership structure, culture, related-party transactions, internal controls, financial reporting policy and transparency.

4. Risk Management

A finance company generally faces higher risk in operation than non-financial corporates owing to its special business characteristics. Managing risks is an inherent and core aspect to its business sustainability. If the company's risks are not managed appropriately, it may cause business failure or bankruptcy in extreme cases. Conversely, an effective risk management system reduces the overall risk profile of a finance company and increases earnings given certain risk level. In the evaluation of risk management, CCXAP will consider the rated company's risk appetite and risk control.

(1) Risk Appetite

The risk appetite of the FC is a crucial factor to assess the management's view of its risk tolerance and risk measurements. CCXAP reviews risk appetite from its recent trends of risk measurement and the risk goals stated by the management. There is a trade-off between risk and return. Aggressive business growth and balance sheet expansion relative to underlying economic growth, earnings retention, and industry average may indicate higher risk appetite. Moreover, evidence of loose internal credit assessment and underwriting standards comparing to its peers also represent its management

intension to take more risks. An elevated risk appetite that is not properly managed results in less creditworthiness of the FCs.

(2) Risk Control

In consideration of this sub-factor, we assess a finance company's adherence to its risk appetite framework and evaluate its underwriting standards on the strength and effectiveness of its risk management tools and systems. We will take into consideration of a number of factors in the assessment such as the effectiveness of internal rating systems, the completeness of risk data, the appropriateness of pertaining credit limits, risk management in market risks and operational control.

5. Operating Scale

Operating scale is an important factor to reflect the comprehensive strength and credit resilience of FCs. The companies with larger operating and revenue scale can be resistant during the economic downturns, while the smaller-scaled companies may be taken over by the larger ones. CCXAP uses the net capital and net operating income to assess the company's operating scale.

(1) Net Capital

Net capital reflects the asset liquidity based on its net assets. A finance company with sufficient net capitals could better resist the financial risks. The net capital is calculated by deducting goodwill and other intangible assets from its equity.

(2) Net Operating Income

The indicator of total net operating income measures the FCs' franchise strength and competitive positioning within its business lines. CCXAP uses last year's net operating income of a finance company as the indicator. Net operating income is calculated by net interest income plus net non-interest income for finance leasing company and lenders.

6. Profitability

Earnings power is a key determinant of the long-term success or failure of a finance company. It is also an important indicator of a FC's ability to generate sufficient capital to support its business development and repayment of obligations. In assessing profitability of FCs, CCXAP uses the ratio of pre-tax net income to average assets and return on average equity to measure the strength and stability of the company's earnings.

(1) Pre-Tax Net Income / Average Assets

CCXAP uses pre-tax net profit to average assets, which is a FC's net income before tax as a percentage of average assets, to evaluate its strength of earnings. The higher the pre-tax net income/average assets is, the more profitable the FC.

(2) Return on Equity

In assessing profitability of a FC, CCXAP uses return on average equity, which is calculated by dividing net income or loss (after tax) by average total equity. This indicator addresses the company's ability to generate a return on its equity investment.

7. Capital Adequacy and Leverage

Compared to most other industries, FCs is highly leverage entities. Capital is a key rating consideration for FCs to test its ability to survivals during systemic or individual crisis. It also enables management to access to capital markets potentially even in times of stress or take advantage of opportunistic acquisitions. We use capital adequacy ratio and total debt/EBITDA to evaluate the capital adequacy and leverage of a FC.

(1) Capital Adequacy Ratio

CCXAP uses the capital adequacy ratio to review a FC's sufficiency of capital, as measured by net capital to total assets. The capital adequacy ratio is the fundamental base to evaluate a finance company's use of leverage. Generally, the regulator often requires FCs to maintain a minimum capital adequacy ratio.

(2) Total Debt/ EBITDA

The numerator is total debt and denominator is EBITDA. Total debt includes unsecured and secured debt. Higher total debt to EBITDA ratio may indicate that a FC uses high leverage compared to its earnings.

8. Asset Quality

Asset quality is a primary driver of earnings and capital formation for most of the finance companies. Good asset quality reduces credit risks during cyclical downturn whereas poor asset quality may lead to a finance company in significant loss owing to its high financial leverage. Especially for finance companies, who often concentrate in a single asset class or operated in limited sectors, as compared to bank, are intrinsically undertaking higher business risk. For example, the asset quality of subprime customers may deteriorate significantly in financial crisis and this may give a profound impact on a less-diversified finance company. In fact, unexpected asset quality deterioration can negatively affect earnings, debt service capacity and capital sufficiency for finance companies. CCXAP uses problem loans/gross loans and asset impairment to tangible assets to evaluate the company's asset quality.

(1) Problem Loans (assets)/Gross Loans (assets)

CCXAP uses problem loans to gross loans ratio to measure a lender's asset quality of its loan portfolio. Problem loans are defined by impaired loans plus accrual loans that are past due 90 days or more, which reflect the proportion of risky assets that a finance company holds. Gross loans include loans to customers and exclude unearned income, allowance for loan losses and other deductions that are deemed to be material. We use problem leasable assets/gross leasable assets for a leasing company.

(2) Asset impairment/tangible assets

The numerator is total asset impairment and the denominator is tangible assets. The amount of tangible assets is calculated by deducting goodwill and other intangible assets from total asset. Companies with higher asset impairment relative to tangible assets may indicate poor asset quality.

9. Cash Flow and Liquidity

Cash flow and liquidity are important for a finance company to remain adequately funded during difficult times. Most FCs rely heavily on confidence-sensitive wholesale funding, which is a disadvantage compared to banks. Banks often have access to central bank funding and whose stable and low-cost retail deposits are resilient to market-driven stresses. A finance company with strong liquidity position and stable cash flow can help maintain its competitiveness in a tight credit market situation or its credit profile in a financial crisis. CCXAP uses three indicators to evaluate cash flow and liquidity: realizable assets to short-term debt, secured debt to tangible assets, and FFO to total debt.

(1) Realizable Assets/Short-Term Debt

Realizable assets/short-term debt measures a finance company's ability to cover short-term debt with highly reliable and readily available liquidity sources. The realizable assets include unrestricted cash, unencumbered investments in liquid sovereigns and government agencies, unsecured cash equivalents as well as other reliable funding sources. Short-term debts include all debts maturing in the next 12 months.

(2) Secured Debt/Tangible Assets

The numerator is secured debt and the denominator is the amount of tangible assets (total assets – intangible assets – credit loss reserves). This ratio measures a company's secured debts as a percentage of tangible assets. The lower the ratio is, the more the financial flexibility of a finance company has.

(3) FFO (Funds from Operations)/Total Debt

The numerator is FFO and denominator is total debt. FFO represents the amount of cash flow from operations before change in working capital. The ratio helps us assess a company's internally generated funds in a steady state.

Other Rating Considerations

Other than the factors and sub-factors considered as above, credit ratings of FCs may be influenced by a number of additional factors including but not limited to: event risk, captive finance companies, and opacity and complexity.

Event Risk

CCXAP will consider the possibility of unexpected events that could cause a sudden change in the issuer's overall credit profile, including asset sales, spin-off, capital restructuring program, change of major shareholders, mergers and acquisition and significant restructuring program.

Opacity and Complexity

Higher-than-average opacity or complexity of a finance company may increase its overall risk profile because it brings additional management challenges, heighten the risk of strategic and business errors, and heighten operational risk. A finance company with complex legal structure and organizational

complexity may tend to be less transparent, because public disclosures necessarily provide a simplified view of operations. Evidence of complexity includes numerous business lines , multiple minority ownership interest, offshore holding companies, pyramid structure and intercompany loans and guarantees. The rated entity may be notched downward if we view that the opacity and complexity of a finance company gives harms to its creditworthiness.

External Support

From the perspective of external support, CCXAP evaluates both government support and group support that a finance company would receive to avoid default.

Government Support

Government support means that when a finance company is facing severe pressure of debt servicing, the government may provide support to serve debt or take actions to avoid default. In assessing the support from the government, we may consider the following factors such as the FCs' economic and political importance to the government, the legal requirements and degree of oversight from the government, and the support and bailout histories.

Group Support

Supports from its parent company and/or affiliate companies affect the company's future development and credit profile. The capability of support is based on the credit assessment of the group. The willingness of support is measured by the company's development strategy, market position, ownership structure, and relative importance to the group. CCXAP, especially, has unique rating considerations that apply to captive finance companies. Captive Finance Company is a wholly-owned subsidiary of a larger parent company to provide financing and related services to dealers and end-users of its parent's products. The product offerings of captive finance companies are often limited and have a narrowed customer base. The rating of a captive company is usually highly associated with the likelihood of parental support and the credit strength of the parent rather than its stand-alone credit profile, stemming from their parent-related business purpose and its strategical importance.

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