

## RATING METHODOLOGY – PRIMARY DEALERS

July 2022



[Click to Provide Feedback](#)

### Table of Contents:

Overview .....	1
Regulatory Framework .....	1
Snapshot of a PD's operations .....	2
Business Risk Assessment .....	2
Financial Risk Assessment.....	5
Promoters and Management.....	8
Assessment of ESG Risks .....	8
Summing Up .....	9
ANNEXURE – Rating Framework.....	10

### ANALYST CONTACTS

#### Karthik Srinivasan

Senior Vice President & Group Head  
+91 22 6114 3444  
[karthiks@icraindia.com](mailto:karthiks@icraindia.com)

#### Anil Gupta

Vice President & Co Group Head  
+91 124 4545 314  
[anilg@icraindia.com](mailto:anilg@icraindia.com)

#### Aashay Choksey

Asst. Vice President & Sector Head  
+91 22 6114 3430  
[aashay.choksey@icraindia.com](mailto:aashay.choksey@icraindia.com)

#### Aayush Behal

Senior Associate Analyst  
+91 124 4545 386  
[aayush.bhal@icraindia.com](mailto:aayush.bhal@icraindia.com)

This rating methodology updates and supersedes ICRA's earlier methodology document on this subject, published in June 2020. While this revised version incorporates a few modifications, ICRA's overall approach to rating entities in the sector remains materially similar.

### Overview

Primary dealers (PDs) are financial intermediaries, which help in developing the primary and secondary markets for the dated securities issued by the Government. The central bank of a country may employ the PDs to fulfil one of its objectives, which is to help the Government complete its borrowing programmes at the lowest cost. In India, the system of PDs was introduced by the Reserve Bank of India (RBI) in 1995 with the following objectives:

- To strengthen the infrastructure in the Central Government (government securities or G-Secs), state government (state development loans or SDLs), Treasury Bills (T-Bills) and cash management bills (CMBs) market to make it vibrant, liquid, and broad-based
- To develop underwriting and market-making capabilities for G-Secs outside the RBI so that the RBI could gradually divest these functions
- To improve the secondary market trading system so that it would contribute to price discovery, enhance liquidity and turnover, and encourage the voluntary holding of G-Secs among a wider investor base
- To make PDs an effective conduit for conducting open market operations

### Regulatory Framework

PD activity can be done departmentally within a bank or as a subsidiary of a scheduled commercial bank or an All India Financial Institution or as a standalone activity by a non-banking financial company (NBFC). Banks willing to undertake the PD business departmentally need to have minimum net owned funds (NOF)<sup>1</sup> of Rs. 1,000 crore, a minimum capital adequacy ratio (CAR) of 9%, net non-performing assets (NNPAs) of less than 3% and a profit-making track record for the past three years.

Any NBFC (subsidiary of a bank, standalone entity or joint venture in India with an overseas partner) with NOF of at least Rs. 150 crore could apply to be a PD. If a PD intends to diversify into other permissible activities, a minimum NOF of Rs. 250 crore is required. The applicant should also have experience in the securities business, particularly in the G-Sec market, of at least one year prior to the submission of the application. Additionally, during the year preceding the year of application:

- The turnover of the applicant in the G-Sec business should be equal to at least 15% of its total turnover
- The applicant's G-Sec assets should be at least 15% of its total assets

<sup>1</sup> NOF is calculated as (a) the aggregate of the paid-up equity capital and free reserves as disclosed in the latest balance sheet of the company after deducting (i) accumulated balance of loss, (ii) deferred revenue expenditure, and (iii) other intangible assets; and (b) further reduced by amounts representing (1) investments of such company in shares of (i) its subsidiaries, (ii) companies in the same group, (iii) all other NBFCs; and (2) the book value of debentures, bonds, outstanding loans and advances made to and deposits with (i) subsidiaries of such company and (ii) companies in the same group, to the extent such amount exceeds 10 per cent of (a) above

Currently, 21 PDs (7 standalone PDs and 14 banks authorised to undertake PD business departmentally) are operating in India. Their operations are regulated and monitored by the RBI. As per the current regulations, PDs are not allowed to have step-down subsidiaries.

## Snapshot of a PD's operations

As per the RBI's guidelines, the major roles and obligations of PDs are as below:

- They are required to support auctions for the issuance of G-Secs (including T-Bills) as per the minimum norms for the underwriting commitment, bidding commitment and success ratio (ratio of total bids accepted to bidding commitment) as prescribed by the RBI from time to time. The RBI may also invite PDs to underwrite the auction of SDLs
- They should also achieve a minimum success ratio of 40% of the bidding commitment in T-Bill (including CMBs) auctions. The success ratios are monitored on a half-yearly basis, i.e. April to September and October to March, separately
- They should offer two-way prices in G-Secs through the Negotiated Dealing System-Order Matching (NDS-OM), the over-the-counter (OTC) market and recognised stock exchanges in India and take principal positions in the secondary market for G-Secs
- They should annually achieve a minimum turnover ratio of 5 times for Government-dated securities and 10 times for T-Bills in reference to the average month-end stocks. The turnover ratio (ratio of total purchase and sales during the year in the secondary market to average month-end stocks) in respect of outright transactions should not be less than 3 times for Government-dated securities and 6 times for T-Bills
- Their investment in G-Secs, T-Bills and corporate bonds on a daily basis should at least be equal to the net call/notice/repo (including collateralised borrowing and lending obligation - CBLO) borrowings plus net RBI borrowings (through liquidity adjustment facility (LAF)/intraday liquidity/liquidity support) plus the minimum prescribed NOF

## Business Risk Assessment

To perform its operations, a PD borrows funds from the call money market or the RBI, and then buys G-Secs. In addition to access to funding from the RBI under LAF, the PDs have access to the standing liquidity facility at the repo rate from the RBI against eligible G-Secs and SDLs depending upon their performance in the primary and secondary markets. The spread between the cost of borrowed funds and the yield on the G-Secs provides the PDs with a net interest income (NII). PDs also raise funds from other sources including banks, commercial papers (CPs), inter-corporate deposits (ICDs) and term money to finance their investments in non-statutory liquidity ratio (SLR; non-G-Sec) instruments or corporate bonds, which represent another source of NII.

As the majority of the investments is long tenured with a fixed coupon rate and the source of funds typically deployed by PDs during the auction is through call money and other short-term borrowings, the ability of the PD to borrow at the best rates to maintain a positive NII is crucial to sustain profitable operations. Moreover, depending on the interest rate conditions, PDs may choose to hold or sell the investments with the objective of improving the profitability or reducing the possible losses. Thus, the interest rate movements in the secondary market and the PD's interest rate outlook tend to have a bearing on its profitability. The three scenarios of interest rate movements are discussed below.

### Steady Interest Rate Scenario

In this scenario, the trading opportunities for the PDs may be limited. Thus, the principal source of profitability is the NII, earned by way of a coupon on the investments less the borrowing costs. A higher net worth (or lower leverage) and hence

relatively lower levels of borrowings would improve the net interest margins<sup>2</sup> (NIMs) of the PD. However, a lower leverage would imply a lower return on the net worth. A PD may continue to hold its investments by rolling over its borrowings or it may gradually reduce its investments by offloading the same to other investors.

## Falling Interest Rate Scenario

In this scenario, the trading opportunities are plenty and the probability of making trading profits is higher. Apart from underwriting operations, PDs make use of the falling interest rate regime to actively trade in their G-Sec portfolios by increasing their investment books through additional borrowings (against these G-Secs). At the same time, the gross interest spreads may reduce as the spread between the borrowing costs and the yield on investments may decline. With the increase in leverage, the NIMs may also go down even though there may be an absolute increase in the NII because of the larger portfolio size driven by the increased leverage. The earnings profile of the PD may likely change in favour of income from trading operations instead of the NII on the portfolio held. Such a scenario could help a PD grow its profits and reserves, which would act as a buffer during adverse market conditions.

## Rising Interest Rate Scenario

In this scenario, a PD may face a difficult time with regard to the NII as well as in terms of making trading profits. During such periods, the NII could be negatively impacted as the rates on call money, which is a sizeable share of a PD's borrowings, tend to increase. To reduce the vulnerability to rising interest rates, a PD may reduce the portfolio size or duration or both and correspondingly its leverage, thereby reducing its NII. With the rise in interest rates, the prices of investments fall, resulting in losses for PDs. Based on strategies and the market outlook, a PD may redraw its strategy for such volatile periods in the markets, which may include reducing the leverage, scaling down the operations, not carrying the positions for the longer term and booking the profits/losses at higher frequencies. Thus, a PD's risk management systems and operating strategies are crucial in such a scenario.

Given their role in the Indian debt market, PDs would need to borrow money from the market and leverage their operations. In light of the above, ICRA considers the following rating criteria while rating the debt programmes of PDs.

## Business Risk Assessment Parameters

- **Market Risk and Risk Management Policy**
- **Credit Risk**

## Financial Risk Assessment Parameters

- **Capitalisation and Leverage**
- **Funding and Liquidity**
- **Profitability**

## Promoters and Management

## Assessment of ESG Risks

- **Environment and Social Risks**
- **Governance Risks**

---

<sup>2</sup> Net interest income / Average total assets

## Market Risk and Risk Management Policy

The source of market risk for a PD emanates from the volatility in the market price of its assets, i.e. primarily debt securities. ICRA analyses the various primary dealer returns (PDRs) submitted by the PDs<sup>3</sup> to assess the movements in their investment portfolios (in terms of size and composition) as well as the funding mix of the liabilities. Additionally, the PDRs are analysed to see the movements in the duration of the assets and liabilities, leverage levels and hence the duration of the NOF, to assess the impact of the movement in the interest rates on the NOF. Stress scenarios for different durations and leverage levels of the PD are drawn to see the loss-absorption cushion available from the NOF. ICRA views the potential loss to NOF ratio as an important metric for evaluating PDs.

ICRA also evaluates the internal operating guidelines and risk management policies such as the prudential norms including the internal value at risk (VaR) norms, permissible PVBP or PV01<sup>4</sup> thresholds set by the Risk Management Committee of the board. Adherence to such policies by the management is considered favourably. A discussion with the management team and/or the auditors is done on instances of breach of risk management policies and the implementation of subsequent corrective action plans. In addition, ICRA evaluates the PD's compliance with regulatory norms in respect of primary and secondary market operations in terms of bidding commitments and turnover ratios, etc.

As PDs also invest in corporate bonds/money market instruments like CPs and certificates of deposit, the quality of these investments becomes important from the profitability, capital and liquidity perspective. In adverse market conditions, the prices and liquidity of non-AAA instruments could see volatility and could adversely impact a PD. Accordingly, the permissible investment limit as per the internal risk management policy for such non-AAA corporate investments in relation to the NOF is also considered as one of the factors for assessing the exposure to market risk. Higher the size of such non-AAA corporate investments, higher is the market risk.

## Assessment of Market Risk and Risk Management Policies

[Indicative Metrics<sup>5</sup>]

	Strongly Positioned	Weakly Positioned
Maximum permissible VaR / NOF	< 10%	> 30%
Daily average VaR / NOF	< 8%	> 24%
Maximum permissible non-SLR (Non-AAA) / NOF	< 100%	> 300%
Interest rate risk allowed as % of NOF*	< 0.50%	> 2.5%

\* If the risk management policy states that the permissible PVBP or PV01 for the entire portfolio of the company is Rs. 5 crore and NOF is 1,000 crore, then  $1000/5 = 200$  bps adverse movement in interest rates will erode the net worth completely. Hence, the lower the PV01 in relation to the net worth, the lower is the risk

## Credit Risk

PDs primarily deal in G-Secs, where the credit risk is negligible. However, the credit risk for PDs may arise from their exposure to corporate debt papers. ICRA evaluates the internal norms and control systems put in place by the PDs to adhere to such norms to evaluate the credit risk borne by the PDs. The internal norms analysed include the credit rating-wise approved investment limits in corporate bonds. To assess the credit risk, ICRA typically considers the size of vulnerable non-SLR investments (typically, non-investment grade) and net non-performing investments in relation to the net worth.

<sup>3</sup> PDRs are submitted to the RBI by PDs on a fortnightly (PDR1), monthly (PDR2) and quarterly (PDR3 and PDR4) basis as per the regulatory requirements

<sup>4</sup> Price value of a basis point (PVBP) measures the gain/loss on the entire portfolio for a 1 basis point (0.01%) movement in the interest rate

<sup>5</sup> The indicative financial metrics mentioned here and elsewhere in the document are intended to provide a broad overview to the readers regarding what ICRA generally considers as 'relatively strong' or 'relatively weak' metrics. It is, however, possible that an entity has relatively weaker metrics on one or more parameters, but its credit risk is assessed to be low because of other mitigating factors, including (but not limited to) stronger metrics on other parameters

## Assessment of Credit Risk

[Indicative Metric]

	Strongly Positioned	Weakly Positioned
(Vulnerable non-SLR + Net non-performing investments) / NOF	< 5%	> 25%

## Financial Risk Assessment

ICRA’s framework for assessing a PD’s financial strength evaluates its ability to generate steady internal accruals while demonstrating a track record of minimising instances of trading losses by managing such risks as demonstrated in the past. It also considers the evolution of the risk management policy. Further, in situations of volatile market conditions, the ability of the PD to cut down its portfolio by maintaining a higher share of liquid investments (especially the non-SLR book) drives the liquidity profile and its debt servicing ability in case of inability to roll over its liabilities.

### Capitalisation and Leverage

The RBI norms stipulate a minimum NOF of Rs. 150 crore for undertaking standalone PD operations and a minimum NOF of Rs. 250 crore for undertaking other permissible activities as well. Additionally, a PD can have Tier II capital arising from revaluation reserves, general provisions, hybrid capital instruments and subordinated debt. PDs are required to maintain an overall CAR of 15% of the risk-weighted assets (RWAs) with the total Tier II capital not exceeding 100% of the Tier I capital<sup>6</sup>. Within the Tier II capital, subordinated debt<sup>7</sup> is limited to 50% of the Tier I capital.

As standalone PDs are required to maintain at least 50% of their total investments in G-Secs (actual holding is typically much higher) at any point in time, as per the RBI’s regulations, the RWAs are limited as G-Secs carry zero credit risk weight. Hence, the RWAs are largely a function of other balance sheet assets like corporate bonds and off-balance sheet exposures like interest rate futures, etc, apart from the market risk on the bond portfolio, calculated as per the criteria defined by the RBI for PDs.

The market risk for PDs arises from their exposure to debt instruments and their associated price sensitivity to interest rate movements. As per regulatory requirements, 50% of the capital required for credit RWAs should be met through the Tier I capital.

The capital required to mitigate the credit risk is driven by the nature of the investment (whether corporate/G-Secs, etc). The capital required to mitigate the market risk is a function of the duration and scale of operations (i.e. the size of the investment book/portfolio), which is typically a function of financial leverage. The financial strength to absorb market risks and the ability to scale up, in the event of trading opportunities, are driven by a PD’s capital levels. A high NOF or Tier I capital acts as a buffer against adverse movements in interest rates.

Given the daily churn in the investment book and hence the borrowings, the reporting dates for financial results (quarter end or financial year end) may not reflect the actual size of the investment book and the leverage and hence the risk appetite of the PD. Accordingly, the daily average of the leverage is computed to assess the risk appetite and the market risk of a PD on an ongoing basis to compare various peer entities. A higher share of the non-SLR book (daily average basis) in relation to the NOF or a higher total investment book leads to more market risk and reflects a PD’s higher risk appetite. Further, the peak leverage during the year may be very different from the daily average or the period-end reporting leverage levels and is also considered for risk profiling.

While there are no regulatory limits on PDs with regard to leverage, adherence to the internally approved limits as per the risk management policies on a regular basis is analysed. Also, the leverage level in relation to peers is compared to assess the overall risk appetite of the PD. Apart from this, the leverage drives the duration of the NOF and the sensitivity of the net worth

<sup>6</sup> Tier I capital is calculated as the sum of paid-up capital, statutory reserves and other disclosed free reserves, adjusted for investments in subsidiaries, intangible assets, deferred tax assets, losses in current accounting period and losses brought forward from previous periods

<sup>7</sup> Subordinated debt should have a minimum maturity of 5 years and are subject to a progressive discount for inclusion in Tier II capital during the last 5 years of maturity. The instrument should be plain vanilla with no features like options and should carry a fixed coupon rate

to interest rate movements. Accordingly, maintaining a prudent leverage and hence a prudent duration of NOF is viewed favourably.

## Assessment of Capitalisation

[Indicative Metrics]

	Strongly Positioned	Weakly Positioned
Net owned funds (Rs. crore)	> 1,200	< 175
Daily average leverage (Non-SLR book / NOF)	< 2x	> 6x
Daily average leverage (Total debt / NOF)	< 10x	> 30x
Peak leverage (Peak total debt / NOF)	< 12x	> 36x

## Funding and Liquidity

PDs are permitted to borrow funds from the call/notice/term money market, CPs, non-convertible debentures (NCDs), repo (including CBLO), ICDs and foreign currency non-resident (bank) [FCNR (B)] loans. PDs are also eligible for seeking liquidity support from the RBI under the latter's liquidity management operations, whenever made available. A high share of G-Secs in the overall assets and access to diverse sources of funding impart superior liquidity to PDs. This may, however, be offset by the size and nature of the non-SLR book maintained by the PD, which may not be as liquid.

There have been changes in the RBI's liquidity management framework as per the [circular](#) dated February 6, 2020. As per the circular, access to the overnight and other shorter-tenure (less than 13 days) LAF has been curtailed for all participants like banks and PDs and will be decided by the RBI based on an assessment of the liquidity conditions. Accordingly, the ability of PDs to borrow for overnight requirements under LAF depends on the prevailing liquidity conditions and the RBI's stance on making available the funding/liquidity facilities to market participants like PDs. Moreover, as these operations are at the discretion of the RBI, the availability of such funding on a regular basis remains uncertain. However, LAF access through the 14-day variable rate repo is still available for banks as well as PDs.

Hence, PDs will have to plan their funding requirements in a better manner as overnight funding through the LAF window is no longer available. They will have to depend on call money markets (secured/unsecured) to fund their overnight/next day liquidity requirements. While borrowing from call money markets shall not be an issue for stronger institutions in a surplus liquidity scenario, it is expected that in a situation of liquidity tightness in call money markets, the RBI will either increase the notified amount in the 14-day variable rate repo window and/or conduct overnight and shorter-tenure LAF operations to provide liquidity to banks as well as PDs.

In a scenario of surplus liquidity, the call money rates are expected to be lower than the repo rate and the market repo will form a larger part of the borrowings for the PDs as it will be cheaper than the RBI repo borrowings. However, when liquidity conditions tighten, the RBI repo borrowings will increase, as these could be cheaper than the market repo.

If a bank or a PD is unable to borrow in the call money market and has G-Secs on its books funded via short-term liabilities like overnight call money borrowings, which need to be repaid the next day, the following are the ways to repay such borrowings:

- a) Sell the G-Secs and/or
- b) Borrow through repo on The Clearing Corporation of India Ltd.'s (CCIL) platform or TREPS, where the settlement is guaranteed by CCIL with no linkage to the underlying institution

Hence, the curtailment of overnight LAF access will require better liquidity management by the PDs, especially in tighter liquidity conditions. However, as borrowings through call money are repriced daily and the rates can inherently be volatile, a larger share of borrowings through this route imparts volatility to the cost of funds. The reliance on the unsecured call money market in the overall borrowing pie is also restricted as the RBI allows the average borrowings through the call/notice/term money market during a fortnight at a maximum of 225% of the NOF (subject to a periodic review by the RBI). The peak

borrowings from the short-term call money market may be much higher than 225% of the NOF during periods of G-Sec and T-Bill auctions, as PDs may have to borrow more on a temporary basis to meet their underwriting commitments.

The end use of the funds borrowed from call money/LAF is also restricted by the RBI for investment in corporate bonds (i.e. borrowings up to only 50% of NOF can be invested in corporate bonds). A PD willing to undertake other activities related to the dealing/underwriting of corporate bonds may have to rely on other sources of borrowings like CPs (no regulatory limits) and ICDs (ICDs allowed up to 150% of the NOF at the end of the preceding financial year) to fund these activities. Liquidity risk for a PD may emerge if it is not able to roll over these borrowings for funding the non-SLR book because of volatile market conditions, while these investments turn illiquid at the same time because of market volatility. The ability of the PDs to maintain a granular non-SLR book across high-rated issuers and frequently test the portfolio for liquidity can help manage/mitigate the liquidity risks.

As investing and trading in G-Secs is their primary business, PDs maintain a high share of investments in SLR securities, which are highly liquid. ICRA assesses the daily average source of funds, eligible for funding the non-SLR book against the actual non-SLR book, to evaluate the extent to which the non-SLR eligible funding may be parked in the SLR book as it provides additional liquidity comfort. Furthermore, ICRA assesses the internal norms of the PD that guide the size and the quality of the non-SLR investments in relation to long-term funds vis-à-vis the actual holdings in the non-SLR portfolio of the PDs to evaluate the liquidity risk for a PD. These long-term funds can include the NOF, NCDs (including Tier II bonds) and term loans with a residual maturity of more than 1 year. In an adverse situation of market disruption, the liquidity of non-SLR investments could be affected and hence higher funding of these investments through long-term funding is preferable to prevent asset-liability mismatches and market risk. Within non-SLR investments, a higher share of AA and below rated investments, which could be less liquid in events of market dislocation, is seen negatively.

## Assessment of Liquidity

[Indicative Metrics]

	Strongly Positioned	Weakly Positioned
Non-SLR book as % long-term funds*	< 75%	> 400%
AA and below rated non-SLR as % of long-term funds	< 50%	> 150%

\* Long-term funds will typically include NOF, NCDs (including Tier II bonds) and term loans with residual maturity of > 1 year

## Profitability

The financial performance of a PD is significantly influenced by the external environment such as the economic cycle, the Government's borrowing programme and interest rate movements. The ability of the PD to adapt quickly to the changing environment is expected to alleviate income volatility.

The historical trends in the profitability of a PD are assessed for their level and stability vis-à-vis peers. ICRA notes that the profitability of a PD is dependent on the degree of its aggression as reflected in the asset characteristics and leveraging levels. As the PD's main business revolves around trading, its non-SLR investments are usually in instruments that carry high credit ratings (ratings of AA and equivalent and above), thereby mitigating the credit risk and the provisioning requirements due to a credit loss. While trading income imparts volatility to the profitability, interest income and underwriting income, other sources of income such as debt syndication fee and corporate bonds underwriting fee, etc, offer diversity to the revenues and impart some stability to the profitability. The track record of a PD in terms of minimising the trading losses, through better ability to predict interest rates, is considered favourably. Further, the dividend payout ratio is capped at 60% by the RBI for PDs, which means that for every year, they are structurally tuned to retain the internal accruals for future requirements. In general, an aggressive dividend distribution policy and hence lower capital retention imply that the benefits arising out of strong profitability may not necessarily translate into balance sheet strengthening.

## Assessment of Profitability

[Indicative Metrics]

	Strongly Positioned	Weakly Positioned
Number of years of trading losses in last 10 years	≤ 2	≥ 6
Weighted average RoE for last 5 years & coming 2 years	> 15%	< 6%
Dividend payout as % of PAT for last 5 years	< 40%	60%

## Promoters and Management

Most PDs are backed by strong promoters and their ability to provide ongoing support to the PDs, such as capital infusion as well as extraordinary support in times of stress, if required, is factored in while evaluating the credit profile of a PD. ICRA favourably views a stable and experienced management to manage the interest rate and liquidity risk profile of the business.

### Quality of Management

Considering the dynamic nature of the debt capital market, the quality of management forms an important parameter in ICRA's framework for assessing a PD's rating. While it is relatively easier for a PD to generate profits during a declining interest rate environment, in ICRA's view, the quality of management remains imperative for tiding over difficult operating environments.

ICRA's assessment factors in the stability of the top management, their experience in debt market business operations and their track record in successfully managing the interest rate cycles. A PD with a proven track record of managing its business efficiently through various interest rate cycles, with a professional, experienced and stable management profile and good market reputation, is viewed favourably by ICRA.

### Ownership/Parentage

Most standalone PDs are promoted by banks or large financial institutions and can benefit from their strategic fit with the group. Given the reputation risk to the parent, the PDs backed by these institutions are expected to have adequate internal controls and processes and thus provide higher rating comfort. The presence of directors and key management personnel from the parent, to oversee the formulation and implementation of risk management policies, is viewed favourably by ICRA. Over and above the standalone credit considerations, the likelihood of extraordinary support from the parent is factored in while assessing a PD's credit profile. This process involves the assessment of the ability and willingness of the parent to extend support to the entity in times of the PD's distress, in addition to the evaluation of the entity's own fundamental credit strength.

## Assessment of ESG Risks

The assessment of environmental, social and governance (ESG) risks by ICRA involves a broad range of considerations that pertains to the sustainability of an entity with focus on aspects that can have a material impact on its credit quality. While the environmental (E) and social (S) risks tend to be sector-related as well as entity-specific and could be driven by external factors such as regulations or demographic changes, the governance (G) risks are largely entity-driven. The impact of the E&S risks on an entity's credit profile tends to be asymmetric. If the ESG risks are material but unmitigated, these generally pull down the rating, but the ratings are usually not pushed up even when the ESG context is favourable.

### Environmental and Social Risks

While undertaking the credit assessment of entities, ICRA seeks to incorporate all relevant credit considerations into its rating decisions while taking a forward-looking view on the risks and mitigants. The relevant credit considerations include (sometimes overtly and sometimes covertly) the E&S factors that could affect the rated entity/transaction. While ICRA's analytical approach does not explicitly disaggregate these risks to assess their impact on the rating, these risks are often assessed broadly. Further, it is not always feasible to disaggregate the sub-components of the E&S risks fully or precisely in credit analysis since these considerations often tend to overlap.

While evaluating the E&S risks, ICRA's objective is to assess the direct and indirect risks that an entity faces and how it already is or is intending to mitigate the impact of such risks on its credit profile. Given that the corporate investments by PDs are generally driven by market opportunities and are not based on lending decisions, a sizeable share largely relates to sovereign entities and service-oriented businesses. Accordingly, the direct exposure of PDs to environmental risks is not material. As for exposure to social risks, the most relevant risk on this dimension pertains to the ability to attract and retain specialised talent—for which the PDs compete with other financial sector companies. This risk apart, other sources of social risks emanating from concerns around responsible production, employee health or safety, labour relations issues, product mis-selling, etc., do not apply to PDs.

### Governance Risks

A sound corporate governance structure attempts to make clear the distinction of power and responsibilities between the board of directors and the management. The constitution of an entity's board and the board's participation in strategy formulation, besides the entity's adherence to legal and statutory compliance requirements are factored in during credit assessment. ICRA seeks to gain a qualitative understanding of the entity's commitment to following transparent and credible practices from the way its financial statements are reported, the level of disclosures, consistency in communication and the openness about sharing information during the credit rating exercise. Besides the corporate group structure (whether simple or complex), the rated entity's related-party transactions and instances of supporting group entities at the expense of debtholders are assessed.

ICRA's evaluation of the governance structure of a company considers the ownership structure and composition, the quality and composition of the board of directors and board-level committees. The size and constitution of the board (adequate number of Independent Directors and representation by key stakeholders) are indicators of the diversity and independence of the board. A board consisting of qualified and independent members with effective oversight is a positive factor. Conservative risk management policies and adherence to the same is a critical attribute, and the extent of the same is assessed while taking a view on the risk appetite of the PD. Apart from auditor qualifications, ICRA assesses the instances of breaches in the key risk thresholds (such as PVBP, VaR, etc.) to gauge the effective implementation of the policies.

### Summing Up

ICRA's credit ratings are a symbolic representation of its opinion on the relative credit risk associated with the entity and the instruments being rated. For a PD, the income and profitability are driven by the sensitivity of its assets (primarily debt securities) to interest rate movements. The impact of interest rate movements gets amplified by leverage with the capital acting as a buffer against such adverse movements. The risk management policies and prudential norms of a PD reflect its degree of aggression and need careful assessment to gauge its risk profile.

## ANNEXURE – Rating Framework

Summary of rating factors and an example to illustrate the key building blocks of a credit rating for a PD

Category	Sub-category	Strong			Comfortable			Adequate			Moderate			Weak			
Risk management	Maximum permissible VaR / NOF																
	Daily average VaR / NOF																
	Maximum permissible Non-SLR (Non-AAA) / NOF																
	Interest rate risk allowed as % of NOF																
Asset quality	(Stressed/vulnerable Non-SLR + Net non-performing investments) / NOF																
Capital	Net owned funds																
	Daily average leverage (Non-SLR book / NOF)																
	Daily average leverage (Total debt / NOF)																
	Peak leverage																
Internal capital generation and retention	Number of years of trading losses in last 10 years																
	Wtd average RoE for last 5 years & coming 2 years																
	Dividend payout as % of PAT for last 5 years																
Liquidity	Non-SLR book as % long-term funds																
	AA and below rated non-SLR as % of long-term funds																
		Enhance						Neutral						Hinder			
Does this factor enhance or hinder the credit profile?	Parent/Group support																
	Final rating	AAA	AA+	AA	AA-	A+	A	A-	BBB+	BBB	BBB-	BB+	BB	BB-	B/ C category		

The above graphic is only for illustration purpose and does not represent a rating output from a formulaic model. The ratings assigned by ICRA are determined by the Rating Committees based on both quantitative and qualitative considerations.

Contact us for any feedback or comments at: [methodologies@icraindia.com](mailto:methodologies@icraindia.com)

### RELATIONSHIP CONTACT

**L Shivakumar**

+91 22 6114 3406

[shivakumar@icraindia.com](mailto:shivakumar@icraindia.com)

### MEDIA AND PUBLIC RELATIONS CONTACT

**Ms. Naznin Prodhani**

+91 124 4545 860

[communications@icraindia.com](mailto:communications@icraindia.com)

### Helpline for business queries

+91-9354738909 (open Monday to Friday, from 9:30 am to 6 pm)

[info@icraindia.com](mailto:info@icraindia.com)

### About ICRA Limited:

ICRA Limited was set up in 1991 by leading financial/investment institutions, commercial banks and financial services companies as an independent and professional investment Information and Credit Rating Agency.

Today, ICRA and its subsidiaries together form the ICRA Group of Companies (Group ICRA). ICRA is a Public Limited Company, with its shares listed on the Bombay Stock Exchange and the National Stock Exchange. The international Credit Rating Agency Moody's Investors Service is ICRA's largest shareholder.

For more information, visit [www.icra.in](http://www.icra.in) and [www.icraresearch.in](http://www.icraresearch.in)

## ICRA Limited

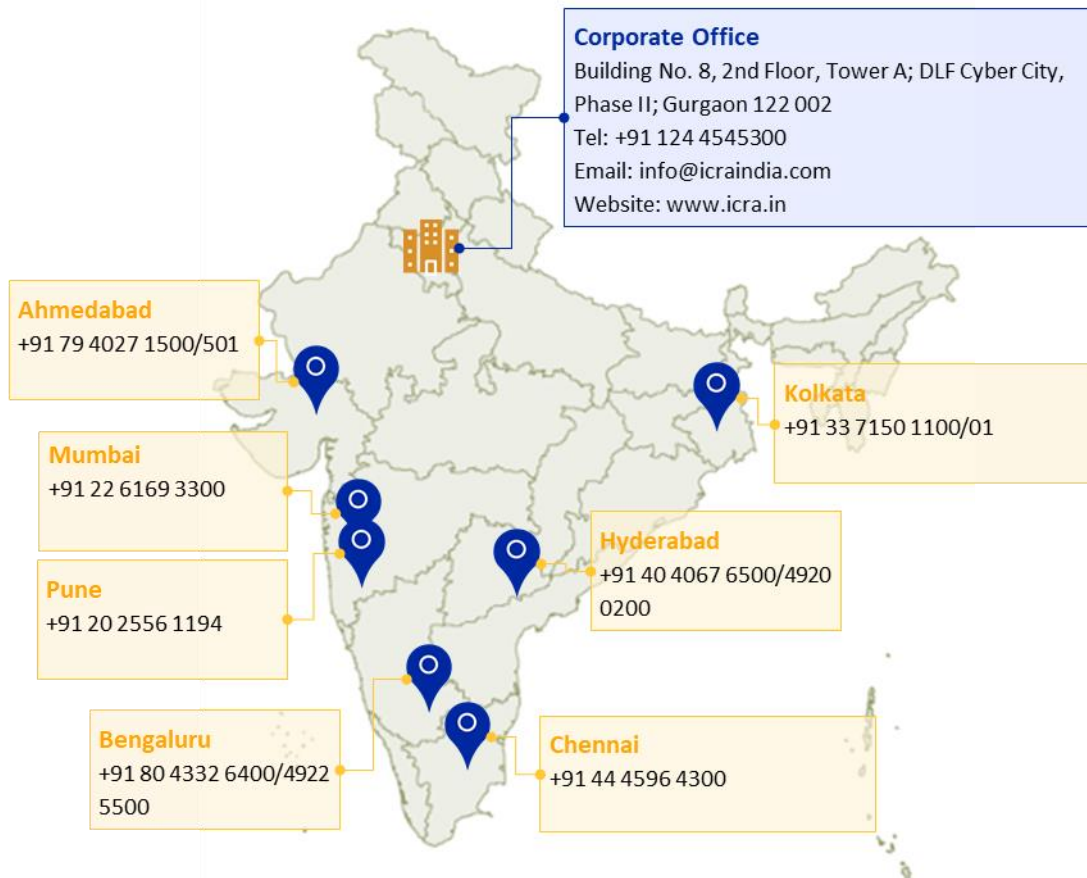


### Registered Office

B-710, Statesman House, 148 Barakhamba Road, New Delhi-110001  
Tel: +91 11 23357940-45



### Branches



© Copyright, 2022 ICRA Limited. All Rights Reserved.

Contents may be used freely with due acknowledgement to ICRA.

ICRA ratings should not be treated as recommendation to buy, sell or hold the rated debt instruments. ICRA ratings are subject to a process of surveillance, which may lead to revision in ratings. An ICRA rating is a symbolic indicator of ICRA's current opinion on the relative capability of the issuer concerned to timely service debts and obligations, with reference to the instrument rated. Please visit our website [www.icra.in](http://www.icra.in) or contact any ICRA office for the latest information on ICRA ratings outstanding. All information contained herein has been obtained by ICRA from sources believed by it to be accurate and reliable, including the rated issuer. ICRA however has not conducted any audit of the rated issuer or of the information provided by it. While reasonable care has been taken to ensure that the information herein is true, such information is provided 'as is' without any warranty of any kind, and ICRA in particular, makes no representation or warranty, express or implied, as to the accuracy, timeliness or completeness of any such information. Also, ICRA or any of its group companies may have provided services other than rating to the issuer rated. All information contained herein must be construed solely as statements of opinion, and ICRA shall not be liable for any losses incurred by users from any use of this publication or its contents.