

This methodology document stands superseded. Refer to ICRA's website www.icra.in to view the updated methodology document on this subject.



ICRA Rating Feature

Rating Methodology for Non-Banking Finance Companies

This note updates and supersedes ICRA's earlier methodology note on the industry, published in April 2016. While this revised version incorporates a few modifications, ICRA's overall approach towards rating non-banking finance companies (NBFCs) remains materially similar.

Overview

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. NBFCs have greater flexibility in the governance structure and operational matters and can lend independent of priority sector targets and statutory reserve requirements. However, at the same time, there are regulatory restrictions on the range of services (like transaction services/cash credit lines, etc) that can be provided by NBFCs and on their funding options (such as access to the call money market, etc). NBFCs typically extend the following types of loans:

- Vehicle loans (for purchase of commercial vehicles, cars, tractors, two-wheelers, etc)
- Construction equipment loans
- Personal loans
- Loan against gold jewellery
- Microfinance
- Loan against property
- Loan against shares
- Corporate loans/business loans
- Real estate loans
- Infrastructure loans
- Project finance loans

ICRA's Risk Analysis Framework for NBFCs

For rating an NBFC, ICRA evaluates its business risk, ownership, management risk and financial risk, and uses this to access the level and stability of the NBFC's future financial performance in likely scenarios, as required. The ratings are determined on a going concern basis rather than on a mere assessment of the assets and debt levels on a particular date. The broad parameters for assessing an NBFC's business and financial risks are presented below and discussed in the sections that follow.

1. Business Risk

- Business Profile
- Operating Environment

2. Financial Risk

- Profitability
- Liquidity
- Capital Adequacy
- Asset Quality

3. Management Risk

4. Ownership/Parentage

While several parameters are used to assess the business and financial risks, an NBFC with a strong business profile and stable financial performance would be viewed more favourably than one with comparable or better financial numbers but with a weaker business profile. Therefore, higher weight is given to the company's business risk profile compared to its financial performance. To elaborate the above, in a benign operating environment, a personal loan finance company may show very good profitability, but it may be unable to sustain the same through business cycles.

ICRA would broadly apply the same methodology to assess the risk profiles of other entities in the lending business like trusts, cooperative societies, nidhi companies, etc, which are not regulated by the RBI.

BUSINESS RISK

• Business Profile

ICRA's analysis of an NBFC's business profile involves the assessment of the product offering, asset mix, borrower profile, geographical presence, size of the franchise/portfolio, track record of operations and the envisaged pace of growth. The assessment of these parameters provides an insight into the NBFC's risk appetite, experience and responsiveness to adverse market-related changes and competitive position. As some of these parameters are qualitative, ICRA tries to remove subjectivity from its analysis by capturing and assessing information on defined sub-parameters and by using these to make a comparison across various companies.

Product Mix and Riskiness

The target asset segments, the overall asset mix and the borrower profile indicate the lender's risk appetite. NBFCs lend to various asset segments, namely vehicle finance, equipment finance, mortgage, business loans, corporate loans, infrastructure loans, real estate loans, microfinance, loan against shares, gold loans, personal loans, consumer loans, etc. Product riskiness is evaluated on the basis of a confluence of factors, namely the prevailing operating environment, historical and recent trends in asset quality, loan granularity, strength of the loan security and recoverability in the event of default. While each asset segment entails a certain amount of credit risk, the target borrower profile is also a factor for assessing the overall credit risk. NBFCs typically cater to non-salaried customers and small businesses, which either have limited credit history or lower loan eligibility from other larger lending institutions, namely banks.

NBFCs with a high share of unsecured credit to borrowers, who have limited credit history, are expected to be more vulnerable in case of any adverse changes in the business or operating environment. Also, higher dependence on one asset segment is deemed riskier as any unforeseen changes in the market or regulatory dynamics could impact the earnings performance of NBFCs. This analysis incorporates ICRA's assessment of the NBFC's assets and its performance through business cycles.

Track Record, Competitive Position and Sustainability

The track record of operations is evaluated in the context of completed loan 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 mortgage finance company of the same vintage would be said to have an average track record (the typical loan tenure being 12-15 years).

The competitive position of NBFCs reflects their ability to respond to market changes by way of changing the lending norms, sourcing strategies, yields, etc, while ensuring that the margins remain commensurate with the risks. A diverse geographical presence generally bolsters an NBFC's competitive position as it could offset the credit risks arising from unfavourable regional developments. Further, an NBFC's franchise strength determines

its capacity to grow while maintaining reasonable risk-adjusted returns and resilient earnings, thereby facilitating the predictability of the future financial performance. It may be noted that two NBFCs, one with a significant market share and another with a niche product offering, can both have a defensible franchise¹, which could, in turn, benefit their individual credit profiles.

An NBFC with a diversified geographical presence and product offering is viewed favourably as its competitive position is likely to be better and the concentration risks are expected to be lower. NBFCs, in their early phases of expansion into new products and geographies, generally face higher credit-related challenges and the same is a monitorable from a rating perspective.

Size has a bearing on a company's competitive position. Larger firms generally operate across states and exhibit better product diversity. They are also expected to have lower credit risk concentration, good stability in earnings, and better financial flexibility.

Optimal portfolio growth and sourcing are key for business sustainability. While aggressive portfolio growth is more likely to reflect as a risk because of a possible leniency/dilution in underwriting norms over a period, slower growth vis-à-vis the industry level could indicate a weakened competitive profile. ICRA also notes that entities with full in-house sourcing and collection teams are likely to have stronger control on the loan origination, monitoring and collection process than entities which depend on external agencies for some of their business processes.

• Operating Environment

The operating environment has a significant bearing on an NBFC's credit rating as it can significantly impact its growth prospects and asset quality. For 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, demand 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.

Regulatory changes can significantly impact the performance of an NBFC. For instance, the establishment of a credit information bureau has helped lenders take informed credit decisions, while the applicability of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act (SARFAESI) to systemically important NBFCs helps them recover loans more efficiently. Similarly, the Insolvency and Bankruptcy Act (IBC), would support recoveries from certain high-ticket defaults. Going forward, NBFCs are likely to be subjected to a tighter liquidity risk management framework. While the same would have some impact on their earnings performance, it should improve their resilience towards unforeseen and unfavourable market movements.

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

FINANCIAL RISK

• Profitability

An NBFC's ability to generate adequate returns is important from the perspective of both its shareholders and debtholders. 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. ICRA also analyses the NBFC's historical performance for

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

stability and quality of earnings and to understand the impact of the various markets, regulatory, operational and business risks on the earnings. Entities which have taken steps to reduce volatility in their earnings performance and those which exhibited better stability in their performance across business cycles are viewed more favourably.

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 changes in the operating, regulatory and funding environment, and its strategy. It is also important for an NBFC to manage its interest rate risk as the same could impact its future profitability. The NBFC's ability to complement its interest income with fee income is also assessed. A large fee income provides more diversification to the income stream, which, in turn, can improve the resilience of earnings, thereby improving the NBFC's risk profile. Other than assessing the income stream, ICRA evaluates the NBFC's operating efficiency (operating expenses in relation to total assets, and the 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 indicators² are compared across peers. Importantly, a high return on equity may not necessarily translate into a high credit rating, as the underlying business risk could be significant as well, implying that the profitability metrics might be prone to being volatile or difficult to predict.

The profitability is typically evaluated on a managed asset basis (including off balance-sheet portfolio) to measure the earnings profile of the entity.

- **Liquidity and Financial Flexibility**

It is important for an NBFC to maintain a favourable liquidity profile for the smooth functioning of its funding activity (fresh asset creation) and for honouring its debt commitments in a timely manner.

For assessing an NBFC's liquidity profile, ICRA evaluates the maturity profile of its assets and liabilities, the resulting asset-liability maturity gaps, the availability of assets which can be securitised/assigned and the other backup available for plugging any gaps and meeting near-term disbursement requirements. ICRA's evaluation also focusses on the diversity of the NBFC's funding sources and their quality (i.e. whether these sources will be available in a stress situation). A high share of short-tenure borrowings (<1 year) exposes entities to refinancing and interest rate risks during adverse market liquidity conditions, especially those which offer relatively longer-tenure loans. Increase in dependence on short-term market borrowings beyond a certain level, depending on credit profile of the entity, could impact liquidity profile, and is a rating sensitivity.

ICRA also studies the borrowing covenants agreed by the NBFCs with their lenders. Some covenants, especially financial covenants, might be close to the current performance levels and hence prone to a breach even with a minor deterioration in the operating environment. The breach of these covenants would generally warrant an early redemption, which, in turn, could trigger cross-default clauses in some of the other borrowings. This would exert pressure on the overall liquidity profile. Therefore, entities with a higher share of borrowings with strict covenants and with early redemption clauses linked to these covenants are likely to face higher liquidity related pressure as the ability to secure fresh funding in a weak operating environment would also be affected.

ICRA also assesses the financial flexibility of the issuer based on its past track record and other factors including strong ownership, access to group entity support, etc. The cost of funding also provides some insight into the financial flexibility of an NBFC. Entities with a vast lender base (number of lenders) and a diverse resource (banks, fund houses, other financial institutions, insurance entities, etc) profile are more likely to have competitive borrowing rates compared to entities with a concentrated resource or lender profile. Further, these entities have a better chance of refinancing during a subdued liquidity environment.

- **Capital Adequacy**

An NBFC's net worth provides protection to the debtholders. Therefore, its adequacy (in relation to the embedded credit, market, and operating risks) is an important consideration for the rating exercise. The riskiness of the product and granularity of the portfolio have a significant bearing on the amount of capital required to

Profit after tax (PAT) as a percentage of average total assets and PAT as a percentage of average net worth

provide the desired degree of protection to an NBFC's debtholders. The requirement of risk capital varies with the concentration and riskiness of the product mix, as the following chart shows.

Risk Capital Requirement Matrix

		Expected Credit Losses and Variability	
		Low	High
Portfolio Concentration	High	Moderate	High
	Low	Low	Moderately high

ICRA adjusts the reported net worth (adjusted for deviations in accounting, off-balance sheet exposures, investments in subsidiaries and other non-core activities, etc) while evaluating the adequacy of an NBFC's risk capital. A capital requirement analysis is also done for the key asset segments (including off-balance sheet portfolios) of the NBFC, if needed, and the computed aggregate capital requirement is compared to the actual overall capital available.

ICRA also evaluates the quality of an NBFC's capital, apart from the level of capital. A higher percentage of Tier I capital (adjusted for any hybrid debt in Tier I) is viewed more favourably. Besides, an NBFC's ability to meet the regulatory capital adequacy requirement, going forward, is also evaluated.

Entities with higher growth rates vis-à-vis the levels that internally generated cash flows could support are likely to witness some moderation in their capital profiles. In such cases, the ability to raise capital from the market or the promoters is also factored in during the rating exercise. NBFCs, which provide visibility on maintaining a comfortable and risk-adjusted capital structure (could vary depending on the target asset class, loan size and borrower profile) over the medium term, are viewed favourably.

• Asset Quality

The asset quality assessment covers, among other factors, the quality of the credit evaluation process and the lending norms, riskiness of the loan mix, risk appetite, availability of data to facilitate credit decision-making, and track record in managing the loan book through life cycles. The asset quality is also assessed for credit risk concentration, delinquencies (adjusted for the vintage of the book), gross NPA[†] percentage, net NPA percentage, credit and provision costs, and net NPAs in relation to the net worth.

The 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) for protecting the debtholders.

Diversification is an important consideration in the assessment of an NBFC's asset quality. It 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 a downturn in any segment. At the same time, diversification into riskier segments may not improve resilience and may, therefore, 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, as is management depth and the ability to adopt the skills and techniques needed to run different businesses.

[†] Non-performing assets

Comparing asset quality indicators across NBFCs operating in different asset classes may not yield meaningful results as the indicators can vary, depending on the asset class, the borrower profile and the accounting policy for write-offs. 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, a static pool analysis is done as this gives a meaningful estimate of the losses at various stages of the loan cycle as well as the overall lifetime losses and is free from the distortions caused by a high growth rate.

MANAGEMENT RISK

The governance structure, quality of management, risk management processes, shareholder expectations and the strategy for managing these expectations are the building blocks for an NBFC's credit risk profile. These are generally supplemented by a comprehensive information technology (IT) & management information system (MIS) and conservative accounting and business policies, etc, which provide a more detailed perspective on the company's performance in relation to the prevailing operating environment.

Governance Structure

ICRA's evaluation of an NBFC's governance structure involves the evaluation of the structural aspects of the type of ownership structure, board and board-level committees, the functioning of these committees and the involvement of key stakeholders in strategic decision-making. A board consisting of qualified and independent members with effective oversight is a positive factor. The size (depending on the scale and complexity of operations) and the constitution of the board (adequate number of Independent Directors and representation by key stakeholders) are an indicator of the diversity and independence, which, in ICRA's opinion, is crucial to ensure sustainable and long-term decision-making.

Management

The quality of the top management, extent of reliance on the promoter/key man for taking strategic decisions, presence of a second line of management and the quality of disclosures are the key variables judged while measuring an NBFC's management quality. Although this part of the exercise is mostly subjective, the actual track record of the management is a supporting factor. Usually, a detailed discussion is held with the management of the issuer NBFC to understand its business objectives, plans and strategies, and views on past performance, besides the outlook on the industry.

Risk Management Systems, Credit Policies and Processes

The NBFC's risk management policies are evaluated carefully to provide guidance for assessing the impact of stress events on the company's financial profile. ICRA compares the customer on-boarding, internal audit process, quality of the MIS and collection mechanisms across NBFCs. ICRA also compares the underwriting policies of the NBFCs with the best practices in the industry to assess the company's risk profile. Some of the key underwriting norms such as loan-to-value ratio, fixed obligation to income ratio, nature of the security, etc, are evaluated and compared across NBFCs. As a sizeable share of the borrowers would fall in the assessed income segment, ICRA analyses the credit policies, appraisal process and the degree of implementation of the same at the field level. Consistent and fair accounting policies are a prerequisite for financial evaluation and peer group comparisons. NBFCs are typically incorporated under the Companies Act and are required to follow the prescribed accounting standards. Further, the RBI has issued prudential norms for NBFCs. While evaluating an NBFC's accounting quality, ICRA reviews its accounting policies, notes to accounts, and auditor's comments. Adjustments, if required, are made in the reported financials for evaluating the key performance indicators and for comparison with peers.

OWNERSHIP/PARENTAGE

The ownership structure could have a key influence on an NBFC's credit profile. The risk profile of an NBFC, which is a part of a large corporate group or has an established promoter (individual/ institution), can benefit given its strategic fit with the group or from the experience of the individual promoter. Over and above the standalone credit considerations, the likelihood of extraordinary support from the parent to an entity or the support that an entity is likely to extend to other group companies is factored in while assessing the credit profile of the entity. This process involves the assessment of the ability and willingness of the parent to extend support to the entity and vice versa, in addition to the evaluation of the entity's own fundamental credit strength.

The assessment also tries to factor in various shareholders' expectations, in case of a highly diverse shareholding structure, and the strategy followed to manage the same. ICRA also evaluates the NBFC's strategy and business plans along with various other stakeholder expectations from the company and the possible impact of the same on its overall credit profile, going forward.

All credit ratings necessarily incorporate an assessment of the strengths/weaknesses arising from the issuer being a part of a group. Some of the other points assessed are:

- Experience and commitment of the promoter in the line of business concerned
- Attitude of the promoter to risk-taking and containment
- Strength of the other companies belonging to the same group as the issuer
- Ability and willingness of the group to support the issuer through measures such as capital infusion, if required

Summing Up

ICRA's credit ratings are a symbolic representation of its opinion on the relative credit risk associated with the entity and instruments being rated. ICRA arrives at this opinion by conducting a detailed evaluation of the entity's business and financial risks and uses this evaluation to project its future financial performance in various scenarios. While several parameters are used to assess an NBFC's business, management and financial risks, an NBFC with a strong business and stable financial performance would be viewed more favourably than one with comparable or better financial numbers but with a weaker business profile.

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