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This methodology note stands superseded. Refer to ICRA's website www.icra.in to view the updated methodology note on the sector.

ICRA's Credit Rating Methodology for Non-Banking Finance Companies

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This note replaces ICRA's earlier methodology note on the industry published in 2010.

Non-Banking Finance Companies (NBFCs) play an important role in the Indian financial market. While the Reserve Bank of India (RBI) regulates both NBFCs and banks, there are some significant differences in the regulatory treatment, with NBFCs being given greater flexibility in governance structure and operational matters, and being allowed to lend independent of priority sector targets and of statutory reserve requirements. However, at the same time, there are regulatory restrictions on the range of services that NBFCs can offer and on their funding options. Typically, NBFCs extend the following types of loans:

- Vehicle loans (for purchase of commercial vehicles, cars, tractors, two-wheelers, etc.)
- Construction equipment loans
- Personal loans
- Micro finance credit
- Loans against property
- Loans against shares
- Corporate loans/business loans
- Infrastructure loans
- Project finance loans

In credit-rating an NBFC, ICRA evaluates the NBFC's business and financial risks, and uses this evaluation to project the level and stability of the NBFC's future financial performance in various likely scenarios. The ratings are determined on a "going concern" basis rather than on a mere assessment of assets and debt levels as on a particular date. The broad parameters for assessing the business and financial risks of an NBFC are presented in the bullet list below and discussed at some length in the sections that follow.

1. **Business Risk**
    - Business Mix
    - Management, Systems and Governance Structure
    - Franchise and Size
    - Operating Environment

2. **Financial Risk**
    - Profitability
    - Liquidity
    - Capital Adequacy
    - Asset Quality

While several parameters are used to assess an NBFC's business and financial risks, the relative importance of each of these parameters can vary across companies, depending on its potential to change the overall risk profile of the company concerned. For instance, in a benign operating environment, a relatively new "personal loan finance company" may show very good profitability, but may be unable to sustain the same through business cycles. Therefore, in this case, a higher weight would be given to the company's business risk profile rather than its financial performance. Further, an NBFC with a strong business profile and stable financial performance would be viewed more favourably than another with comparable or better financial numbers, but with a weaker business risk profile.

BUSINESS RISK

- **Business Mix**

ICRA makes an assessment of an NBFC's business risk by thoroughly analysing, among other factors, the company's asset mix, customer mix, pace of growth, track record, and franchise. As some of these parameters are qualitative, ICRA tries to remove the subjectivity in its analysis by capturing and assessing information on defined sub-parameters, and using these to make a comparison across various companies. This analysis also incorporates ICRA's assessment of the performance of various sectors through business cycles, its outlook on the economy, and its views on issues related to the operating environment.

The assessment of an NBFC's business mix involves evaluating the NBFC's competitive position (ability to change lending norms and/or yields), reliance on outsourcing, pace of growth and responsiveness to market changes, track record, and management experience (in relation to growth plans and the lifecycle of the loans extended), besides the diversification of its loan book.

As for track record, this is evaluated in relation to completed business cycles. Thus, while a five- to six-year-old car finance company is considered to have a reasonable track record (the typical loan tenure being three to four years), a home finance company of the same vintage would be said to have an average track record (the typical loan tenure being 15 to 20 years). Further, if an NBFC is expanding into new products and geographies, its track record and management experience may not provide the same level of comfort as the same of another NBFC with a stable growth rate and growing within existing geographies with the same loan mix.

- **Management, Systems and Governance Structure**

Governance issues, quality of management, systems and policies, shareholder expectations and the strategy followed to manage these expectations, and accounting quality are the building blocks on which an NBFC's credit risk profile is built. The importance of these factors is even higher for a new NBFC, one with a shorter track record, or one with a changing business profile.

Ownership structure could have a key influence on an NBFC's credit profile in that a strong promoter and strategic fit with the parent can benefit an NBFC's earning, liquidity and capitalisation, and hence its credit profile. In assessing an NBFC's ownership structure, the parameters examined include, among others: the credit profile of the promoter, shareholding pattern of the NBFC, operational synergies of the NBFC with its promoter, level of involvement of promoter in the NBFC and level of commitment, and track record and willingness of the promoter in providing fund support.

All credit ratings necessarily incorporate an assessment of the quality of the issuer's management, as well as the strengths/weaknesses arising from the issuer's being a part of a "group". This part of the exercise is mostly subjective, although the actual track record of the management is a supporting factor. Usually, a detailed discussion is held with the management of the issuer to understand its business objectives, plans and strategies, and views on past performance, besides the outlook on the industry. Some of the other points assessed are:

- Experience of the promoter/management in the line of business concerned.
- Commitment of the promoter/management to the line of business concerned.
- Attitude of the promoter/management to risk taking and containment.
- The issuer's risk management policies (credit risk and market risk).
- Strength of the other companies belonging to the same group as the issuer.
- The ability and willingness of the group to support the issuer through measures such as capital infusion, if required.

A careful evaluation of the risk management policies of the NBFC is done as it provides important guidance for evaluating the impact of stress events on the liquidity, profitability, and capitalisation of the company concerned. ICRA also evaluates the strategy and business plans of the NBFC, along with the shareholders' expectations from the company. Although ICRA ratings are for debt holders, meeting shareholders' expectations is important, as otherwise the company's strategy itself could undergo a change (to meet shareholders' expectations), which in turn could alter its credit profile.

ICRA believes that an appropriate governance structure is important to ensure that the powers given to line managers are exercised in accordance with established procedures and that they are in harmony with the broad policy guidelines and strategic objectives of the NBFC concerned. ICRA's evaluation of an NBFC's governance structure involves evaluation of the structural aspects of the Board and Board-level committees, and the functioning of these committees. For instance, internal auditors and audit committees are mutually supportive; it is essential for the audit committee to consider the work of internal auditors so as to gain an understanding of the organisation's risk management processes and control systems, and of the areas that need strengthening.

Consistent and fair accounting policies are a pre-requisite for financial evaluation and peer group comparisons. By virtue of being incorporated under the Companies Act, NBFCs are required to follow the Accounting Standards prescribed by the Institute of Chartered Accountants of India. Further, the RBI has also issued prudential norms specifying the accounting methods to be used for income recognition, provisioning for bad and doubtful advances, and valuation of investments. In evaluating an NBFC's accounting quality, ICRA reviews the company's accounting policies, notes to accounts, and auditor's comments in detail. Deviations from the Generally Accepted Accounting Practices are noted and the financial statements of the NBFC adjusted to reflect the impact of such deviations.

- **Franchise and Size**

For an NBFC, its franchise strength determines its capacity to grow while maintaining reasonable risk-adjusted returns, and to maintain resilience of earnings, thereby facilitating predictability of its future financial performance. It may be noted that an NBFC with a significant market share and a niche player can both have a defensible franchise[1], which could in turn benefit their individual credit profile.

As for size, typically it is seen in relation to an NBFC's loan mix and has a bearing on the company's competitive position, diversity, credit risk concentration, stability of earnings, and financial flexibility.

- **Operating Environment**

The operating environment has a significant bearing on an NBFC's credit rating as it can impact its growth prospects and asset quality quite considerably. In assessing the operating environment, ICRA looks at the overall economic conditions, prospects of the industry related to the asset class being financed, and the regulatory environment. For instance, in the case of a commercial vehicle (CV) financing NBFC, the level of economic activity and freight rates are very important, just as the outlook on real estate is important for a home finance company, from the perspective of both asset creation and asset quality.

For an NBFC, regulatory changes can significantly impact (either positively or negatively) credit losses. For instance, the establishment of the credit information bureau has helped lenders take informed credit decisions, while the proposed introduction of The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002, (SARFAESI) would help NBFCs recover real estate backed loans more efficiently; at the same time, recoveries from unsecured asset classes and vehicle loans had been hit after the regulator took a strict stance on the recovery procedure followed by some financiers.

Intensity of competition has a significant bearing on the credit profile of an NBFC as it can change the company's growth prospects, earnings and management strategy. ICRA's evaluation focuses on the current level of competition as well as the attractiveness of the segment for potential competition by evaluating the growth potential, entry barriers and risk-adjusted returns.

[1] The bigger company on the strength of its standing in the overall market and the smaller one on account of its unique offering or its strong relationship with the key participants in the credit chain of the target segment.

FINANCIAL RISK

- **Profitability**

An NBFC's ability to generate adequate returns is important from the perspective of both its shareholders and debt holders. The purpose of ICRA's evaluation here is to assess the level of future earnings and the quality of earnings of the NBFC concerned, which is done by looking closely at the building blocks: interest spreads, fee income, operating expenses, and credit costs.

The evaluation of an NBFC's profitability starts with the interest spreads (yields minus cost of funds) and the likely trajectory of the same in the light of the changes in the operating and regulatory environment, the liquidity position and financial flexibility of the company, and its strategy. The ability of the NBFC to complement its interest income with fee income is also assessed. A large fee income provides more diversification in income streams, which in turn can improve the resilience of earnings, thereby improving an NBFC's risk profile. After assessing the income stream, ICRA evaluates the NBFC's operating efficiency (operating expenses in relation to total assets, and cost to income ratio) and compares the same with that of its peers. Finally, the credit costs are estimated on the basis of the company's asset quality profile, and the profitability indicators[2] compared across peers. Importantly, a very high return on equity may not necessarily translate into a high credit rating, given that the underlying risk could be very high as well, and being so it could be more volatile or difficult to predict.

- **Liquidity**

It is important for an NBFC to maintain a favourable liquidity profile for the smooth functioning of its funding activity (fresh asset creation) and to honour its debt commitments in a timely manner. It is also important that an NBFC manage its interest rate risk, as the same could impact its future profitability.

In assessing an NBFC's liquidity profile, ICRA evaluates the liquidity policy of the company, the maturity profiles of its assets and liabilities, the resulting asset-liability maturity gaps, and the back-ups available to plug any gaps and meet future disbursement requirements. ICRA's evaluation also focuses on the diversity of the NBFC's funding sources and their quality (i.e. availability of these sources in a stress situation).

- **Capital Adequacy**

An NBFC's capital provides the second level of protection to debt holders (earnings being the first) and therefore its adequacy (in relation to the embedded credit, market, and operating risk) is an important consideration for ratings. Riskiness of the product and granularly of the portfolio have a significant bearing on the amount of capital required to provide the desired degree of protection to an NBFC's debt holders. The requirement of risk capital varies with the concentration and riskiness of the product mix, as the following Chart shows.

Chart: Risk Capital Requirement Matrix

		Expected credit losses and variability	
		Low	High
Portfolio Concentration	High	Moderate	High
	Low	Low	Moderately high

ICRA starts with the adjusted capital (adjusted for deviations from the generally accepted accounting practices) and considers the internal capital generation and possible support from a strong parent/group company while evaluating the adequacy of an NBFC's risk capital for a particular rating

[2] Profit after Tax as a percentage of Average Total Assets and Profit after Tax as a percentage of Average Net Worth.

category. Typically, capital adequacy analysis is done for the individual business lines (including off-balance sheet portfolios) of the NBFC, and the "aggregated capital required" compared with the actual capital available as well as the minimum capital the company is expected to maintain.

ICRA also evaluates the quality of an NBFC's capital, apart from the level of capital. A higher percentage of Tier I capital is viewed more favourably, given its greater permanence. Besides, an NBFC's ability to meet regulatory capital adequacy requirement is also evaluated.

- **Asset Quality**

Asset quality plays an important role in indicating the future financial performance of an NBFC. The focus of asset quality evaluation is on lifetime losses, variability in losses under various scenarios, the impact of likely credit costs on profitability, and the cushions available (in the form of capital or provisions) to protect the debt holders from unexpected deterioration in asset quality.

Asset quality assessment covers, among other factors, quality of the credit evaluation process and the lending norms, riskiness of loan mix, risk appetite, availability of data to facilitate credit decision making, and track record in managing loan book through lifecycles. Asset quality is also assessed from credit risk concentration, trend in viability of customers, trend in delinquencies (adjusted for vintage of the book), Gross NPA† percentage, Net NPA percentage, and Net NPAs in relation to Net Worth.

Diversification is an important consideration in the assessment of an NBFC's asset quality. Diversification is generally evaluated in the context of loan mix, credit risk, portfolio granularity, geographical presence, and borrower profile. High levels of diversification can shield an NBFC from downturn in any one segment. At the same time, diversification into riskier segments may not improve resilience and therefore may not translate into superior ratings. However, an NBFC's ability to manage diversification, especially in multiple businesses and/or new geographies, is a very important issue, just as are management depth and the ability to adopt the skills and techniques needed to run different businesses.

As asset quality indicators can vary, depending on the asset class, borrower profile, NPA recognition norms and the accounting policy on write-offs, comparing these indicators across NBFCs operating in different asset classes may not yield meaningful results. ICRA therefore makes a comparison of the delinquency levels (at 30 days+, 60 days+, 90 days+) for the same asset class and borrower profile across players, adjusted for write-offs. When available, static pool analysis is done as this gives a meaningful estimate of the losses at various stages in the loan cycle as well as of the overall lifetime losses, and is free from the distortions caused by a high growth rate.

† Non-Performing Assets

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