EMERGING Credit Rating Ltd
an independent house of risk assessment

# FINANCIAL HOLDING COMPANIES

**Overview**

This methodology responds to a notable trend towards a pure holding company structure in which the parent is a non-operating holding company, away from the traditional regulated entity-as-parent company group structure. Under a non-operating holding company structure, the corporate parent may own regulated operating entities or a combination of regulated and quasi-related operating subsidiaries. The growing appeal of the pure holding company model stems, in part, from the need for holding companies to increasingly redeploy cashflow from lower risk and highly regulated domestic operations into lesser regulated businesses and markets for future growth. This form of corporate structure better addresses the concerns of creditors of the regulated operating subsidiaries and generally supports lower capital requirements.

A financial holding company (FHC) for the purposes of this methodology is taken to mean an entity which owns or has controlling interest in entities engaged in financial services such as banks, insurance companies and securities firms, and whose consolidated gross revenues is predominantly derived from financial services.

The process that ECRL follows in evaluating a financial holding company consists of several steps:

**Step 1:**
**Stand alone analyses of key group members**

Assign stand-alone individual credit ratings, either on public or confidential basis, to key subsidiaries and associates. ECRL considers entities with the following characteristics as key/core group members:

• Operate lines of businesses integral to the rating agency's understanding of the overall group strategy.
• Share the same name or brand with the main group.
• De facto operate more as a division or profit center within the overall enterprise.
• Senior group management has demonstrated a strong commitment to.
• Represent a significant proportion of the parent group's consolidated position.
• Are appropriately capitalized commensurate with the rating on the group.
• Are reasonably successful/have realistic medium-term prospects of becoming successful at what they do
• Are at least 51% voting-controlled by the group.

Each key group member is subject to a full credit assessment, including both financial and non-financial factors. These ratings are based on each group member's existing credit profile, which excludes the impact of the FHC's existence and is entirely devoid of any influence of external factors (positive or negative) at the wider group level. This rating approach allows ECRL to give appropriate consideration to the variations in inherent risk characteristics of different financial institutions such as banks, insurance companies, and securities companies in its assessment.

**Step 2:**
**Individually weight the ratings relative to the importance of that key member**

Assign weights which are reflective of the constituent entity's importance in the group on the basis of:

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• Each company's normalized expected earnings; and
• The likely capital needs required to maintain capitalization at an adequate level (investment-grade level for insurance entities) under a normal stress scenario. The obvious measures of assets and revenue are regarded as less appropriate given the differences in the nature of the operations of the FHC's subsidiaries, such as FIs and insurance companies. Notwithstanding the legal corporate structure of constituent entities, the group may conduct its business in a manner which would result in the operations of key members being so intermingled as to justify a convergence of ratings.

**Step 3:**
**Arrive at a notional group rating**

Arrive at a notional group rating. ECRL treats the individual companies as if they were divisions of a single entity rather than separate legal entities and incorporates positive credit implications of group revenue and cost synergies as facilitated by the current group architecture and the benefits of risk diversification on a consolidated level. Here ECRL performs an evaluation of the managerial, financial and operational integration between the various entities belonging to the group as well as that between the holding company and constituent entities.

ECRL is mindful that integration also raises the likelihood that the financial conditions or actions of one entity could become problems for other entities within the group and affect the financial condition of the consolidated entity. This could arise in a number of instances including those in which an operating subsidiary is dependent on another troubled subsidiary for its customer base or for operational support and may not be able to operate on a stand-alone basis. Furthermore, the financial condition or actions of others in the financial group could expose other entities in the group to reputational risk. ECRL incorporates emerging weaknesses and possible contagion effects in the notional group rating.

**Step 4:**
**Assessment of the financial performance of the FHC and its leverage.**

To accomplish Step 4, ECRL examines the following:
• Liability structure at the holding company level.
• Debt capital composition, maturity breakdown
• Capital ratio comparison with peers
• Off-balance sheet risk assessment (consider the amount of support that may be needed by weak subsidiaries/affiliates and its likelihood)
• Dividend payout ratio
• Capital composition analysis, preference shares, convertible, ordinary shares
• Ability to tap outside sources of equity, market to book value of equity
• Double leverage (actual and targets)
• Internal capital generation ratio and Return on Equity (ROE)

The main assets of a financial or bank holding company are the shares of its subsidiaries. However, when those shares are in a state of double leverage, this increases the likelihood that the obligations of the parent company cannot be adequately covered by dividends and other income from the subsidiaries. (Double leverage refers to the ratio of the holding company's equity in subsidiaries to holding company equity.) Furthermore, the claims of holding company debt-holders will be subordinate to claims of the creditors of the subsidiaries.

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Double leverage increases as the holding company invests debt proceeds it obtains in its subsidiaries as equity. The increased capital base allows the subsidiary to increase its borrowings as well. Generally, as the double leverage ratio increases, so does the pressure on the operating subsidiary to maintain earnings to service both levels of debt. High double leverage usually indicates that the parent is highly reliant on the dividend paying capacity of its operating subsidiaries to service its debt obligations and shareholder dividend payments.

The financial performance of holding companies is typically expressed in terms of ROE which measures (consolidated) earnings generation on the capital invested into the parent. A declining ROE will affect the holding company's ability to attract and maintain the sources of funds necessary to support operations and meet its obligations.

**Step 5:**
**Analysis of cash flow at the holding company**
ECRL's credit ratings assess the ability of the FHC to meet its financial obligations. Ultimately, the parent's ability to generate cash flow will determine whether it will meet its fixed obligations, such as debt service and preferred stock dividends, as well as fund dividends to common shareholders from internal operations. Non-consolidated historical cash flow statements at holding company level provide an indication of its primary funding sources and reliance on such to maintain operations as well as recent trends. Consolidated cashflow statements, on the other hand, present an aggregate picture of cashflows, much of which may not be available to the parent and are hence limited in their usefulness.

While holding companies rely to a large extent on subsidiary dividends, regulated subsidiaries such as banks and insurance companies do not have full discretion in what they dividend because of regulatory incentives to maintain their equity base. Hence, ECRL takes a subsidiary-by-subsidiary approach to analyze the risks of each of the dividend streams going to the parent. It is also important to identify subsidiaries which may be net consumers of cash because they are in their startup phase or international investments which are not able to repatriate dividends tax-effectively.

Other than subsidiary dividends, we also take into account other sources of cash which the parent may raise by liquidating/selling assets, issuing new equity, increasing borrowings, requiring repayment of advances to its subsidiaries, and requiring other cash payments from subsidiaries. ECRL considers the credit implications of reliance on other sources of cash. Selling income-generating assets will reduce future earnings, and issuing additional debt or equity will increase future funding requirements for debt service or dividend payments. Reliance on short-term debt to fund deficit cash flow increases liabilities and related interest costs without a corresponding increase in earning assets, weakening the holding company's liquidity and earnings performance over the long run.

To supplement its cashflow statement analyses, ECRL also seeks the following information:
- Historical/actual up-streamed dividends to annual fixed charges on debt and/or preference shares
- This ratio gives an indication of the level of actual cash flow payments that have been made relative to interests on all pure debt, and interest/dividends on hybrid securities.
- Present subsidiary payout policy, maximum regulatory dividends
- Projected cash flow of the holding company
- Debt maturity management
- Recent unusual income or cost streams
- Impact of branch, building or acquisition expansion on projections

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- Financing policies, acquisition and expansion plans
- Other means of financial flexibility to meet upcoming debt maturities

**Step 6:**
**Assessment of management and strategy, and other qualitative factors**

ECRL factors into its ratings its assessment of management's business plan, its track record in executing its business and financial plans, its risk appetite, and shareholder orientation (in terms of dividend policy and payout). Our specific evaluation of management focuses on the following:

- The effectiveness of the company's strategic planning and execution
- Appetite for risk
- Overall effectiveness of the company's control framework
- Relative experience and technical competence of the company's management team
- Management's ability to plan and respond to changing circumstances
- Depth, breadth and succession plans

ECRL's assessments of the FHC's debt leverage, financial flexibility and management quality in Steps 4 to 6 will determine the extent to which the long-term issuer rating of the FHC will be notched down from the notional group rating. ECRL believes that a rating differential between the FHC and the notional group rating may be still justified where the holding company is not in a state of double leverage but the operating subsidiaries are rated in the BBB range mostly on account of systemic support. Our opinion stems from our belief the authorities will likely protect the creditors of distressed and insolvent banks and insurance subsidiaries but will be less inclined protect the creditors of the holding company.

**Step 7:**
**Assessment of the issue rating, where relevant**
Where an issue-specific rating is undertaken, ECRL considers the nature of and provisions of the issuance in addition to the protection afforded by, and relative position of, the rated instrument in the event of liquidation and reorganization.

**ECRL'S RATING APPROACH**

**Similar to Standard & Poor's Steps 1 to 3**

**FINANCIAL INSTITUTION RATING CRITERIA**
ECRL's analysis of financial institutions focuses on the CAMEL framework (Capital, Asset Quality, Management, Earnings and Liquidity) with an added component, Risk Management. Capital adequacy Regulatory ratios (Tier 1 and Total Capital) provide the starting point for capital analysis.

The common ratios used by rating agencies are:
- Tangible common equity*/assets
- Tangible common equity*/regulatory risk assets
- Double leverage ratio
- Non-performing loans/Equity + Loan Loss Reserves

* after adjusting for goodwill and revaluations

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FIs with high regulatory capital ratios tend to have easy access to funding sources and capital markets. The reverse applies to FIs who are considered less than well capitalized. Asset quality Traditional ratios are historical measures, and are flawed to the extent that they can be distorted by growth. Asset concentration risk analysis is, however, forward-looking. Concentration risk can be measured by relating a loan category to tangible ordinary capital, and large loan exposures relative to core earnings. ECRL also considers the trend in charge-off levels and loans loss provisions. The asset quality ratios that we usually examine are:

• Loans Loss Reserves/Average Loans
• Charge-offs minus recoveries/Average Loans
• Loan Loss Reserves/(Gross NPLs-IIS)
• Net Non-Performing Loans/Total Loans

Liquidity and Funding - Here, rating agencies look at the composition of the FIs funding, its funding sources, deposits and loans maturity profile and asset liquidity. Useful ratios include

• Total deposits/Total Liabilities
• Loans/Core Deposits
• Loans/Assets
• FIs with large and relatively inexpensive core deposits tend to enjoy wider margins.

Profitability - Key considerations here are earnings levels, trends and stability, all of which affect the ability of the FI to form capital to promote growth. Here we consider:

• Margin trends, net interest income trends, ability to maintain volume
• Other income breakdown, variability/consistency, ability to grow fee income
• Operating expense ratios, composition of overhead, trend of overhead ratios
• Impact of loss provisions, current and past levels, relationship of provisions to maintenance of adequate reserves
• ECRL favours the use of ROA measures; in particular Pretax profits/Average Assets, Core ROA (adjusted for loans loss provisions) and risk-adjusted ROA.

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