Rating specialised lenders: analytical considerations

Scope's bank rating methodology (last updated in May 2018) provides the flexibility to analyse and assess credit risk across a variety of business models, including those of specialised lenders. This report offers insight into how Scope Ratings approaches this subset of lenders, including the risks typical to certain business models that Scope has encountered in its ratings and research.

Specialised lenders are a broad category comprising a diverse ecosystem of banks and non-bank financial institutions. Products range from consumer finance and credit cards to leasing.

Risks for specialised lenders are often a subset of those faced by banks. However, industry-specific risks are also relevant: residual value risk can be material for leasing companies; fraud risk is prominent in digital factoring; asset risk is substantial for lenders in commercial real estate, but almost irrelevant for invoice discounting.

Scope's bank rating methodology places the business model assessment at its centre, acknowledging that financial performance, risk appetite, solvency, asset and liability composition, and even strategy are elements that derive from it.

Scope strives to correctly identify and characterise the business model, determine relevant peers, and implement its analytical roadmap while considering why an aspect may be endemic to a business model rather than a cause for concern (e.g. growing NPEs are bad for banks but not for NPE management companies).

The analysis may involve metrics not common to bank credit analyses (e.g. residual value ratios for lessors or advance rates for factors). Conversely, certain ratios may not apply to certain specialised lenders (e.g. prudential ratios for non-regulated lenders or loans/deposits ratios for non-deposit gathering institutions).

Specialised lenders face a high risk of disruption from technological advances. Numerous fintechs (some with deep pockets) are already innovating processes and value chains. For this reason, credit investors need to understand the competitive advantages in each sub-industry and the ability of these to fend off fast-moving, data-savvy players. It is also essential to have visibility on the lender's intended strategy and assess its suitability to the specifics of the evolving market. A thorough analysis of the business plan alongside discussions with management helps to shape Scope's forward-looking view of the issuer.

When specialised lenders are subsidiaries of larger banking groups, Scope applies its framework on potential parent support. In these instances, a specialised lender's rating is often anchored by the parent's issuer rating unless Scope believes support would not be forthcoming.

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A business model-centric approach

In Scope's view, the analysis of a financial institution must start with the business model. Understanding how the issuer responds to customer needs and how it converts services into viable earnings is paramount to analysing financial and risk metrics. Also crucial is identifying the relevant peers, which ensures quantitative financial and risk indicators can be compared with the appropriate sample. Scope believes the business model ultimately shapes both the income statement and the balance sheet.

To be sustainable in the long run, a business model must produce adequate risk-adjusted profitability through the cycle. For example, a high-risk business model can still be viable if risk is properly priced in and managed and enough capital is set aside for unexpected events. Specialised lenders range widely in terms of risk (and, hence, returns), from the very high-risk subprime and payday loan companies, to the very low-risk mortgage lenders.

For this reason, Scope believes a sole focus on financial metrics offers little insight on credit risk for investors as they often reflect a business model's specifics. Scope's financial institution ratings are therefore not based on scoring financial metrics, but rather a credit opinion informed by both qualitative and quantitative factors which are interconnected.

Peer-based approach

In Scope's opinion, a financial institution's credit dynamics and fundamentals can only be fully understood and assessed in a peer-group context, that is, by comparing and contrasting its performance with similar institutions. Scope's peer-group analysis is embedded from the start of the rating process instead of merely validating the end result. This is because Scope's ratings and analyses for financial institutions measure credit risk from a relative perspective – across time but also compared to domestic and cross-border peers.

For specialised lenders, correct identification of the business model is key to defining the right peer group. However, perfect peers are often difficult to find as issuers generally have unique features. Even so, Scope will perform the analysis using financial institutions in the same or similar economic environments, as these share the same performance drivers as specialised lenders. Scope also notes that specialised lenders often directly compete with banks or their subsidiaries by either offering the same products or catering to the same customers.

External support assumptions

Banks or non-financial corporations commonly have subsidiaries in specialised lending.

According to Scope's methodology, specialised lenders that are subsidiaries of a larger group will generally be rated at either the level of the parent's issuer rating or below, rarely above.

Ratings will account for the subsidiary's credit fundamentals – including the macro characteristics of its geographies if different from the parent's – and the nature, stability and reliability of potential parent support. This can range from implicit support to a legal guarantee.

Appendix: examples of specialised lender business models

The following appendix provides examples of specialised lender business models encountered by Scope in its ratings and research as well as credit considerations regarding these specific sub-industries.

Financial leasing

Financial leasing provides long-term financing for an asset, whereby the leasing company (lessor) buys the assets and rents it to the user (lessee).

Leasing companies in Europe are often subsidiaries of larger banking groups or owned by industrial companies (often car manufacturers), although independent leasing operators also exist. The nature of ownership generally influences their business model, including supervisory constraints, asset composition, funding, and distribution strategy. As most are owned by banks, many leasing companies in Europe are tightly regulated and supervised. Non-bank-owned leasing companies, however, are not subject to EU-level regulations, although several countries have introduced their own laws to regulate leasing companies (e.g. UK, Spain, Germany, Italy, Greece, and France) or registration requirements (e.g. Sweden, Luxembourg, Belgium).

Depending on the ownership structure, leasing contracts are originated either through bank distribution networks, industrial vendors, direct sales or through intermediaries (agents).

Products can be roughly segmented based on the underlying asset financed, into real estate, equipment, and vehicles.

Growth in leasing volumes tends to be cyclical and linked to GDP growth (in particular to investment). As a finance product of choice for SMEs, growth can be supported to specific government incentive schemes, especially in the early stages of the investment cycle. Passenger vehicle finance is more closely linked to the consumption cycle, and real estate leasing to the real estate cycle.

Funding models vary significantly: leasing portfolios are often funded through a mix of securitisations, credit lines from parent company (or banks, when part of a banking group), wholesale unsecured bonds and even deposits in some cases. Understanding the funding model of a lessor in the context of its business model and functions with respect to its different stakeholders is key.

Key risks

Asset quality tends to be not only closely correlated with the macro environment but also cyclical: unemployment is a key driver for non-performance in leasing to individuals (passenger cars); GDP correlates well with leasing to businesses (especially SMEs); real estate leasing follows the real estate cycle.

While the collateralised nature of leasing offers security to the lessor, the collateral's marketability still depends on the product. Residual value risk is the risk that the lessee opts not to purchase the asset at the end of the contract, leaving the exposure with the lessor. For leases on large illiquid assets this risk can be material.

Working capital finance: factoring, invoice discounting

Factoring provides short-term finance for working capital, specifically commercial credits. In a factoring contract, the factor (buyer) buys commercial credit from a seller (transferor), generally a non-financial company.

Factoring can involve or not involve the ultimate transfer of credit risk related to the debtor. In a non-recourse factoring sale, the factor assumes the risk of non-payment. In a recourse factoring transfer, the factor retains the right to collect from the seller in case of non-payment.

The factoring company offers immediate liquidity to the seller in exchange for a factoring fee, thereby lowering a company's working capital needs. The factor also manages collections and, in non-recourse sales, assumes the debtor's credit risk.

Invoice discounting, like a recourse factoring contract, involves no legal transfer. Instead, the borrower uses invoices as collateral for securing a short-term loan. The relationship with the borrower, including collections, remains with the original creditor, and the factoring fee is replaced by a discount rate.

Factoring companies also offer separate credit collection on behalf of third parties, leveraging on their collection platform and expertise.

The largest factoring companies in Europe are generally arms of large banking groups. Independent factors tend to be smaller. In recent years, several Internet-based companies[1] have emerged to offer working capital finance, mainly for discounting invoices. Some have taken this even further by disintermediating the process, to simply offer a platform that allow third party investment in exchange for a fee.

Working capital finance can form part of the wider business banking relationship and can therefore be originated through bank branches or by specialised companies via agents. In recent years, the Internet has emerged as an important distribution channel in view of the clear cost advantages and convenience it offers.

Reverse factoring (supply chain factoring) is typically initiated by large corporates with a fragmented supply chain.

Ad hoc factoring transactions (spot factoring) also exist, but a lack of scale often makes these expensive. More commonly, long-term relationships are established based on an exclusive relationship between a business and a factor (whole ledger factoring) or on at least on minimum number of revenue contracts, which guarantees coverage of due diligence and processing costs.

Factoring and invoice discounting gives companies the chance to unlock resources otherwise tied up in account receivables against a small reduction in profits. This is ideal for fast-growing companies, which are often limited by capital and funding considerations. At the aggregate level, factoring volumes are cyclical and linked to GDP growth.

Factoring is typically funded through a mix of equity, bonds and bank credit lines. Securitisations are also used, though these are generally revolving due to the short-term nature of the underlying credits.

Key risks

Providers of working capital finance typically face high operational risk. The high volume of invoices to be processed over a relatively short period increases instances of fraud or non-enforceable contracts. For smaller sellers this risk tends to be greater and costlier to manage.

The degree of credit risk depends on the business model: in recourse factoring, only a portion (the advance rate) of the total invoice is generally advanced to the transferor upon assignment of a credit to a factor, with the balance (less any fee) paid upon collection. This substantially limits the factor's credit and counterparty risk. In non-recourse factoring, asset risk is higher, as the risk of default resides with the factor. Ideally, the factoring fee prices in this risk. Even so, many factoring companies set aside a reserve

[1] Credimi; Marketinvoice; Invoicefair; Investly among others

account to cover unexpected losses. Reverse factoring tends to increase concentration risk for the factor, which assumes credits from several sellers towards the same borrower.

By contrast, invoice discounting only exposes the lender to counterparty risk with the borrower, and invoices also provide additional collateral.

Working-capital investment platforms only provide an intermediation service and should run limited asset risk.

Factoring and invoice discounting are short-term by nature, hence funding risk tends to be relatively limited.

Specialised consumer lenders

While factoring and leasing companies typically cater to businesses, specialist consumer lenders typically offer one or more products to individuals. These range from credit cards, personal loans and consolidation loans, to point-of-sale finance for household appliances and cars. The latter product types can take the technical form of leases.

Consumer finance is relatively high risk due to its uncollateralised nature. As such, a successful consumer finance business must adequately price in the risks that the borrower may default on its obligations.

Key risks

The credit risk of consumer finance is tightly correlated to the macroeconomic cycle, specifically to unemployment. Consumer finance is often unsecured. When not part of large banking group, consumer finance companies often obtain funding from wholesale markets, which can be unavailable at times. Consumer finance products are ideal for securitisation given their high granularity.

Specialised mortgage institutions

Some institutions specialise in providing house finance to individuals. This activity, routinely carried out by banks, can represent a standalone business model and in some case independent mortgage institutions can indeed come to dominate entire mortgage markets. For example, Nykredit Realkredit is the largest mortgage lender in Denmark (and the largest covered bond issuer in Europe). Origination standards can vary and are typically characterised by a few parameters: loan-to-value ratios and income multiples are among the most commonly used.

In Europe, mortgage lending is often funded via covered bonds, a well-tested and robust financing form.

Key risks

Mortgage lending typically involves low credit risk. Unlike in the US, mortgages in Europe are typically recourse loans, meaning the borrower is responsible for payments beyond the value of the collateral. Mortgage performance is generally linked to the economic cycle (in particular to unemployment and real estate price cycles). Mortgage lenders also have to manage funding mismatch risks, including those arising from volatility in prepayments.

Due to the relative simplicity of the product, the mortgage industry is, in Scope's view, at risk of disruption by the new fintech competitors. In this respect, however, Scope believes many incumbents are protected by tight regulation surrounding covered bond issuance, which confers them an advantage over smaller competitors.

Nevertheless, new competitors are emerging and seem to target a rapid rise in market share. In Sweden, startup Enkla, launched in March 2018, offers mortgages at a steep discount to bank rates and aims to manage EUR 10bn within 18 months; in the UK, peer-to-peer mortgage lender LendInvest reported it had originated over GBP 500m as of July 2018, with a 91% YoY growth.

Payroll-deductible loans

A particular technical form of consumer lending, payroll-deductible loans are common in Italy, especially for public-sector employees. Scope has publicly rated IBL (BBB, Stable), a major player in the Italian payroll-deductible loan market (cessioni del quinto or CDQ).

CDQ loans are repaid by directly deducting up to one-fifth of the borrower's salary or pension. The loan is fixed rate, capped at EUR 75,000, and has a maximum term of 120 months. Originally reserved for public-sector employees, the product was recently opened up to pensioners and private-sector employees. A similar product is the 'delega di pagamento', through which up to 50% of salary can be pledged.

Larger banking groups typically provide payroll-deductible loans in Italy, although smaller independent originators also exist, including vertically integrated specialist IBL.

Outside of Italy, the product is in the early stage of development in the UK, offered by several fintechs (SalaryFinance, Neyber). The form is also widely used in Latin America (such as the credito consignado in Brazil), where many banks in Scope's universe also operate.

In Italy, payroll-deductible loans are originated through bank distribution networks, i.e. through local branches and sometimes through agents. In the UK, framework agreements with employers are a promising channel for private-sector payroll-deductible loans.

Payroll-deductible loan companies tend to be funded via a mix of securitisations and equity. When part of a banking group, such companies can benefit from cheap intragroup funding stemming from their parent bank's deposit base.

At the European level, this is a market with enormous potential for growth. Finance costs are typically cheaper than for unsecured personal loans while affording a high degree of safety to the lender.

Key risks

Payroll-deductible loans carry lower credit risks than their unsecured counterparts. Borrowers have no discretion when making payments, limiting the risk of non-performance to unemployment, death or other instances in which payments cannot be made. Moreover, these risks can be outsourced through insurance policies, already common in the Italian market.

Market risks such as asset/liability mismatches and funding risk have to be carefully managed. Operational risks for this business model can be relevant, given the high number of counterparties involved, especially when actuarial risks are outsourced to insurance companies.

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