Non-Bank Financial Institutions Rating Methodology

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CONTENTS

1. INTRODUCTION

This methodology describes the analytical framework and criteria that Capital Intelligence Ratings (hereinafter CI Ratings or CI) uses when it rates non-bank financial institutions (NBFIs).

This methodology replaces CI's Investment Company Methodology, which until now has been used to assign corporate ratings to complex, diversified non-bank financial entities and groups. The name of the methodology has been changed to better reflect its actual scope, while the analytical framework has been revised for greater clarity and is now broadly consistent with the framework employed in CI's Bank Rating Methodology.

The NBFI methodology is a base methodology which – while sufficient to rate the companies currently covered by CI – may be enhanced in the future with the publication of supplementary criteria papers that are more geared to the specificities of a particular sub-sector.

The methodology does not fundamentally change what we look at when assessing the default risk of NBFIs and better reflects what we currently do in practice. Consequently, we expect the direct impact of the methodology on the credit ratings of the NBFIs we currently cover to be minimal.

Structure of this Methodology Report

The remainder of this methodology paper is organised as follows:

- Section 2 focuses on the scope of our NBFI criteria.
- Section 3 contains an overview of our analytical approach for determining the ratings of NBFIs.
- In Section 4 we explain the rationale for each of the seven analytical pillars of the Entity Standalone Assessment and outline the criteria used to assess the underlying key rating factors.
- In Section 5 we outline our approach to assessing extraordinary support and group factors.
- In Section 6 we summarise our approach to rating above the sovereign.
- Annex 1 contains our rating scales for issuer credit ratings, while the guidelines we use for mapping long- and short-term ratings are presented in Annex 2.

2. ABOUT THIS METHODOLOGY

Scope

This methodology is applicable to a broad range of NBFIs, including finance and leasing companies, securities firms, and asset management companies.

It is also applicable to investment companies, particularly those in the Middle East region that undertake a variety of non-bank financial activities and services such as direct investment, asset management, commercial and consumer financing, and corporate financial advisory services (M&A, debt raising, refinancing etc.).

We may also apply this methodology in part, and in conjunction with, our Bank Rating Methodology to financial institutions that are registered as banks but engage in traditional banking activities (i.e. customer deposit-taking and lending) to a very limited degree and have business models that are closer to those of an investment company, with high reliance on fee and investment income from, for example, asset management, private equity, advisory, and securities activities.

Provided such institutions are regulated and supervised as banks (and so are required to meet bank capital and liquidity standards), we will use the analytical framework contained in our Bank Rating Methodology, but may draw on the criteria described in this report.

This methodology is geared towards NBFIs that assume balance sheet risks as part of operating activities and have substantial on-balance sheet assets that require financing from market and other sources. These firms have significant exposure to credit and market risks and tend to be reliant on short-term, confidence-sensitive funding. Consequently, default risk tends to be driven by balance sheet risks and vulnerabilities (emanating, for example, from high leverage, asset-liability mismatches, or deteriorating asset quality) rather than cashflow. For these firms, capital and liquidity buffers are key to mitigating the principal risks they face.

This methodology may also be applied to service-providing NBFIs that do not necessarily incur significant balance sheet risks as part of their business model and therefore tend to borrow for general corporate purposes (e.g. internal expansion and acquisitions) rather than to finance assets. For these firms, default risk is more a function of cashflow generation rather than balance-sheet risk. We generally include in this broad category certain types of advisory firms, inter-dealer brokerages, mortgage servicing companies, and traditional asset managers.

Given the broad range of NBFI sub-sectors and business models covered by this methodology, it is necessarily general in many respects and not all the criteria are applicable to every NBFI. It is up to analytical teams and ultimately rating committees to determine which key rating factors are most relevant to the analysis of each NBFI, taking into account the industry sub-sector, as well as the firm’s business model and overall risk profile. This is particularly the case in terms of Analytical Pillars 4 to 7. However, guidance on sector-specific analytical considerations are provided throughout this report, and differences in the financial metrics we use to assess high compared to low balance-sheet risk firms are clearly identified.

3. SUMMARY OF OUR ANALYTICAL APPROACH

Overview and Framework

CI Ratings assigns two main types of issuer credit rating (ICR) to NBFIs: long-term international ICRs (LT ICRs) and short-term international ICRs (ST ICRs). These ICRs encapsulate CI's opinion of the overall creditworthiness of rated NBFIs and indicate the general likelihood of default on senior financial obligations denominated either in foreign currency (foreign currency issuer ratings) or in the currency of the jurisdiction in which the firm is domiciled (local currency issuer ratings).

When we rate an NBFI we consider both its standalone credit profile and the likelihood of the NBFI receiving extraordinary external support from owners or, less commonly, the government should such assistance be required in order to avoid default. (Ongoing or 'ordinary' support from owners, for example to facilitate business growth or meet changes in regulatory requirements, is factored into our assessment of the standalone credit profile.)

Where the NBFI is a member of a corporate group, we apply the criteria contained in Parent-Subsidiary Considerations in the Determination of Corporate and NBFI Credit Ratings (issue date: April 2022) to determine the likelihood of extraordinary support. We also use this criteria to assess any potential rating constraints associated with the NBFI's membership of a corporate group and to determine the distance – in terms of notches on the rating scale – between the ICRs of a parent and its subsidiaries.

When we rate an NBFI we also take into account the potential impact on the NBFI's ICRs of sovereign risk factors, including the risk of transfer and convertibility restrictions and other state-imposed controls that could impede the entity's ability to meet its financial obligations in a timely manner. We apply the same considerations and notching criteria set out in our Bank Rating Methodology (notably section 6) and, as with banks, generally expect most NBFIs to be rated no higher than the sovereign of the country in which the NBFI is domiciled.

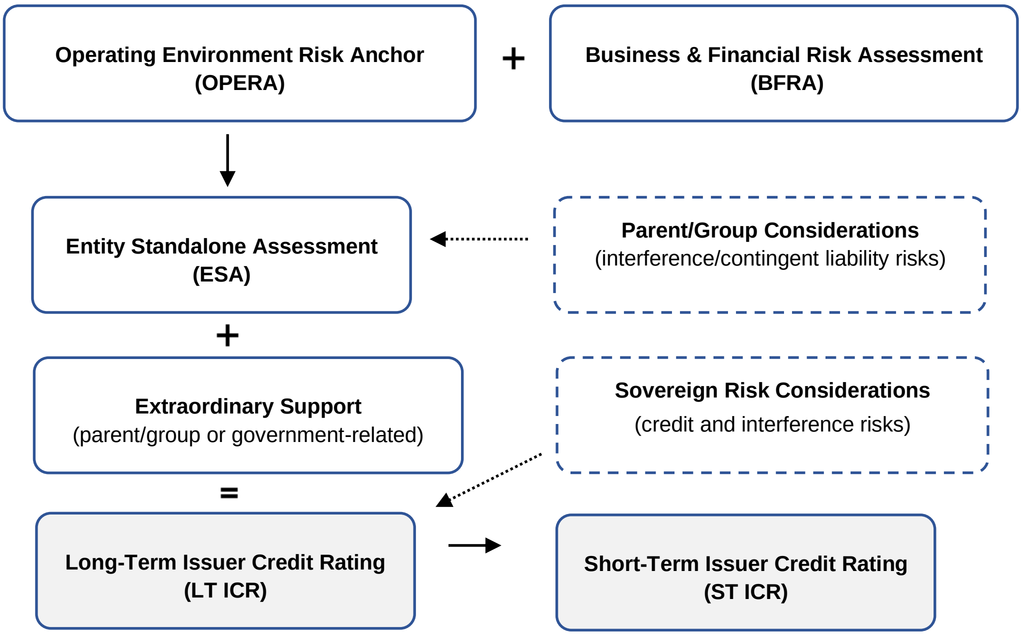
Determining International Issuer Credit Ratings

The framework for determining international ICRs for NBFIs is summarised in Box 1 while the methodological process we follow is outlined in the following sections.

Our evaluation of an NBFI's fundamental credit strength is based on an assessment of seven analytical pillars:

1. Operating Environment Risk
2. Business Risk
3. Governance and Management
4. Risk Profile and Risk Mitigation
5. Funding and Liquidity
6. Earnings and Profitability
7. Capitalisation and Leverage

BOX 1: NBFI ISSUER RATING FRAMEWORK (SIMPLIFIED)



OPERA for NBFIs

Our starting point is to determine operating environment risk, utilising the Operating Environment Risk Anchor (OPERA) we establish for national banking systems, but with some adjustments to better reflect the risks facing NBFIs. These adjustments – which in most cases reflect weaker regulation and supervision compared to banks, as well as a lack of access to central bank liquidity facilities – result in the operating environment anchor for NBFI ratings generally being set up to four notches below, and no higher than, the bank OPERA.

CI acknowledges that the operating environment does not affect all financial institutions within a country in the same way and that some firms are better able to withstand economic shocks than others, reflecting, for example, their business profile and risk appetite, as well as the strength of their liquidity and capital buffers. However, we also recognise that NBFIs, like banks, cannot insulate themselves fully from the economy and broader operating environment.

We do not, therefore, use operating environment risk as a limiting factor in determining an NBFI's ICRs. Instead, under our approach we use our assessment of operating environment risk to establish an anchor that serves to moor ICRs, with the tightness of the anchor (i.e. the distance between the OPERA reference point and the ICR) typically depending on the business and financial strength of the firm plus the credit-enhancing benefits, if any, of extraordinary parental support. That said, in many cases sovereign risk (defined broadly to include transfer and convertibility risk, as well as government default risk) may pose a binding constraint on ICRs.

Business and Financial Risk Assessment

Once we have established the NBFI OPERA, we then evaluate the intrinsic financial, operational and business risk profile of the firm, which we summarise in the Business and Financial Risk Assessment (BFRA). In essence, the BFRA captures those financial and firm-specific non-financial factors (i.e. excluding the operating environment and certain sovereign risk factors) that have a significant bearing on the likelihood of an NBFI failing and requiring extraordinary support in order to remain a going concern, and is largely determined by Analytical Pillars 2 to 7.

Each of these six pillars consists of a number of key rating factors. A firm's relative strength in terms of each key rating factor is assessed and the results of our analysis are combined to form an overall assessment of each pillar. The assessments of all six pillars are then combined to arrive at an opinion of the BFRA. The relative weights of the key rating factors and analytical pillars are decided by CI's rating committee and may vary according to entity-specific circumstances.

The six pillars and associated key rating factors are shown in Box 2.

BOX 2: ANALYTICAL PILLARS OF BFRA

Business Risk	• Business Model • Market Position and Franchise Strength • Business Diversification
Governance & Management	• Quality of Corporate Oversight • Management Effectiveness • Risk Management and Control • Financial Reporting and Transparency
Risk Profile & Risk Mitigation	• Asset Mix and Concentration Risk • Credit Risk and Asset Quality • Market Risk • Operational Risk
Funding & Liquidity	• Funding Structure Risk Profile • Cashflow and Liquidity
Earnings & Profitability	• Profitability and Efficiency • Earnings Quality
Capitalisation & Leverage	• Capital Adequacy and Leverage • Capital Flexibility

The principal characteristics of each key rating factor by assessment category ('very strong', 'strong' etc) are tabulated in each of the report sections below. These 'key characteristics' tables are offered for guidance. They do not constitute a checklist and are not exhaustive. Some, but not necessarily all of the characteristics of a particular assessment category may apply to the rated NBFI and there may be cases where the NBFI is best described by attributes from a combination of assessment categories. It is ultimately for the rating committee to determine which category fits best.

Entity Standalone Assessment

We combine OPERA and BFRA using internal guidelines and taking into account the firm's business and financial profile relative to industry peers, as well as any other relevant rating considerations, to derive an indicative standalone rating for the firm, which we call the Entity Standalone Assessment (ESA). To avoid any confusion with the ICR, the ESA is published in lowercase letters and does not have an outlook (it may, however, include the '+' or '-' modifiers).

Issuer Credit Ratings (ICRs)

We then establish a baseline for the LT ICR either by (i) mapping the firm's ESA to the LT ICR scale and notching the rating up for extraordinary government-related support (if applicable) or, (ii) if group considerations are relevant, applying the criteria contained in Parent-Subsidiary Considerations in the Determination of Corporate and NBFI Credit Ratings. At the same time, we also take into account sovereign risk factors, including the risk of transfer and convertibility restrictions and other state-imposed controls that could impede the NBFI's ability to meet its financial obligations in a timely manner.

The final LT ICR for the firm will generally be set at the same level as the baseline for the issuer rating provided the latter is no higher than the sovereign rating. The NBFI's long-term foreign and local currency ratings would also be equalised (if both are assigned) unless there are convincing reasons for judging default risk to be materially lower in one currency type compared to the other. However, where the baseline issuer rating is higher than the sovereign rating, we would apply our criteria for rating above the sovereign (explained in our Bank Rating Methodology) to determine whether the firm's ratings could be higher than the sovereign or whether they should be constrained by the appropriate sovereign rating.

ST ICRs are mapped from LT ICRs using the guidelines shown in Annex 2.

Rating Scale and Definitions

The scale for ICRs and the associated rating definitions are provided in Annex 1. Outlooks are also assigned to LT ICRs to indicate the likely direction of a change in the ratings over the next 12 months. A Positive (Negative) outlook signals a better than even chance that the rating will be raised (lowered) within a year. A Stable outlook indicates that the rating is unlikely to change in the next 12 months.

National Ratings

In some markets CI may also assign long- and short-term issuer (and issue) credit ratings on a national scale. Unlike international ICRs, national ratings are not comparable across countries and refer instead to the creditworthiness (usually in terms of local currency) of the issuer or issue relative to all other issuers or issues in the same country.

The main purpose of national ratings is to allow greater differentiation among issuers and issues in countries whose sovereign credit ratings are some way below 'AAA' on CI's international ratings scale. In this way, CI's national ratings aim to provide capital market investors with clear credit distinctions between issuers and issues that may not be possible under internationally comparable rating scales.

4. ENTITY STANDALONE ASSESSMENT: ANALYTICAL PILLARS

In this section we explain the rationale for each of the seven analytical pillars of the ESA and outline the criteria used to assess the underlying key rating factors. The analytical pillars are:

1. Operating Environment Risk
2. Business Risk
3. Governance and Management
4. Risk Profile and Risk Mitigation
5. Funding and Liquidity
6. Earnings and Sustainability
7. Capitalisation and Leverage

ANALYTICAL PILLAR 1

OPERATING ENVIRONMENT RISK

An NBFI's financial strength and overall risk profile is heavily influenced by the political, economic and regulatory environment of the country, or countries, in which it operates, and also by the structure and dynamics of the industry itself. For example, the demand for financial products and services and the growth of associated revenues are linked to the size, structure, level of development and performance of the economy. Moreover, the ability to safeguard asset quality, generate investment returns, and undertake asset-liability management is affected, inter alia, by macroeconomic and financial market conditions, the depth and breadth of local financial markets, and prudential regulations.

Changes in economic conditions often provide a leading indicator of financial sector performance and economic disturbances or shocks – for example to output, exports, asset prices, exchange rates and external financing – can have a profound impact on balance sheets and profitability. In addition, shifts in investor confidence or country risk perceptions can drive up funding costs and, in extremis, cause liquidity to evaporate.

The franchise strength, competitive position, and growth prospects of an individual NBFI may also be affected by the size, structure, sophistication, and general risk profile of the sector in which it is active, as well as by developments in the broader financial system. For example, low barriers to entry and overcapacity may lead to strong pressures on pricing and profitability, while market fragmentation may potentially undermine long-term industry stability.

Institutions also matter for the soundness of NBFIs. Regulatory and legal frameworks influence the scope of NBFIs' activities and the risks that they take, while effective supervision facilitates the identification of problems at weak firms before they become severe.

OPERA

Our starting point for assessing the operating environment risk for an NBFI is to consider the Operating Environment Risk Anchor (OPERA) assigned to the banking system of the country (or countries) in which the firm operates.

Bank OPERAs capture those factors that are important for economic growth and broader macroeconomic and financial stability, including the strength of a country's legal and financial infrastructure. They also incorporate general business risks and growth opportunities arising from the structure, level of development, and regulation of a country's banking industry. OPERA also takes into account the ability of the central bank to provide sufficient support to the financial system to alleviate liquidity stresses and funding strains and preserve confidence.

OPERAs are based on an analysis of five (broad) key rating factors, which are further divided into a number of sub-factors. They are:

1. Macroeconomic Strength – which is based on the economic strength, external strength, and macro-financial imbalances components of our Sovereign Rating Methodology.

- Economic strength refers to the capacity of an economy to generate robust output growth, increase per capita income, and be resilient to adverse shocks, or at least able to recover quickly after they occur and considers factors such as economic growth performance, economic diversification, competitiveness, and inflation.

- External strength refers to a country's ability to generate the foreign exchange needed to meet its current and future external debt service obligations in full and takes into account current account performance and financing, external debt capacity, and international liquidity.

- Macro-financial imbalances refer to significant and sustained deviations in macro-financial variables (such as aggregate credit growth, private sector indebtedness, and asset prices) from historical trends or norms. Such imbalances pose a material risk to the economy because they are often unsustainable and may ultimately result in a sharp slowdown in economic activity and potentially severe financial sector stress or a currency crisis.

2. Monetary Flexibility and Capital Market Development – which draws on the monetary policy flexibility and capital market development components of our Sovereign Rating Methodology.

- Monetary policy flexibility considers the ability of the authorities to use policy instruments to influence domestic demand, manage inflation and ensure the sustainability of the country's exchange rate regime. Monetary policy flexibility also captures the capacity of the monetary authorities to adjust the policy stance to counteract economic shocks and to provide temporary liquidity support to the financial system in times of severe disruption.

- Capital market development serves as proxy for the level of development of the financial system and is also indicative of the range of funding options and interest rate and liquidity risk management tools available to financial institutions. The development of local capital markets is also important for the conduct of monetary policy and may help to bolster financial stability.

3. Industry Structure and Performance – which considers the strengths and vulnerabilities associated with the organisation and operation of the banking sector, in particular the extent to which structural factors affect the franchise strength, growth prospects, and the systemic risk exposure of individual institutions. The assessment of this key rating factor also includes an examination of the financial profile of the banking sector, drawing on aggregated micro-prudential indicators of financial soundness, specifically ratios measuring asset quality, profitability, liquidity, and capital adequacy.

4. Regulatory Environment and Institutional Frameworks – which focuses on the effectiveness of bank regulation and supervision and the quality of the legal and financial infrastructure.

- Regulation and supervision considers the extent to which regulatory and supervisory frameworks support a sound and healthy banking sector or, conversely, the degree to which existing or emerging weaknesses in such frameworks could have an adverse impact on the financial stability of the sector.

We frame our analysis around the following:

- The scope and quality of prudential regulations and disclosure requirements;
- The capacity of the authorities to identify institution-specific and systemic risks;
- Their ability and willingness to take timely corrective action; and
- Their track record in doing so.

Legal and financial infrastructure captures a number of important institutional factors that impact operations and risk management. In particular, a clear and effective legal framework is especially relevant to financial institutions for the simple reason that financial instruments are legal contracts. The finance industry's risk profile is therefore strongly affected by the certainty of legal rights within a country and the predictability and speed of their fair and impartial enforcement.

Besides general banking laws and regulations, the elements of a country's legal infrastructure that are of high importance to financial institutions include those governing creditor rights, ownership, contract enforcement, accounting, auditing, and disclosure.

We consider, in particular, the strength of creditor rights, including the effectiveness and efficiency of: (a) bankruptcy or insolvency procedures for corporations and financial firms; and (b) the legal framework to enforce collateral and property.

We also take into account the adequacy of vital financial sector infrastructure, such as payment and settlements systems, credit information systems and property (collateral) registries.

5. Political and Policy Risk – our assessment of this key factor is drawn from our Sovereign Rating Methodology and refers primarily to policy decisions and political events – domestic and external – that could materially affect sovereign creditworthiness. It also takes into account the durability of the social and political fabric of a country and the existence of any underlying vulnerabilities that could potentially engender political instability and undermine the workings of government.

Adjustments to OPERA for NBFIs

All the factors we review to determine bank OPERAs are broadly relevant to NBFIs, with the exception of two bank-specific criteria: the key rating factor ‘industry structure and performance’; and the sub-factor ‘regulation and supervision’. That said, a weak, vulnerable, or distressed banking sector could have adverse implications for NBFIs, particularly in countries where interconnectedness between banks and NBFIs is significant (e.g. due to direct financing or common investment exposures), or where any concerns about the strength of the banking system tends to quickly lower investor risk appetite for exposure to other financial institutions in that country or weigh on customer/client confidence more generally.

In terms of regulation and supervision, prudential oversight of banks is generally stronger compared to NBFIs, and in many jurisdictions bank capital and liquidity rules are broadly aligned with, and periodically updated to remain consistent with, internationally agreed standards.

NBFIs also tend to lack access to central bank facilities, which contributes to higher funding liquidity risk relative to banks (all other things being equal).

Our general view, therefore, is that operating environment risk for NBFIs within a particular country will generally be no lower than, and in most cases will probably be higher than, the level implied by the bank OPERA. Consequently, we make the following adjustments to the bank OPERA to determine the appropriate baseline for an NBFI’s operating environment risk anchor:

- We deduct one notch for a lack of, or more uncertain access to, central bank liquidity facilities.
- We deduct one notch for a less robust, or lighter, regulatory and supervisory framework and less rigorous oversight.
- We may deduct an additional notch where we consider the scope and strictness of prudential rules and standards and/or the quality and enforcement capabilities of the relevant regulatory and supervisory institutions to be particularly weak compared to the banking sector and inadequate given the risk profile of the NBFI sub-sector.
- We may also deduct a further notch for NBFI sub-sectors that experience much greater cyclicality and revenue variability compared to banks and where we believe the associated risks are not adequately captured in our firm-specific criteria (i.e. Analytical Pillars 2 to 7).

This implies that the NBFI OPERA could be up to four notches below the bank OPERA, although in most cases we would expect the differential to be limited to no more than two notches.

Specifically, downward notching may be reduced, or not applied, where:

(i) an NBFI sub-sector is subject to regulatory oversight and prudential standards that are commensurate with those applied to banks in the same country and/or firms within the sub-sector are able to access central bank liquidity facilities (even if subject to meeting collateral requirements); or

(ii) if the above notch factors are less applicable due to the firm's business model (e.g. if it does not incur balance sheet risks as part of operating activities and has no reliance on short-term market-based or confidence-sensitive forms of funding).

In addition, due to the limited number of notches on the OPERA scale, downward notching may also be reduced, or eliminated, when the bank OPERA is below 'bbb-'. This also reflects the fact that the operating environment risk differential between banks and NBFIs tends to be much narrower, or non-existent, when the anchor rating is low, since the much higher level of economic and financial risk is likely to be material for all sectors.

The application of this criteria results in an NBFI sectoral OPERA for the country in which the firm is domiciled and primarily regulated. For NBFIs with substantial operations in more than one country (e.g. through foreign subsidiaries or risk exposures reported on its own balance sheet), we may adjust this 'home' OPERA to reflect the operating environment risk in other countries. The extent of any notch adjustments (positive or negative) will depend on the relative size of foreign exposures and the difference in strength (or risk) between the home and foreign markets.

ANALYTICAL PILLAR 2

BUSINESS RISK

Business risk analysis considers how and where an NBFI makes its money, the stability and defensibility of its business franchise and revenue-generating capacity, and its prospects for sustainable growth. It also focuses on the risks and vulnerabilities inherent in a firm's business model, including its organisational structure.

The sustainability of a firm's business model typically reflects the robustness and resilience of its competitive position, the strength of its brand and reputation, and the diversification of its business activities. Together, these factors form the basis of a firm's ability to generate and maintain appropriate levels of high-quality earnings and capital, which in turn enable it to withstand cyclical swings and periods of economic stress, as well as fend off rivals.

NBFIs typically have to adjust their business models over time to remain relevant in competitive markets. Consequently, management's ability to develop and execute adequate strategic plans is critical for ensuring a firm is able to adapt in order to take account of changing client needs and behaviour, new technologies, and other developments affecting the wider industry, as well as to safeguard its franchise.

We divide our assessment of Business Risk into three key rating factors:

- Business Model
- Market Position and Franchise Strength
- Business Diversification

Characteristics common to higher rated firms include: a leading market position; reliance on relatively stable revenue sources; a diversified business mix; comparatively strong business performance through the cycle; strong strategic planning and execution; and good growth prospects.

Ratings are more likely to be constrained when a firm has a short, untested operating history; has a weak franchise or market share; is reliant on unstable business activities (typically reflected in volatile earnings); exhibits high business concentrations (particularly in terms of product or business line, client base, and geography); or is expected to struggle to adapt to competitiveness challenges or changes in the operating environment (including regulatory changes and secular changes in consumer behaviour).

Complexity of the business model and/or organisational structure may also be a constraining factor in cases where it significantly stretches management's capacity to identify and address risks and emerging challenges, or greatly hampers operational flexibility and the ability to adapt to changing circumstances.

KEY RATING FACTOR 1

Business Model

Business model analysis focuses on how an NBFI generates and sustains revenues and profits, as well as the risks and vulnerabilities arising from what it does and how it does it.

We consider how a firm's business model has evolved over time (with the emphasis on stability and resilience), the seriousness of any threats to the way the firm currently operates, and the appropriateness of any strategic intentions to modify or change the business model in order to ensure sustainability or cope with emerging challenges.

We pay particular attention to the strengths and weaknesses of the business model relative to peers/competitors. Common sectoral or industry specific risks are underweighted in our assessment of this key rating factor since they are also captured to some extent in the adjustments we make to OPERA.

Key considerations include:

- The stability of the business model over time and through economic cycles or, conversely, whether the firm has a track record of significantly altering the business mix or shifting strategic focus.
- Whether the firm's principal business activities are highly volatile, or its revenues or funding very sensitive to financial market conditions and market sentiment, particularly in comparison with sector norms and peers.
- The likely efficacy of, and execution risks associated with, strategies to develop, modify or change the business model (or business mix) in order to enhance the firm's value proposition, competitiveness, and long-term profitability.
- Potential challenges to the current business model arising from expected changes in laws, regulations or technology, including changes driven by environmental, social and governance (ESG) considerations, such as climate change and the associated transition risks.
- Whether planned changes to the size, scale or scope of the business are prudent, or whether expansion plans and growth expectations are unrealistic and a potential source of vulnerability.
- The complexity of the business model and organisational structure, and whether this significantly hinders the ability of management to identify, evaluate and address risks and challenges, or whether it weakens the firm's resilience and ability to adapt quickly.

Business Model, Key Characteristics

Very Strong

Business model is well-established, very stable and highly resilient to operating environment adversities in absolute terms and relative to peers.

Exposure to high-risk activities is not material and the sensitivity of the principal business lines and revenues to changes in investor sentiment or consumer confidence is low.

Operating performance is not significantly affected by fluctuations in economic cycles and financial markets.

Firm has a very strong track record of adapting the business model in a timely manner in order to meet emerging challenges, threats, or secular changes in client preferences and technology and is not expected to be significantly affected by any foreseeable medium-to long-term challenges.

Strong

Business model is well-established, stable and fairly resilient to operating environment adversities.

Exposure to high-risk activities is low and the sensitivity of the principal business lines and revenues to changes in investor sentiment or consumer confidence is modest.

Operating performance is modestly affected by fluctuations in economic cycles and financial markets.

Firm has a strong track record of modifying the business model when necessary but may face significant but likely manageable medium- to long-term challenges.

Adequate

Reasonably stable business model but may be more affected by operating environment adversities compared to higher categories and peers.

Exposure to high-risk activities may be moderate. The principal business lines and revenues may be moderately sensitive to changes in investor sentiment or consumer confidence.

Operating performance may be somewhat affected by fluctuations in economic cycles and financial markets.

Firm has a moderate track record of modifying the business model when necessary and may face significant and likely constraining medium- to long-term challenges.

Moderate

Business model stability is moderate, possibly due to the firm's stage of development and still evolving business mix or periodic significant changes in the earnings mix driven by non-core business lines.

Exposure to high-risk activities may be significant. Reliance on more volatile and confidence-sensitive business lines and revenues may be significant.

Operating performance is significantly affected by fluctuations in economic cycles and financial markets.

Business Model, Key Characteristics (continued)

Firm may have a mixed (or untested) track record of modifying the business model when necessary and/or may face significant short- to medium-term challenges, which it may not be sufficiently well-positioned to meet.

Organisational complexity may be significant and some of the main legal/group entities may be somewhat opaque. Related operational risks may be significant.

Weak

Limited business model stability, possibly reflected in frequent shifts in strategic focus and risk appetite.

Business mix may be unstable/evolving rapidly or exposure to high-risk activities may be high. Reliance on more volatile and confidence-sensitive business lines and revenues may be high.

Firm may have a relatively weak (or untested) track record of modifying the business model when necessary and/or may face major short- to medium-term challenges, which it may be unable to meet.

Organisational complexity and opacity may be high and the business raison d'être for some legal/group entities unclear.

KEY RATING FACTOR 2

Market Position and Franchise Strength

The strength and sustainability of an NBFI's franchise is ultimately reflected in the long-term strength and stability of its earnings. Indeed, a firm's franchise is an important element of its ability to support the growth of existing business activities, as well as to establish and grow new business lines.

Firms build their franchise via their ability to deliver value to clients through changing economic environments, and by their ability to accommodate changing client needs and expectations at an appropriate cost.

Franchise strength is underpinned by those factors that make a firm competitive, differentiate it from its rivals, protect it from new market entrants, and which are difficult or costly for others to replicate.

Strong market positions are often, but not necessarily, associated with competitive advantages such as better pricing power, greater economies of scale and cost efficiency, strong product innovation capabilities, stable client relationships, more favourable growth opportunities, and higher operational barriers to entry for competitors.

Strong market positions are sometimes equated with the size of the firm, as large companies may benefit from economies of scale and scope and be better able to exploit market opportunities. However, in CI's view, size does not guarantee sustainable economic success, as the complexity of larger groups requires more sophisticated managerial and risk-management capabilities – the cost of which may partially offset some of the benefits of scale and scope. Indeed, small-scale NBFIs can thrive as niche players with defendable and profitable business positions.

In assessing market position and franchise strength, we consider:

- The strength of the firm's market position – as evidenced by, for example, indicators of market share, and market and product rankings (e.g. investment performance rankings in the case of asset managers) – as well as the firm's actual and expected performance through the business cycle, and how it coped in the past with any adverse economic shocks.
- Whether the firm's franchise strength benefits from formal barriers to entry (such as capital requirements or compliance with regulations), or from obstacles to market entry associated with economic advantages such as economies of scale, network effects, entry costs (including high sunk costs) and technology.
- The strength of the firm's brand, reputation and pricing power, and the loyalty or 'stickiness' of its customer/client base.
- The firm's vulnerability to competition, as indicated, for example, by the quality or substitutability of products and services – and often reflected in price-sensitive key business lines and limited product differentiation.

- Whether new market entrants pose a significant challenge to the firm's franchise strength and market position.
- Whether recent changes in market position/market share have been driven by aggressive business practices or excessive risk-taking.
- Prospects for increasing products/services and sales in volume terms over the medium term without significantly weakening the risk profile of the entity.
- Whether the firm's strategy to increase or defend its franchise value relies on expanding higher-risk, higher-return business lines or shifting into activities that offer less functional synergies.
- Whether the firm's franchise strength or market position benefits from it being a member of a larger, well-established, and successful group or, conversely, whether the firm's franchise strength might be adversely affected by weaknesses, failings, or brand erosion at the parent level.

Market Position and Franchise Strength, Key Characteristics

Very Strong

Leading and sustainable market position in all or most key business lines and/or geographies, with no discernible weaknesses.

Strong competitive advantages internationally (e.g in terms of economies of scale, distribution channels, product innovation, product differentiation, pricing power and client relationships). Likely benefits from very high formal or informal barriers to entry.

Very good growth potential and prospects across all key markets and segments.

Strong

Sound and sustainable market positions in most key business lines and/or key geographies. May be reliant on a leading position in a single large economy.

Sound competitive advantages with limited weaknesses. Likely benefits from high formal or informal barriers to entry.

Good growth potential and prospects in most key markets and segments.

Adequate

Adequate (mid-tier) franchise/brand with moderately good or average market positions in key business lines and/or key geographies. Alternatively, franchise strength may be associated with a strong position in a single small- or medium-sized economy or a leading and defendable position in a niche sector or activity.

Adequate competitiveness with some weaknesses. Barriers to entry likely provide moderate protection against new entrants.

Average growth potential and growth prospects in some key markets and segments.

Moderate

Moderate (below average) market positions in key business lines and/or key geographies. Operating history may be limited.

Moderate competitiveness with possibly significant constraints (e.g. weak pricing power/price-sensitive market position, limited brand presence, limited economies of scale, scope etc, customer base that exhibits significant turnover).

Moderate growth potential and prospects in key markets and segments, albeit subject to substantial competition and/or regulatory pressures. Alternatively, the focus of business growth/franchise development may have shifted to high risk and potentially more volatile (non-core) business lines or geographies.

Weak

Weak market positions and very limited franchise strength across business lines and geographies. Operating history may be very limited.

No significant competitive advantages, very limited brand presence, and possibly serious weaknesses in a number of key areas.

Very limited growth potential and prospects due to inherent shortcomings/constraints and substantial competitive and/or regulatory pressures.

KEY RATING FACTOR 3

Business Diversification

The breadth and diversification of an NBFI's products and services, as well as its client base and distribution channels, contributes to the growth, reliability and diversity of earnings. Moreover, well diversified firms with low concentrations and limited correlations in terms of business segment, product, geography, and client are generally better positioned to withstand cyclical swings and extended periods of economic stress, as well as adapt to changes in customer preferences and in the broader competitive or regulatory environment.

A diversified product range will be reflected in a mix of revenue sources by business line. In general, the more varied that revenue, the less vulnerable a firm will be to a downturn or loss of custom in any single business line. Diversification within business lines is also an important consideration. For example, in the case of asset managers diversification is considered with respect to asset class (equity, fixed income etc), industry focus, and investor type (e.g. whether largely institutional or retail, or a combination of both), as well as the variety of investment products/funds. The extent of any correlations between products and/or business lines is also relevant as revenues of closely correlated, but formally different, products may be hit equally hard in the event of an economic downturn.

We also consider whether a firm's clients or assets, as well as AUM, are concentrated in a single geographical region and if not, to what extent they are diversified across regions and national borders. Geographical diversification can also bring unexpected risk, particularly where distance stretches management oversight or where local market risk is not adequately evaluated and addressed due to a possibly inexperienced leadership team. Since extensive geographical reach can place heavy demands on an NBFI's resources, we also consider whether the firm has adequate support structures, knowledge and experience, as well as sufficient local market access and critical mass in order to take full advantage of the expected benefits of that diversification.

Key considerations include:

- The degree of revenue concentration risk posed by high reliance on a single business line, geography or asset class, or by having a small number of key clients (customers and counterparties).
- Whether the firm is highly exposed to business disruption risk due to a high reliance on a small number of key suppliers.
- The expected riskiness of new or recent diversification efforts (e.g. launching new products with no obvious synergies, or aggressively entering new markets where the firm has limited expertise).
- Whether the product range is narrow or highly correlated and, if so, whether the attendant risks are mitigated to a significant extent by an associated revenue stream that has proven to be reasonably stable during economic downturns.

Business Diversification, Key Characteristics

Very High

Very high level of diversification and very low levels of concentrations and correlations across business segments, customers, and geographies, including by industry standards and relative to peers.

High

High business diversification and generally low levels of concentrations and correlations relative to most peers.

Geographical diversification may be moderate but the markets the firm operates in are relatively large and a source of stable business volumes and revenue streams.

Adequate

Adequate diversification with material, but manageable, levels of concentrations and correlations that are in line with the average for peers.

Alternatively, business or geographical concentrations may be significant but associated risks are considered to be moderate and revenues from core business lines have proven to be fairly robust through economic cycles.

Business Diversification, Key Characteristics (continued)

Moderate

Significant business concentrations and less diversified than average for peers.

May be reliant on a few key business lines and a higher risk product mix, and have little or no geographical diversification.

Business volumes and revenue streams may be reliant on a few key clients.

Low

High business concentrations and substantially less diversified than most peers.

May be very reliant on a very small number of possibly volatile business lines.

Business and revenue streams may be highly dependent on a few large customers.

ANALYTICAL PILLAR 3

GOVERNANCE AND MANAGEMENT

The focus of this analytical pillar is on how the governance and management of a company may support or potentially hinder its overall risk profile and operational and business performance.

Governance is an important ratings consideration given the number of corporate failures that have been associated with factors such as inadequate oversight by passive or uniformed boards of directors, ineffective internal controls, and weak risk management.

Good corporate governance helps to protect the legitimate interests of creditors, shareholders and other stakeholders, including employees. It also plays an important role in an entity implementing successful business strategies, using resources efficiently, and conducting day-to-day operations in a safe and sound manner, consistent with its established risk appetite and overall risk profile.

Good corporate governance is also a key contributor to an NBFI's ability to identify and respond to new risks and emerging challenges and to cope with adverse changes in business, economic and financial conditions. Conversely, governance deficiencies can lead to a range of credit-relevant problems. For example, concentrated ownership structures (e.g. institutions owned by management, families or non-financial corporates) may give rise to potentially harmful conflicts of interest, while overly-complex or non-transparent structures can create significant challenges for board of director oversight.

Boards of directors that lack independence or sufficient diversity and expertise may be less committed to fulfilling their fiduciary and other responsibilities, opening the door to ineffective or irresponsible management behaviour. Similarly, weak governance may contribute to the pursuit of aggressive business growth strategies and excessive risk taking – particularly if accompanied by inadequate risk management or inappropriate incentive structures and compensation schemes.

Our overall assessment of Governance and Management is based on four key rating factors:

- Quality of Corporate Oversight
- Management Effectiveness
- Risk Management and Control
- Financial Reporting and Transparency

The assessment focuses on firm-specific policies, procedures, and practices. Any legal or institutional impediments to good corporate governance are captured in our assessment of the operating environment. At a minimum we would expect companies to adhere to the established corporate governance standards in their domestic market. However, meeting minimum local standards may not be enough to avoid a negative assessment if we observe policies, practices or relationships that diminish the quality of corporate governance.

Indeed, significant governance deficiencies may result in a rating being notched below the level that might otherwise have been assigned because of the high associated risks, such as poor decision making, insufficient planning, and excessive risk-taking (e.g. if the board of directors is uninformed or passive). Moreover, where governance and oversight are weak, there is greater scope for financial and other key risks to be missed by senior management and directors or, more nefariously, hidden from investors and other stakeholders.

In our assessment we typically give greater emphasis to practices and actions as opposed to codes and policies. Most NBFIs have adopted explicit corporate governance standards and codes of conduct and ethics, and many produce associated reports. However, there are sometimes doubts as to whether the professed standards are actually applied consistently and whether, in practice, governance checks and balances function in the ways indicated on paper.

KEY RATING FACTOR 1

Quality of Corporate Oversight

The focus of this key rating factor is on the effectiveness of the board of directors, specifically whether the board has sufficient independence, authority, expertise, diversity, and resources to discharge its core responsibilities effectively, hold management to account, and provide appropriate checks and balances against conflicts of interest.

We generally expect the board to perform a number of key oversight functions, including the following: reviewing (and guiding) corporate strategy, risk management, annual budgets and business plans; monitoring company performance; and reviewing remuneration/compensation structures (including with a view to minimising incentives for excessive risk-taking).

We also expect the board to consist of a sufficient number of suitably qualified independent non-executive members who are proactive in performing their oversight duties and have a demonstrated track record of holding management and other "insiders" to account.

The quality of corporate oversight may have a negative impact on ratings in cases where deficiencies in arrangements or practices raise significant concerns about the stewardship of the company and/or the protection of creditor and other stakeholder rights.

Characteristics that may result in an unfavourable assessment include:

- Limited board independence (as indicated, for example, by the relative strength of executive directors/insiders, including if they make up more than two-thirds of the board's members).
- A lack of diversity of experience and expertise among board members or inadequate experience and expertise (including family members holding board positions without appropriate knowledge or qualifications).
- Passive or inactive boards that say little, fail to remove and replace underperforming directors, seldom change members (e.g. non-executive directors tend to remain in post for more than 10 years), or that are dominated by one individual.
- A board size that is either too small to have an appropriate balance of directors or too large to be effective (taking into account the size, complexity and risk profile of the business).
- Preferential treatment to related parties (particularly where related party transactions lack transparency and board oversight, or do not appear to serve a legitimate economic purpose).
- Complex or opaque organisational structures which might impede the ability of the board to oversee business performance and to identify and assess risks (complexity may also pose similar challengers for management, investors, and regulators).
- A track record of regular violations of laws or regulations that have resulted in losses and/or significant harm to the firm's corporate identity or social responsibility profile.
- A lack of board committees, or committees that consist of an insufficient number of members or include members without appropriate qualifications and experience (especially in the case of audit and risk management committees).
- Inadequate independent oversight of the audit and risk management functions.

Moderate and low board effectiveness is often reflected in the following: under-developed strategic planning; management incentive schemes that (inadvertently) increase the risk profile of the firm; and inadequate succession planning for senior management.

Quality of Corporate Oversight, Key Characteristics

Good

Board is proactive and exercises strong oversight of senior management, corporate strategy, risk-taking activities, and conflicts of interest.

Majority of board members are independent. All board members have substantial experience and expertise, as well as access to sufficient information and resources, to understand and evaluate the firm's risk profile and conflicts of interest.

Board committees are proactive, independent, and exercise strong oversight of internal control functions.

Satisfactory

Board is active and exercises satisfactory oversight of senior management, corporate strategy, risk-taking activities, and conflicts of interest.

At least one-third of board members are independent. All board members have sufficient experience and expertise, as well as access to sufficient information and resources, to understand and evaluate the firm's risk profile and conflicts of interest.

Board committees are active, independent, and exercise satisfactory oversight of internal control functions.

Moderate

Board exercises a moderate (less than adequate) degree of management and risk oversight.

Board may contain an insufficient number of independent members and/or some board members may lack adequate experience and expertise.

The size or structure of board and/or board committees may not be appropriate given the risk profile and complexity of the firm. Board members and resources may be stretched, impeding proper oversight.

Compensation arrangements may undermine the objectivity of independent members by linking their compensation to short-term business performance.

Low

Board may lack any effective independence. Board decisions may be dominated by one member or a small number of executives/insiders; other board members may be largely passive.

Little or no evidence of proper (independent) board scrutiny of the firm's senior management and risk taking.

Evidence that strong executives/individuals are able to override compliance or control-related policies and procedures without sanction.

Board may primarily serve the interests of the controlling shareholder, possibly to the detriment of other shareholders. Related party transactions may be high and not subject to proper review/challenge.

KEY RATING FACTOR 2

Management Effectiveness

Management effectiveness is to some extent revealed by an NBFI's performance over time, particularly through changes in the business cycle and when confronted by market adversities. Management effectiveness may therefore be gauged by the company's financial track record and indicators of franchise strength, such as the size of, and trends in, its market share.

Financial performance and franchise strength are captured in other key rating factors. However, there are a number of aspects of management quality that may be important on a forward-looking basis for long-term performance. These include:

- Experience and recent track record of the current management – which we consider a good starting point for assessing the ability to grow the business and respond to new challenges.
- Depth and breadth of management – in particular whether the company is reliant on a small number of key people and to what extent associated risks are mitigated by, and broader continuity supported by, succession planning.
- Senior management turnover – which if high may indicate excessive interference by the board or owners – as well as the ability to attract and retain qualified staff throughout the organisation.
- Management's capacity to develop comprehensive and plausible business plans; its success in meeting strategic objectives, including related financial and operational goals; and its ability to adapt plans and policies to unanticipated challenges and events.
- Management risk culture – whether management (other than risk managers) has a clear understanding of the amount of risk that is acceptable in order to implement the company's business plan, and whether this is consistent with corporate strategy.

Management Effectiveness, Key Characteristics

Very High

Highly experienced and stable management team, with good depth and a very successful track record of steering the business through economic/market cycles and adapting to unexpected adversities.

Key person risk is very low and succession planning is very strong.

Strategic plans cover medium- to long-term time horizons and are comprehensive and credible. Related financial and operational targets are consistently met.

Management risk culture is strong, with a strong understanding across senior management of the company's risk profile and risk appetite, and risk considerations permeate through the organisation.

High

Experienced and stable management team, with good depth and a successful track record of steering the business through economic/market cycles and adapting to unexpected adversities.

Key person risk is modest and succession planning is strong.

Strategic plans cover medium- to long-term time horizons and are comprehensive and credible. Related financial and operational targets are routinely met.

Adequate

Reasonably experienced and generally stable management team, with adequate depth and a reasonable track record of steering the business through economic/market cycles and adapting to unexpected adversities.

There may be some reliance on a small number of key individuals, although associated risks are likely mitigated to a significant degree by succession planning.

Strategic plans extend at least to the medium term but may be less than comprehensive and/or subject to significant changes from time to time. Related financial and operational targets are often, but not always, met.

Moderate

Management team may have a moderate degree of depth and experience and a mixed track record of steering the business through economic/market cycles and adapting to unexpected adversities.

Management Effectiveness, Key Characteristics (continued)

Management turnover may be significant or there may be strong reliance on a small number of key individuals, with limited succession planning.

Strategic plans may not be well developed or sufficiently forward looking and/or may be subject to regular change, possibly driven by short-term opportunism or due to overly optimistic underlying assumptions. Financial and operational targets are often missed.

Management effectiveness may be undermined by resource constraints, which are unlikely to be resolved in the short to medium term.

Low

Management team may lack depth and experience and may be untested or have a generally poor track record of steering the business through economic/market cycles and adapting to unexpected adversities.

Management turnover may be elevated or there may be very high reliance on a small number of key individuals, with little or no succession planning.

Strategic planning may be weak and not properly documented and/or subject to frequent and possibly sizeable shifts. Financial and operational targets are typically missed.

Management effectiveness may be greatly undermined by resource constraints, which are unlikely to be resolved, even in the medium to long term.

Management risk culture may be weak, possibly reflecting shortcomings in risk-related policies and procedures, limited or inconsistent risk messaging/communication, weak enforcement of rules/standards, or incentive structures that encourage high risk transactions/behaviour.

KEY RATING FACTOR 3

Risk Management and Control

This rating factor involves an assessment of the effectiveness of an NBFI's policies, procedures and resources for identifying, assessing, monitoring and mitigating all relevant risks, as well as its ability to maintain risk levels within acceptable limits. Our analysis includes an assessment of the firm's risk appetite, as well as a review of how it has managed risks over the time, including through economic cycles, market fluctuations and periods of market stress, and as evidenced by its loss history.

Robust risk management capabilities are important for all NBFIs, although the degree of sophistication may vary with the nature, scale and complexity of the business model. In general, though, we place more weight on risk management in our overall assessment of this analytical pillar for those firms that utilise their own balance sheet as part of operating activities and are more exposed to credit, market and liquidity risks (compared, for example, to service providers and advisory firms).

Key considerations include:

- The extent to which the risk management function is truly independent of revenue-generating business units (both in terms of reporting lines and in terms of the ability to overcome more subtle pressures to co-opt its independence) and is able to voice concerns effectively.
- Whether the risk management function has direct access to the board of directors (including through regular reporting), as well as to all business lines that have the potential to generate risks.
- The adequacy of resources for identifying, measuring and monitoring risk (including staff expertise, quantitative tools, data and IT infrastructure).
- Whether the company has implemented a holistic entity-wide approach to risk management that encompasses all business lines and internal control functions (rather than treating each business unit separately) and includes non-financial risks (e.g. operational, reputational and legal risks), as well as financial risks (e.g. credit, market, liquidity etc).
- The strength and rigour of underwriting standards (where relevant to the business model), including credit approval processes, and whether such standards are likely to be eroded under competitive pressure.

- The adequacy of measures to minimise credit and settlement risk in securities and derivative transactions, such as collateral and margin requirements, stop-loss arrangements, and netting agreements.
- The appropriateness of internal concentration and risk exposure limits and the degree of compliance with such limits.
- The firm's track record in successfully managing risk through the economic cycle and periods of stress, including its performance relative to peers.
- Whether risk appetite leans towards conservative or aggressive, whether agreed risk limits are adhered to in the pursuit of strategic objectives, and whether there is evidence of corrective action being taken when limits have been breached.

Risk Management and Control, Key Characteristics

Very Strong

Very strong risk management function with very good architecture, procedures, policies, systems and tools in place.

High quality staff in sufficient numbers and with very strong systems and measurement tools to identify, evaluate and routinely monitor all areas of risk on a consistent and timely basis.

Risk management function operates independently, has high stature and authority within the organisation, is highly integrated into the firm's operations, and has a demonstrated ability to shape risk policies and control risk exposures through appropriate management and mitigation mechanisms.

Risk appetite is reasonably conservative. Risk limits or standards are appropriate and compliance with such limits/standards is very high. Exposures that are close to or exceed approved limits are reduced or mitigated in an effective and timely manner.

Very strong track record of managing risk through periods of economic and market stress.

Strong

Strong risk management function with good architecture, procedures, policies, systems and tools in place.

Good quality staff in adequate numbers and with strong systems and measurement tools to identify, evaluate and routinely monitor all areas of risk on a consistent and timely basis.

Risk management function operates independently, has stature and authority within the organisation, is well integrated, and has a demonstrated ability to shape risk policies and control risk exposures.

Risk appetite is reasonably conservative. Risk limits or standards are generally appropriate and compliance with such limits/ standards is generally high. Exposures that are close to or exceed approved limits are usually addressed in an effective and timely manner.

Strong track record of managing risk through periods of economic and market stress.

Adequate

Adequate risk management function with fairly good architecture, procedures, policies, systems and tools in place.

Human and technical resources for identifying, measuring and monitoring risk are adequate, but the breadth and depth of risk management may be somewhat limited (e.g. focused almost exclusively on financial risks, or with a less than fully comprehensive limit framework and standards).

Risk management function is reasonably independent and has reasonable stature and influence.

Risk appetite may be moderately conservative to moderately aggressive. Adopted risk limits or standards are generally appropriate but may not be very comprehensive or sophisticated. Compliance with such limits/ standards is reasonably good. Exposures that are close to or exceed approved limits are for the most part addressed in an effective and timely manner.

Adequate track record of managing risk through periods of economic and market stress.

Moderate

Risk management function may not have sufficient resources, systems and expertise to identify, measure, monitor and manage risk (given the complexity and/or risk profile of the firm).

Risk management function may not be adequately integrated into the firm's operations and may lack sufficient authority and/or independence.

Risk Management and Control, Key Characteristics (continued)

The scope of risk management may be significantly restricted.

Risk limits or standards may be somewhat basic, inadequately specified or inconsistent and sometimes (inappropriately) revised to accommodate business opportunities.

Compliance with internal risk limits may be mixed and/or breaches not systemically evaluated and addressed.

Risk appetite may be aggressive/high (e.g. as evidenced by relaxed underwriting standards relative to peers or increasing exposure to higher risk activities or markets).

Track record of managing risk through periods of economic and market stress may be mixed.

Weak

Risk management function is weak with a significant lack of resources, systems and expertise to identify, measure, monitor and manage risk (given the complexity and/or risk profile of the firm).

Risk management function may not be sufficiently integrated into the firm's operations and may be significantly lacking in independence and/or authority.

The scope of risk management may be greatly restricted.

Risk limits or standards may be basic, poorly specified, or inconsistent and subject to frequent change.

Compliance with internal risk limits may be low and breaches not systemically evaluated and addressed.

Risk appetite may be very aggressive/very high (e.g. as evidenced by weak and declining underwriting standards relative to peers or rapid growth in exposure to higher risk activities or markets).

Track record of managing risk through periods of economic and market stress may be poor.

KEY RATING FACTOR 4

Financial Reporting and Transparency

Comprehensive, relevant, accurate and timely disclosure of information on an NBFI's financial condition and performance, business activities, and risk management practices is essential for sound and effective corporate governance. Otherwise, it is difficult for shareholders, non-executive board members, creditors and other stakeholders to monitor management effectiveness and the firm's performance, and to identify adverse developments at an early stage. Moreover, accounting deficiencies and weak internal controls – such as an internal audit function lacking in independence and authority – may enable operational and other risks to go undetected, or be used to hide fraudulent activity or corrupt practices.

Over the past decade we have observed an improving trend in the frequency, timeliness, comprehensiveness, materiality and comparability of corporate financial reporting and related disclosures, including the implementation of International Financial Reporting Standards (IFRS) across most developed and developing markets.

Despite such improvements, we still observe material differences in the quality of public disclosure and transparency across countries and between individual entities. The same holds true for the interpretation of regulatory and accounting standards by individual NBFIs. Consequently, we consider the extent to which a firm exploits any accounting or reporting latitude in order to paint an overly positive picture of its financial health (e.g. through aggressive revenue recognition and valuation practices).

When assessing the quality of transparency and disclosure, we focus on potential weaknesses and warning indicators that may warrant further investigation and ultimately lead to an unfavourable assessment. These include:

- External and internal auditors who appear to operate without sufficient independence, lack quality, or do not have a good reputation in the local market;
- Instances where external auditors have issued an adverse opinion, determining that the financial statements are materially misstated and do not conform to the relevant accounting, regulatory or legal standards;

- Aggressive interpretation of accounting standards; and
- Shortcomings in the timeliness, comprehensiveness, and consistency of financial disclosures.

Financial reporting and transparency is a largely asymmetrical rating factor. The impact of good disclosure on ratings is usually neutral, in part because it cannot on its own outweigh weaknesses in a firm's business or financial risk profile. However, significant shortcomings in the quality of financial reporting and disclosure would normally have a negative impact on ratings, while severe deficiencies would pose an insurmountable obstacle to ratings been assigned or maintained.

Financial Reporting and Transparency, Key Characteristics

Satisfactory

Financial statements are prepared in accordance with international standards and have been reliable and consistent over time.

Financial and related disclosures are considered to be comprehensive, accurate and timely.

Less Than Adequate

Financial statements are prepared using local standards that are somewhat below international norms and/or there are some moderate concerns about their comprehensiveness and reliability.

Shortcomings with regards to accounting practices and internal controls may raise some questions about the accuracy and completeness of some key aspects of financial and related disclosures. The firm's accounting practices may be aggressive or obfuscatory.

External auditors may have issued a qualified opinion, identifying some important issues, financial statements may be subject to periodic (unusual) restatement, and the firm may be occasionally late with its regulatory filings.

Weak

Financial statements are prepared using local standards that are significantly below international norms and/or there are substantial concerns about their comprehensiveness and reliability.

Financial and related disclosures may be very limited in scope and/or there may be serious concerns about the accuracy of the firm's disclosures. The firm's accounting practices may be particularly aggressive or obfuscatory.

External auditors may lack independence or may have issued an adverse opinion or a disclaimer. Financial statements may be subject to regular (unusual) restatements, and the firm may be frequently late with regulatory filings.

ANALYTICAL PILLAR 4

RISK PROFILE AND RISK MITIGATION

The focus of this analytical pillar is on the risk profile of an NBFI's exposures (assets and off-balance sheet items). We consider the nature and scale of risk exposures both in absolute terms and after considering mitigants aimed at reducing the degree of risk and the size of potential losses. We also consider (where appropriate to the business model) an NBFI's capacity to accommodate losses through accumulated provisions without impairing its capital.

Credit risk and market risk are the two principal risks facing most NBFIs. Although not necessarily linked to any particular exposure, operational risk (including cyber security) may also be an important rating factor, particularly for firms engaged in IT-intensive, high-frequency activities, and we may lower our overall risk profile assessment of an NBFI if we believe operational risk to be material.

Our evaluation of an NBFI's risk profile and risk mitigation is based on four broad-based key rating factors:

- Asset Mix and Concentration Risk;
- Credit Risk and Asset Quality;
- Market Risk; and
- Operational Risk

The weight we place on each of these factors will depend to some extent on the business model of the NBFI. The first two key rating factors are generally more important for finance companies and (to a lesser extent) securities firms that assume balance sheet risk through investing, underwriting, and lending activities. They tend to be less relevant to firms with limited balance sheet risk, such as traditional asset managers, pure brokers (inter-dealer brokers), and advisory firms. For securities firms and asset managers, market risk and operational risk are usually more important rating drivers.

KEY RATING FACTOR 1

Asset Mix and Concentration Risk

In this key rating factor we assess an NBFI's asset mix in terms of its fundamental soundness and consistency with the firm's stated business and investment strategies. We focus in particular on the degree of risk and vulnerability in the asset structure, especially in terms of:

(a) the relative importance of asset class and credit exposure categories that are considered to be higher risk; and

(b) risk characteristics that may increase an NBFI's relative susceptibility to asset risk/asset quality problems independently of the asset class or credit category, in particular exposure concentrations and rapid (excessive) growth of the asset base and off-balance sheet activities.

We consider a number of factors including:

- The size of the asset base in absolute terms, as small NBFIs may be less capable of coping with event risk compared to large NBFIs (all other things being equal).
- The degree of exposure to relatively high-risk assets (e.g. private equity and speculative real estate), as well as to complex assets, such as derivatives, securitisations and off-balance sheet activities. Where appropriate we may use financial instruments allocated to level 3 of the fair value hierarchy and, in some cases, level 2 as a proxy for higher risk exposure.
- Recent changes in the risk profile of the asset base, in particular indications of a permanent increase in risk appetite – proxied, for example, by trends in the ratio of risk-weighted assets (RWAs) to total assets. Evidence that the firm is tolerating much higher levels of risk in order to increase profitability is generally regarded negatively.

The most important vulnerabilities in the asset structure tend to arise from high exposure to individual borrowers, issuers or counterparties, or excessive sectoral concentrations of loans and investments.

Such concentrations may leave a firm vulnerable to financial loss if the obligor or counterparty defaults or fails to perform, or if the asset loses significant value.

CI generally regards credit concentration risk to be high and a potential rating constraint when an NBFI's asset structure features any of the following:

- High exposure to a single industry or economic sector, particularly highly cyclical or troubled sectors or, more broadly, to a highly correlated set of sectors or activities, especially sectors with more volatile income streams (e.g. commercial real estate and construction).
- Large exposure to a small number of borrowers.
- Outsized exposure to a single issuer.
- High exposure to related or connected parties, such as entities within the same group.
- High exposure to borrowers, issuers or counterparties in more volatile emerging markets or in countries currently under, or at elevated risk of, economic and financial stress.
- High exposure to illiquid investment assets (relative to long-term stable funding).

A high share of loans in foreign currency may be viewed similarly, particularly if borrowers lack a natural hedge against adverse movements in exchange rates.

The pace of asset growth is another important risk factor as excessive growth may presage an increase in an NBFI's risk profile. This could be intentional, for example if the firm is pursuing an aggressive growth strategy focused on higher-risk/higher-reward activities or markets. However, it may also be unintentional since rapid asset growth may stretch a firm's risk management capabilities and internal controls, resulting in poorer lending and investment decisions.

An important supplementary factor in assessing forward-looking risks associated with the growth rate and composition of assets is the quality of a firm's risk management, including the soundness of underwriting standards. Prudent risk management is a rating strength and any concerns we may have about the current pace or composition of asset growth may be at least partly allayed where there is evidence the NBFI is taking appropriate risk-reducing or mitigating actions. Examples of the latter include tightening prudential standards, reducing exposure to problematic sectors or activities, lowering limits on risk concentrations, and diversifying asset allocations.

Asset Mix and Concentration Risk, Key Characteristics

Very Low

The nature and composition of risk exposures imply very low risk.

Exposure to higher risk assets and illiquid investment assets is very low.

Risk exposures are very well diversified.

Asset growth is sustainable and driven by core activities.

The overall risk profile of the NBFI's assets is not expected to change to any significant degree in the medium term.

Low

The nature and composition of risk exposures imply low risk.

Exposure to higher risk assets and illiquid investment assets is low.

Risk exposures are well diversified.

Asset growth is generally sustainable and driven mainly by core activities but may also reflect new or higher risk business lines or products that are expanding at a faster rate than the total.

The overall risk profile of the NBFI's assets is not expected to increase significantly in the medium term.

Moderate

The nature and composition of risk exposures imply moderate risk.

Exposure to higher risk assets and illiquid investment assets may be moderate.

Risk exposures are adequately diversified, and concentrations are generally within acceptable limits. There may

Asset Mix and Concentration Risk, Key Characteristics (continued)

be some significant geographical or sectoral concentrations, possibly reflecting the size or business model of the NBFI or the narrowness of the local economy. There may be significant, but not high, exposure to issuers, borrowers or counterparties in economies that are particularly volatile or weak.

Asset growth may be slightly above sustainable levels and/or reflect non-core and higher-risk activities.

The overall risk profile of the NBFI's assets may be expected to increase moderately in the medium term.

Moderately High

The nature and composition of risk exposures imply moderately high risk.

Exposure to higher risk assets and illiquid investment assets may be substantial.

Risk exposures may not be sufficiently diversified and there may be some sizeable concentrations that are at or slightly in excess of prudent levels. There may be some sizeable exposures to issuers, borrowers or counterparties in economies that are particularly volatile or weak.

Asset growth may be significantly above sustainable levels and/or reflect a significant shift into non-core and higher-risk activities.

The overall risk profile of the NBFI's assets may be expected to increase significantly in the intermediate term.

High

The nature and composition of risk exposures imply high risk.

Exposure to higher risk assets and illiquid investment assets may be relatively high.

Concentration risk may be comparatively high and there may be some large concentrations that are well above prudent levels. There may be high exposure to issuers, borrowers or counterparties in economies that are particularly volatile or weak.

Asset growth may be highly excessive and/or reflect a significant expansion of higher-risk activities.

The overall risk profile of the NBFI's assets may be expected to increase significantly in the short to intermediate term.

KEY RATING FACTOR 2

Credit Risk and Asset Quality

Credit risk refers to the risk of a borrower or counterparty failing to honour the terms of a contractual obligation, resulting in the cash flows of the asset being delayed or not paid in full. Credit risk can arise in a variety of ways, for example from the risk of default on a direct loan or bond obligation, or from a derivative counterparty or guarantor failing to meet their obligations. Such defaults typically result in the impairment of the exposure in the form of provisions or write-offs and can have adverse consequences for a firm's earnings, liquidity, and capital position.

The type and relative importance of credit risk exposure tends to differ by business model. For example, in the case of finance companies it is the quality of the loan book/financing portfolio that usually matters most. For securities firms, credit risk is more associated with margin lending, securities borrowing or lending, repurchase agreements, and derivative contracts, as well as with settlement-related counterparty failures.

Our assessment of an NBFI's credit risk exposure is tailored to the business model of the firm, but in broad terms takes into account, inter alia:

- The quality of the loan book and securities and investment portfolios, as well as historic credit losses;
- Potential credit loss mitigation from collateral and other credit enhancements; and
- The capacity to absorb future credit losses from aggregate provisions/ loan loss reserves.

Asset Quality

To assess the quality and performance of the loan/financing portfolio of an NBFI (particularly finance companies), we draw on a variety of asset quality indicators, including non-performing exposure

(NPE) ratios and the NPE accretion rate, which taken together provide an indication of the relative size and direction of problematic exposures.

In the case of securities firms, we focus more on the size and frequency of any losses on margin lending activity, as well as the performance of any unsecured financings (e.g. bridge financing or accommodation loans).

When evaluating asset quality, we also consider key qualitative factors, such as the firm's loan classification criteria and approach to loss recognition. More specifically we will generally lower our assessment of asset quality from the level implied by headline ratios if any of the following conditions apply:

- Asset quality is materially worse than indicated by NPE ratios owing to weaknesses in the NBFI's approach to classifying loans or recognising impairments. This may include deficiencies in the following: the measurement and valuation of NPEs; the accuracy of classification standards; and adherence to those standards. Compared to banks, NBFIs may be able to exercise greater discretion in key areas such as the application of loan classification criteria and loss recognition, and may be able to adopt more liberal or undue forbearance practices. We critically evaluate forms of forbearance which allow both borrowers to more easily honour their obligations and firms to postpone the recognition of possible losses.
- The NBFI's exposures are unseasoned and/or asset quality has not been tested in a more unfavourable economic environment.
- The level of foreclosed real estate and other property on the firm's books suggests that asset quality is weaker than indicated by NPE ratios.
- Recent improvements in the firm's NPE ratios largely reflects the transfer or sale of 'bad' assets to a special asset management company or special purpose vehicle.
- Observed declines in NPE ratios are misleading due to the pace of asset growth (denominator effects) or the amount of write-offs.

To assess the credit quality of an NBFI's securities and investment portfolios we consider:

- Recent or expected impairments on securities, investments and other non-loan exposures, including credit losses on off-balance sheet activities.
- The creditworthiness of the issuers of securities.
- The degree of investment exposure to private equity, real estate and complex securitised instruments (which we consider to be particularly risky asset classes), while making some allowance for the level of in-house resources and degree of due diligence underlying investment decisions and risk monitoring.
- The liquidity profile of the securities and investment portfolio, with assets that are available for sale or held for trading usually regarded as less vulnerable to credit risk, except when current market liquidity conditions pose a material risk to the firm's ability to exit or hedge a position in the near term. Significant holdings of unquoted securities issued by sub-investment grade entities would generally be regarded as a potentially material source of credit risk for the NBFI.

Holdings of derivative financial instruments may also be an important consideration – for example if counterparty credit risk or 'wrong-way risk' is high – although it is often difficult in practice to fully gauge such risks due to weaknesses in financial reporting disclosures.

Credit risk associated with other key counterparties, such as clearinghouses, may also be a relevant consideration, particularly in emerging markets.

Credit Loss Mitigation and Absorption Capacity

The management of NPEs is a material rating consideration factor for NBFIs that engage in lending activities, not least because it has an important bearing on the size of losses. To assess bad-debt management we review the procedures and processes that are employed to deal with loans and financings that are past due or non-performing and evaluate the firm's track record of success in resolving delinquencies and restructuring problematic assets at a manageable cost.

We also assess the ability of an NBFI to reduce the size of default-related losses through the recovery of assets pledged or secured against loans and other credit facilities. This is especially relevant in countries where provisions against impaired exposures are created after accounting for the value of collateral (securities, property, and other assets) or other forms of credit risk mitigation (such as guarantees and credit derivatives), and where reserve coverage ratios are less than 100%.

That said, our approach to credit risk enhancements, especially less liquid forms of collateral, is deliberately cautious and in general we only make a positive allowance for collateral where the following apply:

- Collateral and asset valuations are deemed reliable, conservative and adjust to changing economic and market conditions;
- Security claims/foreclosure provisions can be enforced in a timely and cost-effective manner; and
- The firm is expected to be able to liquidate or sell reclaimed/repossessed assets within a reasonable timeframe (which may also depend on the efficiency of the legal system and courts).

For securities firms we consider in particular the extent to which credit risk is reduced through collateralisation and margin requirements.

For reverse repos and securities borrowing/lending activity we consider the quality and liquidity of acceptable collateral (e.g. cash and highly-rated government bonds), the adequacy of initial margins/haircuts to reflect credit, volatility, or liquidity risk (in cases where collateral is not of the highest quality), the strength of the collateral monitoring and valuation framework (we expect collateral to be valued daily to ensure appropriate cover against credit risk), as well as associated posting requirements (re-margining).

Similarly, for margin lending we review the firm’s collateral requirements, margin compliance monitoring and adjustment capabilities, and track record of successfully liquidating client positions once they become under-margined. We will lower our assessment of the rated firm if we believe that margin requirements are generally set too low or are not properly enforced.

More broadly, we will also lower our assessment if a firm has significant uncollateralised positions, particularly with speculative grade counterparties, or lacks adequate internal credit rating systems for evaluating and monitoring counterparty creditworthiness and for setting prudent counterparty limits.

Reserve Coverage

For NBFIs engaged primarily in term lending/financing activities, we place more weight on the capacity to accommodate losses through reserves rather than to potentially reduce the size of losses through asset recoveries.

We use the loan loss or reserve coverage ratio to provide a prima facie indication of a firm’s capacity to accommodate losses through accumulated provisions. While high reserve coverage is generally preferable to low reserve coverage, we also consider the driving factors behind the determinants of the ratio to ensure that it provides a meaningful measure of loss absorption capacity.

Consequently, we also examine the trend in reserve coverage over time, as well as the underlying provisioning policy of the NBFI. Where material, we also gauge the adequacy of provisions for credit losses on other impaired assets (such as securities), as well as for off-balance-sheet positions (for example guarantees) and other contingent liabilities.

We also consider a firm’s approach to charge offs, as entities that are quick to write off problem loans (rather than create specific reserves) tend to operate with comparatively lower reserve coverage ratios (all other things being equal).

Credit Risk and Asset Quality, Key Characteristics

Very Low

Current level of NPEs is very low; expected trend is stable or positive. Credit risk of performing exposures is very low.

Quality of investments and other non-loan assets is very high overall. Securities held are overwhelmingly of very high credit quality and are readily marketable and liquid. There is little exposure to equities or other financial assets that are not actively traded or to other illiquid assets.

Off-balance sheet credit risk exposure is very low.

Credit losses and impairments relating to securities and investments are very low and not expected to increase significantly in the intermediate term.

Credit loss mitigation and absorption capacity is very high.

The coverage, quality and enforceability of collateral are regarded as very high.

Loan loss coverage is very high.

Low

Current level of NPEs is low; expected trend is stable or positive. Credit risk of performing exposures is low.

The quality of investments and other non-loan assets is high. Securities held are overwhelmingly of high credit quality and are readily marketable and liquid. There may be modest exposure to equities or to financial assets that are not actively traded or to other illiquid assets.

Off-balance sheet activity is low.

Credit losses and impairments relating to securities and investments are low, but recent or ongoing changes in the size and composition of the portfolio may suggest a modest increase in risk in the intermediate term.

Credit loss mitigation and absorption capacity is high.

The coverage, quality and enforceability of collateral are regarded as high.

Loan loss coverage is high.

Moderate

Current level of NPEs is moderate; expected trend may be broadly stable or slightly negative. Credit risk of performing exposures is moderate or lower.

The quality of investments and other non-loan assets is moderate. Securities held are generally of moderate credit risk and readily marketable and liquid. There may be a moderate degree of exposure to equities or to financial assets that are not actively traded or to other illiquid assets.

Off-balance sheet activity may be elevated but adequately managed overall.

Credit loss mitigation and absorption capacity may be moderate.

The coverage, quality and enforceability of collateral may be moderate.

Loan loss coverage may be moderate.

Moderately High

Current level of NPEs may be moderately high; expected trend may be negative. Credit risk of performing exposures may be moderate or moderately high.

The quality of investments and other non-loan assets may be less than satisfactory. A substantial proportion of the securities and investments portfolio may consist of financial assets issued by sub-investment grade issuers or assets that lack liquidity.

The firm may have substantial exposure to potentially risky assets such as private equity, property development, real estate, complex structured products, and debt and equity securities issued by corporates with weaker credit quality. There may be significant off- balance sheet risk exposures.

The firm may have recently taken significant impairment charges on non-loan assets or unrealised losses on securities.

Credit loss mitigation and absorption capacity may be less than satisfactory.

The coverage, quality and enforceability of collateral may be less than satisfactory.

Loan loss coverage may be less than satisfactory.

Credit Risk and Asset Quality, Key Characteristics (continued)

High

Current level of NPEs may be high; expected trends may be negative. Credit risk of performing exposures may be moderately high or high.

The quality of investments and other non-loan assets may be low. A high proportion of the securities and investment portfolio may consist of financial assets issued by sub-investment grade issuers or assets that lack liquidity.

The firm may have high exposure to potentially risky assets such as private equity, property development, complex structured products, and debt and equity securities issued by weaker corporates. Off-balance sheet risk exposures may be high.

The firm may have recently taken large impairment charges on non-loan assets or unrealised losses on securities.

Credit loss mitigation and absorption capacity may be weak.

The coverage, quality and enforceability of collateral may be low.

Loan loss coverage may be low.

KEY RATING FACTOR 3

Market Risk

CI analyses an NBFI's exposure to market risk, especially as fluctuations in the market value of assets can adversely impact a firm's earnings, as well as its equity position. Some NBFIs – securities firms in particular – are directly exposed to market risk from their trading, dealing, and market-making activities, including, in some cases, the need to maintain sizeable inventory positions. Others, such as finance companies, are more sensitive to interest rate risk arising from the asset-funding profile or from certain non-credit related activities such as mortgage servicing. Firms with long-term (unhedged) investments – for example in property or private equity – may also be affected by valuation changes, while NBFIs with significant cross-border exposures may be vulnerable to foreign exchange risk.

Market risk may also be an important rating factor for NBFIs with limited balance sheet-funded activities, albeit indirectly. For example, market volatility may weigh on an investment fund's performance and weaken its ability to retain clients, thereby dampening fee income. In extremis, a sudden drop in market values could cause investors of open-ended funds to rush to redeem, compelling the asset manager to dispose of assets at falling prices and potentially resulting in the deterioration of the firm's equity position.

Public disclosure of market risk, while improving, is still not high and lacks any meaningful standardisation and consistency, making peer comparisons particularly difficult. Consequently, CI may assess a variety of indicators to gauge the level of market risk of individual NBFIs (subject to data availability) including:

- Changes and trends in trading revenues, market risk RWAs, assets with no observable market value (level 3 assets), and value-at-risk (VaR) observations to gauge the level of trading risk.
- The impact of standard interest rate shocks (e.g. change of 100bp shift in the yield curve) on net interest income or equity to measure the exposure to structural interest rate risk (ALM risk).
- The level and performance of investments in traded financial instruments to assess the exposure to interest rate and equity price risk.
- The level and performance of investments in less liquid or illiquid asset classes (e.g. private equity and real estate).
- The sensitivity of earnings (and capital) to changes in foreign exchange rates.

We take a more critical view if our analysis of the level, nature, composition, complexity, and concentration of exposures suggests that market risk is relatively high or increasing strongly. Indicators of high or fast-rising market risk may include:

- Significant reliance on proprietary trading.

- High sensitivity of earnings and/or capital to changes in interest rates or exchange rates.
- Trend increase in market risk RWAs, VaR or the volume of trading assets.
- Increasing willingness to underwrite securities offerings on a commitment basis.
- Large holdings of securities issued by sub-investment grade entities or, more generally, of securities that tend to exhibit high price volatility.
- High concentrations in the securities and investment portfolio (e.g. in terms of issuer, asset type or sector).
- High investment exposure to less liquid or illiquid asset classes.

Our overall assessment of this key rating factor takes into account not only an NBFI's exposure to market risk, but also its ability to manage and mitigate relevant risks within its risk tolerances. We therefore consider the strength of risk management – including the track record of managing market risk through the use of appropriate mitigation techniques such as collateral requirements and hedging – and review the size and frequency of a firm's market risk related losses (if any) over recent cycles compared to peers. For trading activities, we may also consider the effectiveness of risk quantification and exposure management tools such as VaR models, stress tests and scenario analysis, as well as concentration limits and stop-loss limits.

Market Risk, Key Characteristics

Very Low

Nature, composition, complexity, concentration and level of market risk exposures imply that market risk is very low.

Interest rate and exchange rate sensitivity (impact on capital and/or earnings) is very low.

Proprietary trading is very low.

Mitigation techniques and controls are very strong given the degree of exposure to market risk.

Low

Nature, composition, complexity, concentration and level of market risk exposures imply that market risk is low.

Interest rate and exchange rate sensitivity (impact on capital and/or earnings) is low.

Proprietary trading is low.

Mitigation techniques and controls are strong given the degree of exposure to market risk.

Moderate

Nature, composition, complexity, concentration and level of market risk exposures imply moderate market risk.

Interest rate and exchange rate sensitivity (impact on capital and/or earnings) may be moderate.

Proprietary trading may be moderate.

Mitigation techniques and controls may be adequate given the degree of exposure to market risk.

Moderately High

Nature, composition, complexity, concentration and level of market risk exposures imply that market risk is moderately high.

Interest rate and exchange rate sensitivity (impact on capital and/or earnings) may be moderately high.

Proprietary trading may be moderately high.

Mitigation techniques and controls may be less than adequate given the degree of exposure to market risk.

High

Nature, composition, complexity, concentration and level of market risk exposures imply that market risk is high.

Interest rate and exchange rate sensitivity (impact on capital and/or earnings) may be high.

Proprietary trading may be high.

Mitigation techniques and controls may be weak or insufficient given the degree of exposure to market risk.

KEY RATING FACTOR 4

Operational Risk

Our assessment of operational risk considers the risk of loss resulting from system failures, inadequate internal processes, breaches of procedures, and other operational deficiencies, as well as from the materialisation of reputational, legal and compliance-related risks.

Operational risk is difficult to assess and quantify accurately, but the risks may be mitigated to some extent by a combination of comprehensive internal controls and adequate capital buffers. However, when operational risks crystallise, the losses can be substantial.

The nature and significance of the operational risks run by NBFIs is, to some extent, a function of the strength of governance and the business model. A firm with a weak governance framework and poorly designed or inadequately enforced internal controls will generally be more at risk of experiencing operating failures, all other things being equal. In terms of business activities, operational risk tends to be higher for securities firms that need to execute and process large volumes of transactions in real time via technological platforms. In such settings, IT failures, model errors, input mistakes (fat finger errors) or rogue behaviour (e.g. limit breaches) can potentially result in financial losses for the firm (e.g. on proprietary trades) or its clients, and subsequent legal action against the firm by its clients.

NBFIs that operate outside of real-time, high-volume environments and that are less reliant on technology are typically less vulnerable to loss from classic operational risks, such as systems failures. However, they may still be exposed to reputational, legal or compliance risks arising, for example, from product mis-selling, cyberattacks and data security breaches, or failure to adhere to know-your-customer or anti-money laundering regulations.

Operational risk is captured, to some extent, in our assessment of risk management and control. Consequently, for the purpose of this analytical pillar we treat operational risk as a neutral factor provided:

- The NBFI has adequate internal systems and controls;
- No material operational failures have occurred in recent years; and
- The firm's principal business activities are not particularly susceptible to operational risk.

If any of these conditions do not apply, we will make a negative adjustment to our overall assessment of the NBFI's risk profile.

ANALYTICAL PILLAR 5

FUNDING AND LIQUIDITY

This analytical pillar focuses on: (a) the ability of an NBFI to support its business activities with funding sources that are appropriate for its business model and do not expose it to undue risk; and (b) its capacity to ensure sufficient liquidity to meet liabilities as they fall due, including in a stress situation.

NBFIs are typically reliant on wholesale funding (including repos), which tends to be sensitive to investor confidence and market conditions, especially at shorter maturities. Compared to banks, NBFI funding profiles generally lack the stability of retail deposits. Moreover, it is unusual for NBFIs to have access to 'lender of last resort' arrangements with central banks. As a result, liquidity squeezes, whether driven by firm-specific or market-wide stress events, may potentially trigger a payments default – even for firms that might still be solvent on a balance-sheet basis.

In this sense, compared to a bank, it is even more important for NBFIs to match the term of their funding sources to the maturity of associated assets and to maintain a buffer of highly liquid assets or reliable contingent liquidity/credit facilities to enable them to withstand stressed funding conditions.

Accordingly, our assessment of this analytical pillar is based on two key rating factors:

- Funding Structure Risk Profile; and
- Cashflow and Liquidity

KEY RATING FACTOR 1

Funding Structure Risk Profile

We evaluate a firm's funding profile in terms of the following:

- Stability and diversity of funding sources
- Maturity profile of the funding base
- Access to funding markets
- Contractual funding constraints
- Funding risk management

Stability and diversity of funding sources – Stable funding profiles help support business activities and mitigate against funding liquidity risk. Stable funding is typically diversified across a range of sources, sourced via financial obligations with reasonably long tenors, and derived from reliable (not 'flighty') types of depositor, investor, or counterparty (e.g., those holding instruments that are insured or secured or with a demonstrated track record of extending facilities in bad times as well as good).

We tend to view less favourably:

- Undiversified funding bases, especially a high reliance on borrowing from a small number of counterparties;
- High reliance on short-term debt (not least as this significantly increases refinancing risks); and
- High dependence on secured financing, as this may greatly reduce financial flexibility (and result in the effective subordination of senior unsecured creditors).

In terms of the currency of funding, we generally expect firms to match the currency of their assets with the currency in which they borrow to fund those assets. Any significant mismatches may be a potential source of vulnerability unless appropriately managed and hedged.

Heavy reliance on cross-border funding may also pose stability risks, particularly if the foreign investor base is confidence sensitive and therefore more likely to withdraw funding (especially if unsecured) should the firm suffer setbacks or market conditions become stressed.

Maturity profile of the funding base – The funding profile should be appropriate in tenor in terms of the asset base being funded, taking into account both the expected contractual and behavioural maturities of liabilities. Refinancing risk may be a constraining rating factor in cases where longer-term assets are funded to a significant degree by liabilities with shorter residual maturities. While over-reliance on short-term debt is a risk factor, we would not necessarily view unfavourably the funding of short-dated or liquid assets with short-term borrowing. Maturity concentrations may also be a cause for concern, especially if the investor base is narrow or potentially volatile, or if market conditions or firm-specific factors suggest refinancing may be challenging.

Access to funding markets – We assess the strength of the firm's access to wholesale funding markets, taking into account its relationship with creditors and its track record of issuing debt in a timely manner and at an acceptable cost (i.e., without significantly impacting earnings) in order to support asset origination and the repayment of maturing obligations. Ratings will typically be impacted negatively in cases where market access on a forward-looking basis is expected to be limited or potentially unreliable, taking into account also the magnitude of projected financing needs and expected financial market conditions.

Contractual funding constraints – Covenants, including negative pledges, and other restrictions within current credit lines or capital market arrangements could potentially restrict the ability to raise additional funding, especially on a secured basis. Consequently, we review a firm's general adherence to financial covenants and other restrictions, the extent to which funding options are constrained by such provisions, and the likely materiality of any violations.

Similarly, we consider the risks that may arise from a firm's reliance on funding arrangements that require it to meet additional collateral calls or margin calls if market conditions change.

Funding risk management – Funding risk management, including strategies to meet expected funding needs on at least an intermediate-term horizon, is important for the continuity of business performance, cost optimisation, and eliminating or reducing potential obstacles to timely and affordable debt service. Accordingly, we expect NBFIs to have operationalised appropriate funding policies and decision-making processes, and may lower our overall assessment of this key rating factor if there is little evidence that active planning is taking place.

Conversely, clear evidence of particularly strong funding risk management and strategy may have a positive impact on our overall assessment. In such cases we would expect firms to critically examine funding sources and needs on an ongoing basis and maintain and periodically test multi-year funding plans that include detailed consideration of how adequate funding would be sustained in the event of market strains or unforeseen adversities. We would also expect the firm to be active in managing its debt, including by routinely pre-funding approaching debt repayments well in advance of the maturity date.

Funding Structure Risk Profile, Key Characteristics

Very Strong

Funding profile exhibits very high stability and good diversity, and is highly aligned with the nature, scale, maturities, and currencies of the asset base. There are no significant funding concentrations.

Excess funding relative to funding needs is available from various highly stable sources. Reliance on wholesale/confidence-sensitive funding is very low.

Longer-term assets are predominantly funded by liabilities with similar residual maturities.

Refinancing risk is very low and there are no significant maturity concentrations.

Strong

Funding profile exhibits high stability and generally good diversity, and is adequately aligned with the nature, scale, maturities, and currencies of the asset base.

There are limited funding concentrations.

Ample funding is available from several stable funding sources.

Funding Structure Risk Profile, Key Characteristics (continued)

Reliance on wholesale/confidence-sensitive funding is low.

Longer-term assets are largely funded by liabilities with similar residual maturities.

Refinancing risk is low and there are no significant maturity concentrations.

Adequate

Funding profile exhibits adequate stability and is generally aligned with the nature, scale, maturities, and currencies of the asset base. There may be some material, but highly manageable, concentrations in the funding structure.

Adequate funding is available from predominantly stable but possibly not diverse sources.

Reliance on wholesale/confidence-sensitive funding may be moderate. A moderate portion of longer-term assets may be funded by liabilities with shorter residual maturities.

Refinancing risk may be moderate. Maturity concentrations may be material but manageable; funding availability may be somewhat sensitive to adverse changes in economic and financial market conditions.

Moderate

Funding profile exhibits moderate stability. There may be some significant mismatches and concentrations.

Adequate funding is generally available, albeit from a limited number of funding sources. Funding availability may be vulnerable to adverse changes in economic and financial market conditions and uncertain in times of market stress.

Reliance on wholesale/confidence-sensitive funding and/or short-term funding may be significant. Reliance on secured forms of borrowing may be significant. Covenants and negative pledges in existing debt arrangements may mean there is limited flexibility in arranging new borrowing.

Refinancing risk may be moderate-to-high due to sizeable maturity concentrations.

Weak

Funding profile is characterised by significant mismatches and concentrations. There may be moderate-to-high reliance on potentially volatile funding sources.

The availability of sufficient funding relative to funding needs may be fairly dependent on favourable market conditions and creditor sentiment, and may be highly uncertain at times of market stress.

Reliance on secured forms of borrowing may be fairly high. Covenants and negative pledges in existing debt arrangements may mean there is limited flexibility in arranging new borrowing.

Refinancing risk may be high. Maturity concentrations are expected to be manageable in the short term but challenging in the intermediate to medium term, where there may be some uncertainty with regards to the refinancing of debt falling due.

KEY RATING FACTOR 2

Cashflow and Liquidity

Liquidity risk may arise from a multiplicity of sources on both the asset side and liability side, as well as from off-balance sheet activities, with the mix of liquidity risk drivers relevant to each firm varying, to a large extent, with the business model, funding structure and risk exposure profile. Situations that may give rise to heightened liquidity risk include large maturity mismatches, market constraints on the ability to monetise assets (or access funding sources in a timely manner), and contingent liquidity events – both firm-specific (e.g. an unanticipated surge in redemptions, in the case of an open-ended investment fund) and associated with unexpected changes in economic and financial market conditions.

While a sound funding profile provides the first line of defence against funding liquidity shocks, the confidence and, in some cases, credit-risk-sensitive nature of many types of NBFI financing, combined with a lack of access to central bank facilities, means that funding disruptions and liquidity strains – when they do occur – may quickly cause default risk to accelerate. Consequently, we place significant emphasis on a firm's liquidity position and liquidity management, including how well-positioned we think it is to withstand potentially stressed market conditions.

Our approach to assessing liquidity risk takes into account cashflow generation capacity, liquidity buffers and contingent sources of liquidity that could be utilised in stressed conditions to cover liabilities falling due.

Net cash generated by operating activities is a key source of liquidity on an ongoing basis for all entities, and firms with strong and resilient cashflows though the economic cycle are often better able to withstand temporary strains in funding markets. Indeed, for some types of NBFIs, for example those with business models characterised by low balance sheet usage and limited involvement in maturity/liquidity transformation, cashflow metrics may be of more immediate relevance for assessing funding liquidity risk than liquidity buffer ratios.

We also expect NBFIs to hold, or have access to, excess liquidity to meet cashflow needs in the event of unanticipated shocks to funding sources or business activities. Sources of liquidity considered by CI to be generally reliable in this context include unrestricted cash, deposits, and unencumbered investments in securities issued by the firm's own sovereign and higher-rated foreign governments, as well as other unencumbered marketable securities and available committed, unsecured credit lines.

As there is no single metric that captures all aspects of liquidity risk, we use a variety of measures to gauge a firm's liquidity position and resilience to shocks, including narrowly defined debt repayment coverage ratios, as well as broader indicators of balance sheet liquidity.

These include:

- **Liquid resources to short-term debt** – where liquid resources consist of liquid assets (i.e. cash and banks plus marketable securities, but excluding cash and securities segregated for regulatory purposes, for example to protect customer assets) and available committed unsecured lines, while short-term debt is measured on a remaining maturity basis.
- **Broad liquid assets to short-term debt** – where the numerator is the sum of liquid resources (defined as above) plus short-term gross financing receivables, and the denominator is short-term debt on a remaining maturity basis.
- **EBITDA to interest expense** – which is a more appropriate indicator of liquidity strength for NBFIs with low balance sheet use, including limited reliance on interest earnings assets.

Since ratios require context to be meaningful and each has its own limitations, our liquidity analysis draws on qualitative considerations as well. For example, while it may be straightforward in normal times for NBFIs to generate liquidity by selling or pledging securities to secure borrowings from private counterparties, or in some cases central banks, this might be far more challenging during periods of stress. Consequently, when assessing liquidity buffers that include securities, we also consider whether the instruments are likely to remain liquid at times of stress and, if so, whether their sale is likely to entail sizeable discounts.

Similarly, we consider whether committed credit facilities would likely remain available in a stress situation, taking into account the financial strength of the bank/counterparty, the length of its business relationship with the firm, and whether the firm is close to breaching associated covenants – the consequence of which might be total or partial line cancellation. (In this context we note that empirical evidence suggests strong banks are more likely to waive covenant violations.) We may also put less weight on backup credit facilities that contain material adverse change (MAC) clauses, although these have tended to be less commonly invoked by banks. Uncommitted facilities are far less likely to be available in stressed situations and are therefore not considered an appropriate source of potential liquidity in our assessment.

We also consider the extent of any contingent liquidity drains the firm faces and which might increase in a stressed environment, such as the need to meet additional margin or collateral calls. Liquidity ratios will overstate the true strength of the firm's liquidity position where such contingent risks are high, and we will temper our overall liquidity assessment accordingly.

We may also lower our funding and liquidity assessment in cases where the amount of debt falling due in the short to medium term is relatively large and we believe that the firm may face challenges refinancing maturing obligations in a timely manner and/or the sources of repayment are uncertain.

We view favourably firms that have effective systems in place to monitor liquidity requirements, undertake an appropriate level of stress testing, and maintain contingency plans for a range of possible funding liquidity risk scenarios.

For those firms that are subsidiaries, our overall assessment of this key rating factor (and analytical pillar) may also be bolstered by the availability – on an ongoing basis – of funding and liquidity from a stronger parent or group, provided there are no regulatory or legal obstacles to the continuation of this support.

Cashflow and Liquidity, Key Characteristics

Very Strong

The liquidity position is very robust and the ability to withstand stressed market conditions is very high.

Sources of reliable and unencumbered liquidity greatly exceed liquidity needs.

Relations with banks and other creditors are very strong; financial market reputation is very high.

Contingent liquidity risks (from margin calls, lending or underwriting commitments etc) are low and contractual and regulatory constraints (e.g. from covenants or on intra-group liquidity transfers) are not material.

Contingent liquidity plans are well-established, comprehensive, and credible and indicate no significant impact on the liquidity position in a stressed environment.

Strong

The liquidity position is robust and the ability to withstand stressed market conditions is high.

Sources of reliable and unencumbered liquidity comfortably exceed liquidity needs.

Relations with banks and other creditors are strong; financial market reputation is high.

Contingent liquidity risks are modest and contractual and regulatory constraints are low.

Contingent liquidity plans are well-established, comprehensive, and credible and indicate a modest impact on the liquidity position in a stressed environment.

Adequate

The liquidity position is adequate, as is the ability to withstand stressed market conditions.

Sources of reliable and unencumbered liquidity moderately exceed liquidity needs.

Relations with banks and other creditors are sound; financial market reputation is good.

Contingent liquidity risks are modest and contractual and regulatory constraints are low.

Contingent liquidity plans are well-developed, reasonably comprehensive, and generally credible and indicate a moderate but generally manageable impact on the liquidity position in a stressed environment.

Moderate

The liquidity position is moderate, as is the ability to withstand stressed market conditions.

Sources of reliable and unencumbered liquidity modestly exceed liquidity needs.

Relations with banks and other creditors are reasonable but access to credit and markets may be somewhat restricted during periods of stress.

Contingent liquidity risks may be significant; contractual and regulatory constraints may be material.

Contingent liquidity plans may not be sufficiently developed and/or may indicate a significant impact on the liquidity position in a stressed environment.

Low

The liquidity position is weak and the ability to withstand stressed market conditions is low.

Sources of reliable and unencumbered liquidity are generally below liquidity needs.

Relations with banks and other creditors may be mixed and access to credit and markets significantly restricted during period of stress.

Contingent liquidity risks may be fairly high; contractual and regulatory constraints may be significant.

Contingent liquidity plans may be non-existent or greatly underdeveloped.

ANALYTICAL PILLAR 6

EARNINGS AND PROFITABILITY

Earnings provide an NBFI with the ability to absorb losses, asset write-downs and other adverse shocks without eroding the capital base. Good profitability also enables an NBFI to replenish or increase its capital internally through retained income, as well as pay a regular stream of dividends to shareholders, making it more likely that they will support calls for additional capital when needed. Profitability is also important for investor confidence, which is essential given that NBFIs tend to be more reliant on wholesale funding.

Profitability is generally considered to be high when revenue is more than sufficient to cover operating costs (including interest payments on debt) and provisioning expenses on a consistent basis, while contributing to an NBFI's capital needs and long-term growth objectives (including through re-investment in technology and human resources). Conversely, persistent net losses erode capital and, in the absence of appropriate corrective action, threaten the viability of an institution.

CI's assessment of earnings strength and sustainability for NBFIs is analogous to our approach to banks and encompasses various quantitative measures of returns, margins (where applicable), and costs, as well as a more qualitative, forward-looking evaluation of an NBFI's capacity to generate revenues and sustain profitability over time. We consider the quality of earnings in terms of stability, recurrence, and diversification, as well as the capacity of earnings to absorb losses and other charges. We also assess cost discipline, efficiency, and cost management.

Our analysis is encapsulated in two key rating factors:

1. Profitability and Efficiency
2. Earnings Quality and Stability

KEY RATING FACTOR 1

Profitability and Efficiency

CI's analysis of profitability and efficiency includes a detailed assessment of an NBFI's revenue sources and cost structure, which together determine underlying earnings capacity. We examine the principal drivers of revenue, cost and earnings over time, as well as future prospects. Furthermore, in addition to looking at absolute performance levels, we also take into account the level of risk assumed as profitability can be boosted, at least temporarily, through a significant increase in exposure to credit, interest rate and other risks.

Our analysis of profitability and efficiency draws on various financial indicators, which have been selected on the grounds of relevance, availability and comparability. We do not overemphasise the latest available financial results because earnings and profitability indicators may be heavily distorted by tax strategies, asset valuation methods, accrual and reserving practices, as well as by extraordinary or non-recurring items. We place more emphasis on cash-based earnings and attach less weight to unrealised sources of revenue (e.g. derived from mark-to-market pricing) as it less clear if and when the firm will receive such amounts in cash form. We may also apply quantitative or qualitative adjustments to reported financial statements if we deem such changes necessary to better reflect the underlying economics or to enhance comparability.

Generally, we view positively NBFIs which demonstrate:

- Sound (risk-adjusted) revenue and profitability indicators through economic and market cycles; and
- Strong cost efficiency indicators, a flexible cost base (including with regards to compensation and staffing, especially for securities firms and asset managers), and a consistent track record in managing costs.

Conversely, we view more negatively NBFIs which exhibit:

- Weak revenue and profitability indicators through economic and market cycles; or
- Weak cost efficiency indicators, an inflexible cost base, and a poor track record of managing

costs.

In assessing the profitability and efficiency of firms that generate earnings from their asset base (e.g. finance companies and securities firms with market-making functions), we focus on trends in the following ratios:

- **Return on Average Assets** (ROAA) – which compares net income to average total assets and provides an overall indication of an NBFI's efficiency in using its assets, as well as an indication of the scope for earnings to offset losses relative to the size of the firm's asset base. The numerator, net profits, takes into account income from all sources, as well as all operating costs and other expenses. The ratio must be interpreted carefully if an NBFI generates significant earnings from off-balance sheet activities that are not captured in the denominator.
- **Operating Profit to Average Assets –** which is a variation on ROAA, the crucial difference being that profit is measured before tax charges, provisions and extraordinary items, thereby making it a useful ratio for comparative purposes.
- **Net Interest Margin** (NIM) (where applicable) – which gauges the profitability of an NBFI's interest earning assets. Where data is limited, NIM may be proxied by the ratio of net interest income (interest income less interest expense) to average total assets. Net interest income is an important component of revenue for finance companies and securities firms with lending activities. While a higher NIM is generally favourable, it could also reflect higher risk lending activities or else be affected by inappropriate accounting practices such as the recognition of unpaid interest on non-performing exposures.

For firms that use their balance sheets less intensively (e.g. asset managers and service-oriented NBFIs), we focus instead on ratios that gauge the return on revenues (adjusted for any significant non-cash items), in particular:

- **EBITDA to total revenue** (EBITDA margin) – adjusted where possible for non-recurring and one-off items.

On the cost side, for all business models, we also analyse trends in the ratio of:

- **Operating Expenses to Gross Income** (cost-to-income ratio) – which essentially compares the administrative other overhead costs incurred in generating an NBFI's gross income with the level of that income. As such it provides an indication of the efficiency of a firm's use of resources and the extent to which earnings are absorbed by operating expenses. The lower the cost-to-income ratio, the greater the firm's ability to cope with a decline in earnings without having to resort to drastic cost-cutting measures. Conversely, a high ratio implies less operating flexibility and could reflect excessive salaries and bonuses or large management fees, as well as relative weaknesses in income generation.

Profitability and Efficiency, Key Characteristics

Very Strong

Earnings and profitability are highly robust through economic and/or market cycles.

Key profitability metrics are consistently very strong relative to peers and are commensurate with a low-to-moderate risk appetite.

Firm exhibits superior cost control and cost management.

Strong

Earnings and profitability are generally robust through economic and/or market cycles.

Key profitability metrics are consistently strong relative to peers and are commensurate with a low-to-moderate risk appetite.

Firm exhibits generally better cost control and cost management than peers.

Adequate

Earnings and profitability are generally good but may be somewhat variable through economic and/or market cycles.

Key profitability metrics are adequate and generally on par with peers, but may reflect a moderate risk appetite.

Firm's cost control and cost management is broadly in line with peers.

Profitability and Efficiency, Key Characteristics (continued)

Moderate

Earnings and profitability are generally moderate and variable through economic and/or market cycles (and more vulnerable to adverse changes in business conditions, financial markets or asset quality).

Key profitability metrics may be variable and often below the peer average and/or may reflect a moderate-to-high risk appetite.

Firm's cost control and cost management is somewhat weaker than peers.

Firm may be facing significant competitiveness challenges; cost efficiency may be relatively weak or declining and funding costs reasonably high.

Weak

Earnings and profitability are generally weak. At best, they may be highly correlated with economic and/or market cycles. At worst, the structural earnings weakness is unlikely to be remedied by an improvement in the broader economic environment or financial market conditions.

Key profitability metrics may be highly volatile (but fundamentally weak) and/or may reflect a high-risk appetite.

Firm's cost control and cost management is weak by industry standards.

Firm may be engaging in higher risk activities and/or cost cutting to improve its bottom line.

Firm may be making insufficient provisions for probable losses and may have failed to recognise losses that have already occurred.

KEY RATING FACTOR 2

Earnings Quality and Stability

An assessment of earnings strength would be incomplete or even misleading without an assessment of the underlying quality and stability of those earnings. Quality and stability in this context refer to the ability of a firm to consistently generate favourable earnings and to maintain this performance going forward.

An NBFI that has strong headline indicators of current profitability and cost efficiency could be assessed more cautiously if there are concerns about its ability to sustain this performance. As profits can be boosted by short-term (transient) factors, we always examine carefully sudden improvements in reported income by firms that do not have a track record of consistent and resilient earnings.

Earnings quality and stability are influenced by a number of factors including: the inherent riskiness and volatility of the underlying product offering/activity and client type; the diversity of revenue sources; and the degree of structural rigidity of operating expenses (i.e. whether spending could be easily reduced should revenues decline).

We generally regard the following revenue sources to be more reliable and less vulnerable to sudden confidence-driven change (on a prime facie basis without assessing their reliability and variability through market and/or economic cycles):

- Net interest income from stable sources;
- Lease income; and
- Fee and commission income that is contractually recurring or from stable sources. This may include facility fees, loan servicing fees on third party portfolios, as well as (flat) fees from asset management (their dependence on AUM and link to market prices notwithstanding), retail brokerage, and agency services.

In contrast, revenues from market- or confidence-sensitive activities tend to be more volatile, less reliable, and harder to predict. These typically include:

- Income from proprietary trading and investment activities.

- Other market-sensitive sources of revenue, such as investment performance fees (which are usually subject to hurdle rates and watermarks) and co-investment income (which is subject to fair value changes).
- Deal fees from transactional activities, such as the acquisition and placement of investments.
- Net interest income derived from elevated asset-liability mismatches.
- Non-recurring or extraordinary income (e.g. gains and losses on financial instruments, foreign exchange and real estate held for investment; other investment income, such as dividends or rentals; and gains and losses on the sale of foreclosed properties).

In CI's view, an NBFI which benefits from high levels of stable and recurring revenues and earnings, preferably generated by core business lines and in core geographic areas, is generally in a better position to absorb losses and other negative financial trends over economic and market cycles.

Likewise, an NBFI with a strongly diversified revenue and earnings base (reflecting core business lines and geographies) is typically in a better position to generate stable and sustainable earnings than a more narrowly focused NBFI or an NBFI that is reliant on elevated levels of opportunistic activities and/or lacks the necessary expertise in certain activities.

CI views heightened revenue and earnings volatility negatively. Such volatility is identified by significant changes in the level and/or composition of revenues or earnings over a short time frame, particularly if based largely on market-sensitive activities or driven by non-core business lines and/or high levels of extraordinary or non-recurring earnings.

In our opinion, it is much harder to assess the prospects for future earnings when a significant proportion of income is derived from non-recurring or volatile sources. Moreover, high volatility may signal weak underlying recurring profitability, and a shortfall of stable earnings against operating expenses may also increase an NBFI's vulnerability to business adversities.

While CI generally regards earnings structures with significant exposure to market risk or high reliance on gains from the sale of financings or other assets to be of medium or low quality, a demonstrable track record of robust and relatively stable earnings from such sources through market cycles would be given appropriate consideration in our overall assessment of this key rating factor and may offset some of our general concerns. This is more likely to be the case where we also observe good geographical and segmental diversification of customers, financial instruments and financial markets, supported by sound risk management practices.

In assessing earnings quality, we would generally view more positively an NBFI that demonstrates some or all of the following characteristics:

- Revenues derived mainly from relatively stable and sustainable sources and core business lines;
- A very strong track record of robust growth, little volatility and sound diversification of revenues and earnings;
- Core earnings performance that is expected to remain strong over the coming years;
- Ability to adjust the cost base (if necessary) to offset the impact of a decline in revenue, without weakening the quality of its core offerings and business franchise (considered also in key rating factor 1);
- Profitability that is unlikely to be significantly impacted by a moderate downturn in the economic cycle or financial market fluctuations (highly indicative of quality but also captured in key rating factor 1);
- For lenders, pre-provision earnings which are consistently sufficient to absorb elevated credit costs in a more stressful environment.

In contrast, we would tend to view more negatively any of the following characteristics:

- Heightened revenue and earnings volatility, identified by significant changes in the level or mix of revenues or earnings over a short time frame, particularly if driven by non-core business lines or high exposure to market risk.

- High levels of extraordinary or non-recurring earnings (such volatility may signal weak underlying recurring profitability or an elevated vulnerability to sudden changes in the operating environment or other adverse developments).
- For lenders, pre-provision earnings that provide only a limited buffer against elevated credit costs.
- High funding costs relative to peers, as these may not only impact operating profitability but may also drive an NBFI to move its risk appetite towards higher risk (e.g., in the case of finance companies by targeting higher reward loan/customer types, or via lower underwriting standards).

Earnings Quality and Stability, Key Characteristics

Very High

Revenue stability is very high and underpinned by very high levels of contractually recurring income.

Overwhelming majority of revenue is derived from stable sources and core business lines and is sustainable.

Revenue diversification is high.

Cost flexibility is high.

High

Revenue stability is high and underpinned by high levels of contractually recurring income.

Majority of revenue is derived from stable sources and core business lines, but a small portion may come from more volatile sources.

Revenue diversification is moderate to high.

Cost flexibility is moderate to high.

Adequate

Fair balance between stable and more confidence/market-sensitive income sources.

Recurring revenue generation is adequate, but there may be some structural weaknesses.

Income may exhibit moderate volatility and/or moderate diversification.

Cost flexibility is adequate.

Moderate

Revenue stability is moderate, with possibly significant reliance on income from confidence/market-sensitive sources.

Recurring revenue generation is moderate, with some significant structural weaknesses.

Revenue diversification may be relatively limited.

Cost flexibility may be moderate.

Low

Revenue stability is low, with possibly high reliance on income from confidence/market-sensitive sources.

Core earnings may be erratic or declining, and reliance on volatile income or income from unsustainable sources may be increasing.

Revenue diversification may be low and from relatively low-quality sources.

Cost flexibility may be low.

ANALYTICAL PILLAR 7

CAPITALISATION AND LEVERAGE

Capital provides an NBFI with the ability to absorb unanticipated losses and maintain a cushion to meet its financial obligations while remaining a going concern. Capital is therefore important for maintaining the confidence of investors, counterparties and depositors as it reduces the potential cost to liability holders of the firm failing.

Capital also enables an NBFI to leverage (or gear) its balance sheet and is a key determinant of a firm's ability to expand its asset base and, in turn, increase earnings. However, excessive leverage reduces financial flexibility and may be particularly problematic during times of stress as it typically increases the risk that the cash flow generated from a firm's assets will be insufficient to cover the fixed servicing obligations associated with debt.

Capital also provides an incentive for the owners of an NBFI to ensure it is managed in a prudent manner as they have their own funds at stake.

In assessing an NBFI's capital and leverage, CI focuses on the following key rating factors:

1. Capital Adequacy and Leverage

2. Capital Flexibility

KEY RATING FACTOR 1

Capital Adequacy and Leverage

The quality of the capital base matters. Although total capital (book equity) is simply the difference between assets and liabilities, not all items that are eligible for inclusion in total capital are capable of absorbing losses as they materialise and without triggering insolvency or administration (and therefore default).

From CI's perspective, it is critical that an NBFI's risk exposures are backed by a high-quality capital base that is permanently and freely available, with no repayment requirements and against which losses can be written off whilst the NBFI continues to conduct its normal business activities.

Capital instruments with the greatest capacity to absorb losses on a going-concern basis include common shares, retained earnings and disclosed reserves (i.e. common equity). For NBFIs, we view as medium quality those types of hybrid capital instruments and preferred stock with strong equity-like features that may also absorb losses and help prevent insolvency.

We view as lower quality those types of capital that are less reliable – due, for example, to uncertainty about their future realisable value – or are generally only available to absorb losses after a firm has failed and is being wound up. These include asset revaluation reserves and traditional types of subordinated debt. We generally do not give any credit for weaker forms of capital in our assessment of this key rating factor.

In addition to assessing the quality of capital, it is equally important to evaluate whether an NBFI holds sufficient levels of high-quality capital relative to both the size of its exposures and the riskiness of its assets. Risk exposures may be many times higher than an NBFI's equity due to the leverage obtained through borrowing and the use of derivatives. Excessive leverage increases the likelihood of default by amplifying the impact of adverse (loss-generating) changes in asset quality or asset prices on the solvency of the firm.

For NBFIs with significant balance sheet usage (including asset managers with significant exposure to co-investments or illiquid assets), the main quantitative metrics we focus on are the ratios of:

- **Total tangible assets to total tangible equity** – which shows the extent to which assets are funded from sources other than own funds and may provide an indication of a firm's vulnerability to asset-side risks, including a decline in asset values and the forced sale of assets at a loss at a time of severe stress. Total tangible equity is defined to broadly to include high and medium types of going-concern capital, including hybrid instruments. The higher an NBFI's leverage on this measure, the lower the amount of capital it has to absorb losses per unit of asset, all other things being equal. This ratio makes no allowance for the quality of an NBFI's loans and investments, so two firms could have the same leverage ratio but asset bases that differ greatly in terms of credit risk, market risk and liquidity. Consequently, we take into account factors such as the quality and liquidity of assets when evaluating capital using this metric.

- **Total debt to total tangible equity** – which indicates the extent to which a firm's activities are financed by debt and therefore provides a measure of financial flexibility or, conversely, an indication of how challenging it might ultimately be for a firm to meet its debt obligations in the event of a large adverse shock — hence the focus on going-concern capital in the denominator. In this context, a high leverage ratio may be of particular concern if the firm is reliant on short-term funding, especially from potentiality volatile sources.

For securities firms with material balance sheet risk, we also consider the:

- **Net adjusted leverage ratio** (total tangible assets *less* reverse repos and securities borrowed divided by total tangible equity) – as this provides a complementary indicator of economic risk when a firm engages in significant collateralised securities financing transactions with the same counterparty. In our opinion, the broader assets-to-equity ratio may potentially overstate the risk to an NBFI when a large proportion of assets are fully collateralised receivables.

Where available, we will also take into account **risk-weighted measures of capital adequacy**, applying broadly the same considerations we use for banks. However, for most of the NBFIs we cover, ratios of capital to RWAs are neither required by regulators nor prepared on a voluntary basis (and used for decision-making purposes) by the firms themselves.

For more service based NBFIs (including some types of asset managers), we focus instead on leverage as indicated by the ratio of:

- **Total debt to EBITDA** – which is a more useful indicator for those firms with limited risk assets on their balance sheet and for whom cash-flow adequacy tends to be a more important rating factor than capital adequacy. For such firms, capital buffers may be below the levels we would expect to observe for NBFIs with lending or direct investment operations without necessarily impacting the rating. However, leverage may be a ratings constraint if the firm incurs a high level of debt relative to the riskiness and variability of the cashflow generated by its assets.

Where relevant, we also consider a firm's adherence to regulatory capital standards and whether it has been able to comfortably exceed minimum requirements over time, or whether it has experienced difficulties managing its regulatory capital.

Capital adequacy cannot be evaluated using static ratios only. Indeed, capital ratios, judged in isolation, may provide a spurious or misleading indication of the relative strength (or weakness) of an NBFI's capitalisation. We therefore consider the extent to which an NBFI's capital position is commensurate with its risk on a forward-looking basis, including, but not limited to, its business model, business strategy, asset-liability structure and operating environment.

For example, an NBFI that appears to be sufficiently capitalised based on current quantitative metrics may be deemed less adequately capitalised overall after considering:

- The liquidity profile of assets and relative riskiness in terms of credit risk and market risk.
- The pace of balance sheet asset growth (particularly if rapid) and the pace relative to equity (i.e. leverage growth).
- The potential impact of off-balance sheet items, as well as securitised assets and other derivative related exposures, on capital.
- Risks arising from off-balance sheet entities (for example, special purpose vehicles), or unconsolidated subsidiaries that are significantly undercapitalised.
- Risks stemming from large related-party transactions.

- Asset quality and the level of provisions/reserves held outside capital against potentially problematic assets (for lenders a shortfall of provisions against problem loans signals the risk of greater-than-expected losses and may potentially erode the amount of capital actually available to the firm).
- The appropriateness of loan classification and provisioning rules – both of which may affect the measurement of capital.
- The ability to generate capital internally through earnings and sustained profitability.
- The quality of financial disclosure and regulatory supervision.

Capital Adequacy and Leverage, Key Characteristics

Very Strong

Capital and leverage are fully commensurate with the firm's risk profile (broadly defined to include exposure to credit, market and operational risk, risk from the funding structure, and earnings volatility) and indicate a strong capacity to absorb severe shocks.

Strong

Capital and leverage are commensurate with the firm's risk profile and indicate adequate capacity to absorb severe shocks.

Adequate

Capital and leverage are reasonably consistent with the firm's risk profile and indicate adequate capacity to absorb moderate shocks.

Moderate

Capital and leverage may not be fully consistent with the firm's risk profile. Leverage may be high compared to peers. Capital buffers may be moderate, and capital may be impaired to a small degree by unprovided NPEs or by other assets where book value exceeds market value.

The firm has moderate-to-adequate capacity to absorb small-to-moderate shocks.

Weak

Capital and leverage are inconsistent with the firm's risk profile and indicate inadequate capacity to absorb small-to-moderate shocks. Leverage may be very high compared to peers and capital buffers too low given the firm's exposure to risk (credit, market, operational).

Capital may be significantly impaired by unprovided NPEs or by other assets where book value exceeds market value.

KEY RATING FACTOR 2

Capital Flexibility

Capital flexibility considers an NBFI's ability to manage its capital position over time and in response to changing circumstances and, in particular, to increase capital – internally or externally – when needed. Future needs often arise in connection with a firm's strategic objectives and acquisition plans, but may also be necessary in the aftermath of large losses linked, for example, to significant stress in the loan or investment portfolios.

We consider an NBFIs track record of building (or rebuilding) its capital base through retained earnings, its ability to continue doing so, as well as the appropriateness and flexibility of dividend and share buyback policies. We view internal capital generation as a structural feature and generally look through cyclical improvements in earnings and capital.

We also consider a firm's ability to raise new capital from shareholders, taking into account the latter's track record of supporting the firm during both good and bad times.

NBFIs may also be able to raise new capital by selling subsidiaries or parts of their operations. Such asset sales could reflect strategic repositioning, but might also be a response to financial pressure and the need to raise capital through gains on sale and/or by reducing risk assets. The likelihood of success and the level of proceeds will depend on the attractiveness to potential buyers and general market sentiment. Particularly for firms under pressure, these options might not be available. Even if successful, the potential impact on the firm's franchise strength would also need to be considered.

Listed NBFIs might seek to raise new capital from stock markets, although this option is also highly dependent on market sentiment and would, in most instances, not be an option for weak firms or during periods of general market stress.

For NBFIs within a group structure, we also assess the ability of the group to meet the capital requirements of the rated firm in the event of need with readily available own funds located outside that entity. Capital fungibility and transferability may be a supportive rating factor, provided it is not significantly constrained by regulatory practices, debt covenants or other legal restraints.

Capital Flexibility, Key Characteristics

Very High

Capital flexibility is very high, underpinned by very strong and robust internal capital generation and appropriate (flexibly applied) dividend and share buy-back policies.

Shareholders are highly supportive of maintaining a very strong capital position.

Other sources of capital flexibility may also be strong.

There are no material impediments to the free flow of loss-absorbing capital between group members. Sufficient capital is highly likely to be available from other parts of the group if needed.

High

Capital flexibility is high, underpinned by strong and resilient internal capital generation and appropriate dividend and share buy-back policies.

Shareholders are supportive of maintaining a strong capital position.

Other sources of capital flexibility may also be fairly strong.

There are no significant impediments to the free flow of loss-absorbing capital between group members.

Adequate

Capital flexibility is adequate. Internal capital generation is good but may be somewhat variable.

Shareholders are generally responsive to capital needs, and dividend/share buy-back policies are generally appropriate.

Other sources of capital flexibility may be adequate.

There may be some moderate impediments to the free flow of loss-absorbing capital between group members.

Capital Flexibility, Key Characteristics (continued)

Moderate

Capital flexibility is moderate. Internal capital generation is generally satisfactory, but variable.

Shareholders are mildly supportive, but may not always be sufficiently responsive to capital needs. Dividend and share buy-back policies may be somewhat aggressive.

Other sources of capital flexibility may be limited.

Capital fungibility and transferability between group entities may be subject to significant constraints. There may be some uncertainty regarding the availability of sufficient capital from other parts of the group if needed.

Low

Capital flexibility is low. Internal capital generation is weak and highly inconsistent.

Dividend and share buy-back policies may be inappropriate. Shareholders are unlikely to be a reliable source of new capital should additional resources be needed to strengthen the capital base or grow the business.

Other sources of capital flexibility may be very limited.

Capital fungibility and transferability between group entities may be highly constrained. Sufficient capital is unlikely to be available from other parts of the group if needed.

5. EXTRAORDINARY SUPPORT AND GROUP CONSIDERATIONS

Once we have established the ESA, we evaluate the likelihood that, in the event of difficulties, the NBFI would receive sufficient and timely financial assistance from its parent, shareholders, the government, or other support providers to enable it to remain current on its liabilities and avoid a payments default or insolvency.

Such support, which we label ‘extraordinary support’, can potentially mitigate weaknesses in the firm’s standalone financial profile and therefore improve its creditworthiness, resulting in its ICR being notched up above the ESA.

This type of temporary assistance is different to the ‘ordinary support’ that a firm might receive, for example from its parent, during the normal course of business, such as an increase in equity to facilitate business growth or to meet changes in regulatory requirements. Ordinary financial support, as well as the operational and business benefits (and risks) that may accrue to an entity from being part of a larger group, is reflected in the ESA.

Where the NBFI is a member of a corporate group, we apply the criteria contained in Parent-Subsidiary Considerations in the Determination of Corporate and NBFI Credit Ratings to determine the likelihood of extraordinary support and to assess the rating impact of other potential group influences.

For subsidiaries, the application of our parent-subsidiary criteria may result, inter alia, in:

- The ICR being notched above its standalone level due to the likelihood of such extraordinary support from a stronger parent (or group).
- The ICR being constrained by the rating of a weaker parent due to group interference risk even though it may be the stronger of the two entities on a standalone basis (interference risk aside).
- The ICR being set higher than the rating of the parent due to greater standalone strength and limited linkages, which may include effective constraints on potentially harmful parental interference. If linkages are limited and autonomy high, a firm’s default risk may be largely (or wholly) unaffected by stress at the parent level or elsewhere within the group. Consequently, its ICR will largely depend on its standalone strength and may potentially be notched above (or decoupled from) the actual or notional rating of the parent/group.

Where an entity’s ICR incorporates extraordinary support, we indicate the degree of uplift and the reasons for it in the published credit rating rationale.

6. SOVEREIGN CONSIDERATIONS

The final LT ICR assigned to an NBFI will generally be set at the same level as the baseline for the issuer rating provided the latter is no higher than the sovereign rating of the country in which the firm is based.

If the baseline ICR is higher than the sovereign rating, we apply our criteria for rating above the sovereign (explained in our Bank Rating Methodology) to determine whether the firm's ratings could be higher than the sovereign and, if so, by how many notches. This entails considering whether the firm's financial strength and debt-servicing capacity would be sufficiently robust to withstand the direct and indirect impact of a government default (including potential losses on sovereign debt and other financial instruments) and highly stressed operating conditions.

Even if a firm is able to withstand severe sovereign and related economic stresses, it could still default should the government decide to interfere with the ability of entities to service financial obligations in a timely manner by imposing highly restrictive measures, such as exchange controls and payments moratoria. We refer to this direct impact as sovereign interference risk.

Sovereign credit risk and sovereign interference risk are often highly positively correlated; but they can differ (or decouple), and interference risk is usually much harder for firms to mitigate or circumnavigate.

In general, where sovereign interference risk in the event of a government debt crisis is high, an NBFI will be rated no higher than the sovereign rating.

Where sovereign interference risk is moderate or low, a sufficiently strong NBFI could be rated above the sovereign. However, the maximum rating differential would normally be restricted to three notches above the sovereign long-term local currency rating for an NBFI's long-term local currency ICR and two notches above the sovereign long-term foreign currency rating for its foreign currency ICR.

Our policy of generally restricting ICRs in the ratings space above the sovereign rating reflects the degree of uncertainty in the assessment of a firm's capacity to withstand sovereign-induced stress. This in turn reflects several key unknowns, including the scope and severity of a future crisis and the policy reaction of the authorities in the event of financial stress (including the severity of any restrictive measures).

We may deviate from this practice when the likelihood of a government default in the short term is very high and we are better able to evaluate with greater certainty the institution's ability to survive the associated stress. In addition, we may increase the notching differential in cases where we are convinced that the government would not impose transfer and convertibility or other debt-service impeding restrictions were it to default on its own obligations, or that the NBFI would be exempt from, or somehow able to circumvent, any such restrictions. However, such cases are likely to be uncommon.

ANNEX 1: ISSUER CREDIT RATINGS: RATING SCALE AND DEFINITIONS

CI's international issuer credit ratings (ICRs) indicate the general creditworthiness of an entity (such as an NBFI, bank, corporate or sovereign) and the likelihood that it will meet its financial obligations in a timely manner. Foreign currency ratings refer to an entity's ability and willingness to meet its foreign currency denominated financial obligations as they come due. Foreign currency ratings take into account the likelihood of a government imposing restrictions on the conversion of local currency to foreign currency or on the transfer of foreign currency to residents and non-residents.

Local currency ratings are an opinion of an entity's ability and willingness to meet all of its financial obligations on a timely basis, regardless of the currency in which those obligations are denominated and absent the risk of transfer and convertibility restrictions that may constrain the servicing of foreign currency obligations. Both foreign currency and local currency ratings are internationally comparable assessments.

Foreign and local currency ratings take into account the economic, financial and country risks that may affect creditworthiness, as well as the likelihood that an entity would receive external support in the event of financial difficulties.

The following rating scale applies to both foreign currency and local currency issuer ratings. Short-term ratings assess the time period up to one year.

Long-Term Issuer Credit Ratings

Investment Grade	
AAA	The highest credit quality. Exceptional capacity for timely fulfilment of financial obligations and most unlikely to be affected by any foreseeable adversity. Extremely strong financial condition and very positive non-financial factors.
AA	Very high credit quality. Very strong capacity for timely fulfilment of financial obligations. Unlikely to have repayment problems over the long term and unquestioned over the short and medium terms. Adverse changes in business, economic and financial conditions are unlikely to affect the institution significantly.
A	High credit quality. Strong capacity for timely fulfilment of financial obligations. Possesses many favourable credit characteristics but may be slightly vulnerable to adverse changes in business, economic and financial conditions.
BBB	Good credit quality. Satisfactory capacity for timely fulfilment of financial obligations. Acceptable credit characteristics but some vulnerability to adverse changes in business, economic and financial conditions. Medium grade credit characteristics and the lowest investment grade category.
Speculative Grade	
BB	Speculative credit quality. Capacity for timely fulfilment of financial obligations is vulnerable to adverse changes in internal or external circumstances. Financial and/or non-financial factors do not provide significant safeguard and the possibility of investment risk may develop.
B	Significant credit risk. Capacity for timely fulfilment of financial obligations is very vulnerable to adverse changes in internal or external circumstances. Financial and/or non-financial factors provide weak protection; high probability for investment risk exists.
C	Substantial credit risk is apparent and the likelihood of default is high. Considerable uncertainty as to the timely repayment of financial obligations. Credit is of poor standing with financial and/or non-financial factors providing little protection.
RS	Regulatory supervision (this rating is assigned to financial institutions only). The obligor is under the regulatory supervision of the authorities due to its weak financial condition. The likelihood of default is extremely high without continued external support.
SD	Selective default. The obligor has failed to service one or more financial obligations but CI believes that the default will be restricted in scope and that the obligor will continue honouring other financial commitments in a timely manner.
D	The obligor has defaulted on all, or nearly all, of its financial obligations.

Short-Term Issuer Credit Ratings

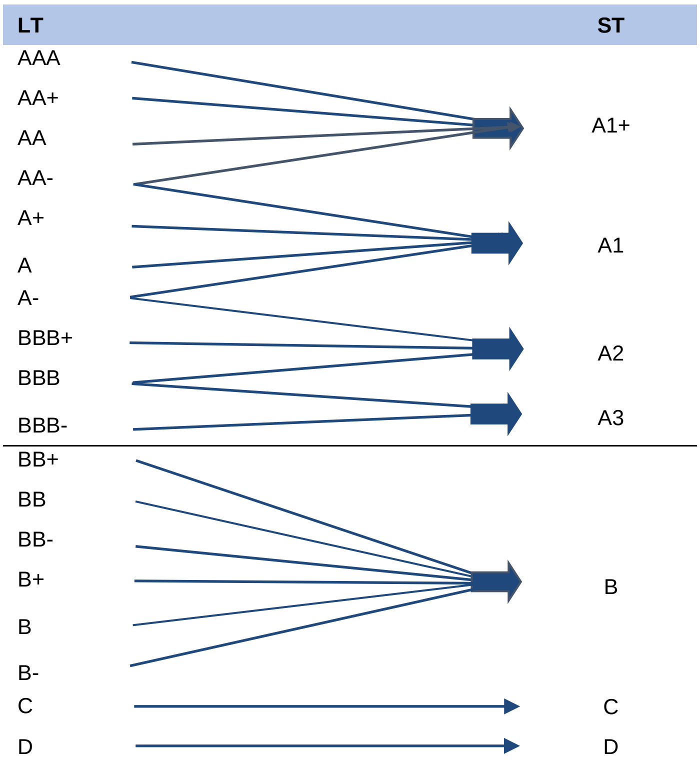
Investment Grade	
A1	Superior credit quality. Highest capacity for timely repayment of short-term financial obligations that is extremely unlikely to be affected by unexpected adversities. Institutions with a particularly strong credit profile have a '+' affixed to the rating.
A2	Very strong capacity for timely repayment but may be affected slightly by unexpected adversities.
A3	Strong capacity for timely repayment that may be affected by unexpected adversities.
Speculative Grade	
B	Adequate capacity for timely repayment that could be seriously affected by unexpected adversities.
C	Inadequate capacity for timely repayment if unexpected adversities are encountered in the short term.
RS	Regulatory supervision (this rating is assigned to financial institutions only). The obligor is under the regulatory supervision of the authorities due to its weak financial condition. The likelihood of default is extremely high without continued external support.
SD	Selective default. The obligor has failed to service one or more financial obligations but CI believes that the default will be restricted in scope and that the obligor will continue honouring other financial commitments in a timely manner.
D	The obligor has defaulted on all, or nearly all, of its financial obligations.

CI Ratings appends '+' and '-' signs to foreign and local currency long-term ratings in the categories from 'AA' to 'C' to indicate that the strength of a particular rated entity is, respectively, slightly greater or less than that of similarly rated peers.

Outlook: expectations of improvement, no change or deterioration in an entity's long-term issuer ratings over the 12 months following its publication are denoted 'Positive', 'Stable' or 'Negative'.

ANNEX 2: CORRESPONDENCE BETWEEN LONG-TERM AND SHORT-TERM ISSUER RATINGS

Short-term ratings are mapped from long-term ratings using the guidelines below. Deviations may be permitted where entity-specific circumstances render the guidelines inappropriate.



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General Contact Information

Capital Intelligence Ratings Ltd, PO Box 53585, 3303 Limassol, Cyprus

+357 2526 0000

marketing@ciratings.com