Crisil Ratings criteria for Finance and Securities companies

(Including approach for financial ratios and hybrid instruments)

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Contents

Section I.

Crisil Ratings methodology for finance companies

Executive summary

Finance companies are engaged in retail and wholesale finance but are not registered as banks or financial institutions. Retail finance companies offer loans to buy cars, two-wheelers, commercial vehicles, and houses, and extend unsecured personal loans and loans against property and shares (Securities companies have been excluded from this definition). Wholesale financing includes financing of medium-sized and large companies, including infrastructure and real estate entities.

The industry includes non-banking finance companies (NBFCs) and housing finance companies (HFCs). Typically, NBFCs finance vehicles (cars, commercial vehicles, and two-wheelers) and consumer durables, and provide gold loans and unsecured loans. Some NBFCs extend wholesale lending to companies, both small and big. HFCs, typically, provide home loans, loans against property and construction finance to real estate developers. NBFCs are registered with the Reserve Bank of India (RBI) and HFCs with the National Housing Bank (NHB). NBFCs also include NBFC-IFCs[1] and IDF-NBFCs[2], which specialise in infrastructure financing. The factors considered for assessing the credit quality of IDF-NBFCs are listed in Annexure 1 of this section.

NBFCs and HFCs continue to play a critical role in the Indian financial sector. They benefit from their:

- Ability to customise credit appraisal for borrowers in the unorganised sector
- Robust collection architecture
- Faster turnaround time

The NBFC/HFC industry includes not only standalone players, but also subsidiaries of manufacturing companies and financial services firms.

The RBI (Amendment) Act, 1997, formalised the regulatory regime for the NBFC sector. It authorises the RBI to determine policies and issue directions to NBFCs regarding income recognition, accounting standards, classification of assets, provisioning for non-performing assets (NPAs) and capital adequacy. While the RBI's regulatory oversight primarily covered deposit-taking NBFCs initially, the central bank has not only extended its regulatory coverage to non-deposit-taking NBFCs over the years, but also brought out sector-specific regulations, such as for asset finance companies, microfinance companies, gold loan companies, IFCs (infrastructure finance companies) and IDFs (infrastructure debt funds). Furthermore, the RBI has increasingly aligned the regulations for NBFCs with that of banks with respect to asset classification norms, capital requirement and corporate governance. This has structurally strengthened the NBFC sector.

NHB was set up in 1988 to act as the principal agency to regulate HFCs, both local and national, and to provide financial and other support to them. NHB follows prudential norms similar to those proposed by the RBI for the home loan portfolio of banks.

Crisil Ratings has revised rating methodology[3] to factor in the recent market developments in the NBFC/HFC space. Crisil Ratings considers asset quality, capitalisation, and earnings as core parameters in the assessment process. Asset quality indicates the risk levels within which the finance company operates, while capitalisation indicates the cushion available to absorb potential losses that may arise due to the risks taken, and to ensure growth. Hence, these reflect the business and financial risk appetites of the entity and are considered key determinants of the rating. Earnings indicate the ability to price risks and generate sufficient returns to augment the capital base for loss absorption as well as growth.

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[1] *IFC refers to infrastructure finance companies*
[2] *IDF refers to infrastructure debt funds*
[3] *For accessing the previously published document on 'Rating criteria for finance companies', follow the link:* *https://www.crisilratings.com/content/dam/crisil/criteria_methodology/financials/archive/crisil-ratings-criteria-for-finance-companies-feb2024.pdf*

Other parameters, such as market position, resource profile, liquidity and management are considered supplementary parameters.

Crisil Ratings believes managing Environmental, Social and Governance (ESG) risks and opportunities will have a bearing on the credit profile of an issuer. Based on materiality and adequacy of data on ESG factors, Crisil Ratings will assess and suitably factor in the ESG profile of finance companies in its credit risk analysis.

Given that securitisation is a key funding source for non-banking finance companies (NBFCs) and housing finance companies (HFCs) in India, Crisil Ratings' analysis includes the securitised assets in its analysis on the scale and asset quality, earnings, capital position, and funding and liquidity of the originator.

Scope

This section highlights the Crisil Ratings methodology to assessing the credit quality of finance companies (NBFCs and HFCs). Crisil Ratings uses the CRAMEL framework to rate finance companies—the same framework used to rate banks and financial institutions. It entails assessing the following parameters: capital adequacy, resource- raising ability, asset quality, management, earnings, and liquidity. In addition, Crisil Ratings factors in the market position of the NBFC/HFC and other issues specific to finance companies.

The methodology outlined in this section is used to arrive at the standalone rating of an NBFC/HFC. The section also covers Crisil Ratings' methodology to financial ratios used for analysing finance companies, including adjustments it carries to the reported metrics in the financial statements. For entities that are subsidiaries or belong to large corporate groups, Crisil Ratings may notch up the standalone rating for support from the parent company/group/government. The criteria for notch-up (*Crisil Ratings criteria for factoring parent/ group/ government linkages*) can be found on the Crisil Ratings website, www.crisilratings.com.

Methodology

The Crisil Ratings methodology to rating finance companies involves a comprehensive assessment of several parameters. Some core parameters are considered to have a major influence on the credit quality of an NBFC/HFC, while others are considered supplementary.

Crisil Ratings takes a forward-looking view on the performance of the NBFC/HFC on these parameters while arriving at the rating. The nuances of specific asset classes are taken into consideration, thereby ensuring dynamic assessment of the NBFC's credit quality depending on changes in its asset class mix.

Core parameters (high influence on credit risk profile of a finance company)		
Asset quality	**Capitalisation**	**Earnings**

Supplementary parameters (degree of influence depends on the characteristics of the NBFC/HFC)			
Market position	**Resource profile**	**Liquidity**	**Management profile**

Core parameters

Crisil Ratings considers asset quality, capitalisation and earnings as the core parameters that drive the credit risk profile of a finance company. The interplay of these parameters determines the ability of the NBFC/HFC to underwrite, price and manage its risks, and maintain adequate capital to absorb losses during times of stress and to ensure profitable growth.

The standalone rating of the finance company will be typically anchored around the assessment on these core parameters.

Asset quality

Asset quality is a primary consideration in assessing credit risk of finance companies, as of banks. NBFCs/HFCs inherently cater to riskier asset classes and difficult-to-address customer segments, compared with banks. In order to maintain asset quality, these entities need to have tighter operational controls, stringent risk management practices and efficient recovery mechanisms.

Weakening of asset quality could lead to higher credit costs, which can impact returns and erode the headroom available in the capital structure to absorb losses. Eventually, these can impact growth prospects and potentially curtail availability of funds, thereby endangering the solvency of the entity.

The portfolio quality could vary depending on the asset class in which the NBFC/HFC operates. For instance, home loans have traditionally displayed lower delinquency profiles and are considered less risky compared with other secured asset classes, which are, in turn, considered less risky compared with unsecured lending. Wholesale lending carries higher risk due to concentration and the typically low credit quality of the target customer segments of many NBFCs.

In analysing asset quality, Crisil Ratings assesses the company's credit risk management system and evaluates its portfolio quality. Crisil Ratings evaluates the company's underwriting standards, target customer segments, approval authorities, collection procedures and management information systems that allow it to monitor and address potential credit problems and loss-mitigation strategies. The asset diversity in terms of asset classes and geographical distribution, delinquency trends, weak asset levels, credit costs, write-offs and recovery levels are also analysed.

Crisil Ratings compares the available information on the above-mentioned parameters to assess portfolio quality and adjusts for differences in calculation methodologies. As asset quality indicators can be distorted by growth, Crisil Ratings analyses gross non-performing assets (GNPA) levels on a lagged basis as well as on a static pool basis to measure the asset quality of different vintages.

GNPA refers to the value of on-balance sheet loans or advances that have not been paid by the borrower for at least 90 days. For NBFCs which have adopted Indian Accounting Standards, the equivalent of GNPA is gross stage 3 assets.

GNPA% = GNPAs / Gross advances or Gross Stage III loans / Gross Loans

In addition to on-balance sheet advances, NBFCs may have significant securitisation and co-lending portfolio. Asset quality performance for this portfolio may also be analysed separately by evaluating the GNPAs on the basis of the overall assets under management (AUM). AUM refers to the overall interest-earning or fee-earning assets including the on-balance sheet advances, off-book securitisation portfolio as well as co-lending or business correspondent portfolio. This adjustment is mainly used in NBFCs since there is a significant off-book portfolio.

Crisil Ratings uses below approach to arrive at AUM:

AUM = On-balance sheet advances + off-book securitisation portfolio + co-lending book + business correspondent book, if any.

In addition, some NBFCs invest in debt instruments of a borrower instead of giving a loan/advance. Where investment in such debt instruments form an integral part of the lending business, Crisil Ratings may factor in these investments as credit-substitute and consider it as part of AUM on a case-to-case basis.

For wholesale lending books, which are less granular, Crisil Ratings factors in concentration risks; asset-specific characteristics such as the credit quality of the borrowers, collateral cover and recovery prospects; and the extent of portfolio diversification, credit appraisal and recovery mechanisms of the NBFC/HFC.

Capitalisation

Capital represents the level of protection available to the company's creditors to absorb losses from credit and other risks. Analysis of capital adequacy covers the absolute quantum and quality of capital, cushion over regulatory capital requirement, risk-adjusted capital levels and the management's capitalisation policy. The analysis also considers the company's leveraging ability based on the asset class it focuses on as well as its asset quality outlook. The leveraging ability of finance companies operating in less risky asset classes, displaying low volatility in delinquency levels and credit costs (such as housing loans), exceeds that of riskier asset classes such as unsecured lending or wholesale loans. Crisil Ratings takes a forward-looking view on leverage and considers the steady-state gearing expected to be maintained by the NBFC/HFC while evaluating capitalisation parameter.

Adjusted gearing = Adjusted borrowings / net-worth

In adjusted borrowings, Crisil Ratings includes all forms of on-balance sheet debt (including bank loans, debentures, deposits etc) and assets securitised via the trust route. The assessment also factors in any significant reliance on the securitization transactions via direct assignment route.

In case of co-lending, details of the first loss default guarantee, if any, are evaluated. In addition to the reported networth, Crisil Ratings evaluates the adjusted networth after factoring the first loss default guarantee.

Crisil Ratings also evaluates the growth outlook for the company's asset base and the ability to generate capital internally or from the capital markets. Thus, the company's capital formation rate (which is a function of profitability and dividend payout ratio) and stock performance, if listed, become relevant.

Earnings

Earnings are key to augmenting the capital required to support growth and absorb losses. The earnings profile indicates the entity's ability to price its anticipated risk. A comfortable earnings profile can help mitigate risks. Also, stable earnings directly influence ability to attract both debt and equity.

Crisil Ratings considers return on managed assets (ROMA) as a critical indicator of earnings. This indicates the returns generated by a company on the managed assets. Managed assets comprises of the total reported assets on the Balance Sheet, the off-book securitisation assets and co-lending / business correspondent book, if any. Originators in securitisation transactions typically retain residual benefits in the securitised loans in the form of upfront premium/profit or excess interest spread. These are typically accounted upfront in the profit and loss account. Additionally, originators also earn servicing fee linked to the securitisation assets. Therefore, Crisil Ratings evaluates Return on Managed Assets.

ROMA = PAT / Total average managed assets

This ratio encompasses all the various building blocks of the profitability of an NBFC/HFC that indicate how efficient it is in managing its:

- Pricing (as indicated by yield on assets)
- Operations (as indicated by operating expenses)
- Asset quality (as indicated by credit costs), and

- Fundraising (as indicated by the cost of funds)

Stability and sustainability of earnings are also key parameters. Earnings need to be viewed in conjunction with the asset quality of the finance company. Herein, credit costs refers to the provisions and write-offs accounted in the profit and loss account by the NBFC. Earnings are typically higher for entities operating in riskier asset classes, in order to cushion against potential volatilities and to build up capital to absorb losses.

While analysing a company's profitability on a historical basis and in relation to its peers, Crisil Ratings adjusts for changes or differences in accounting policies, securitisation gains and the like. The analysis is forward looking and the past profitability performance is only a base for estimating future profitability.

Supplementary parameters

Crisil Ratings considers market position, resource profile, management and liquidity as supplementary parameters that can influence the credit profile of NBFCs/HFCs.

Market position

Crisil Ratings analyses the market position of a company on the basis of its assets under management that includes on balance-sheet assets as well as securitised assets. This is because securitised assets continue to be serviced by the originator.

Under market position, Crisil Ratings assesses the predictability of business volume in the face of potential economic and market fluctuations. A strong market position provides benefits in terms of operating leverage and pricing power. The ability to tap a vast consumer base enables an NBFC to continuously replenish its portfolio, and provides avenues for cross selling and diversification. NBFCs with weak market position, on the other hand, may find it difficult to ensure a sustained future performance, especially during economic downturns.

One of the factors on which market position is assessed is the market share of the NBFC/HFC in the asset class it operates in. Crisil Ratings considers the extent of competition from other NBFCs/HFCs, and even banks and financial institutions, for a forward-looking assessment of the ability of the NBFC to maintain or grow its market share. The scalability of the asset class is also considered. For instance, the market size for tractor finance is limited, while the housing loans market is much larger. Therefore, entities will be able to achieve only limited scale in tractor finance, while they can scale up their housing loan book to a much larger extent.

Distribution network (branches, direct sales or marketing agent network), brand equity, service standards, track record, customer relationships and product portfolio are analysed. Diversification across product, customer or geographical segments, which provides cross-selling opportunities, is also considered.

Resource-raising ability

As funds are a finance company's raw material, the ability to mobilise them is a crucial element of the operating model. The Crisil Ratings analysis of a finance company's resource profile incorporates the cost of resources, diversity of resource profile, and appropriateness of the funding strategy in light of the asset types being financed.

Resource profile is, in a way, a reflection of the credit quality of the NBFC/HFC. Highly rated finance companies will have access to diverse funding sources and may enjoy better interest rates. A weak resource profile with limited diversification can potentially hamper the performance of the entity, especially if there is a liquidity squeeze at the funding source.

NBFCs/HFCs with access to diverse credit markets (capital market, money market, banking sector, external market, deposits) are better placed compared with those with limited access to credit markets. Ability and track record in switching funding sources are also considered. For instance, a squeeze in systemic liquidity may hinder easy access of funds from the money market. Ability to switch to other sources (banking sector or external borrowing) in such a situation will define the strength of the resource profile. The ability to securitise assets is also factored in the resource profile assessment. Funding diversification is one of the important advantages of securitisation for finance companies.

However, compared with the banking sector, NBFCs and HFCs are at a natural disadvantage when raising retail liabilities owing to restrictions on minimum tenure and interest rates, the absence of cheque-issuing facility, and smaller branch network. They are, therefore, depend heavily on wholesale funding, which leads to a certain degree of risk in their funding profile.

Growing importance of ESG risks and opportunities

The past few years have seen the emergence of ESG-led investments globally. ESG investments account for about a third of global assets under management and are expected to grow more than 2.5 times to ~$100 trillion by 2030. Investments in emerging markets, pegged at ~15% in these global funds, are likely to reflect a similar trend, thereby significantly improving access to funds for ESG-focused entities. While ESG-led investing is at a nascent stage in India, its adoption is steadily picking pace. Crisil Ratings believes ESG readiness will, in time, become an important distinguishing feature for finance companies to diversify their resource profile.

Finance companies have limited direct environmental impact and have a reasonable social impact because of their substantial employee and customer base, and their key role in promoting financial inclusion. Furthermore, the lending decisions will have a bearing on environmental factors and hence affect their overall ESG profile. Given the nature of the sector, strong governance is pivotal in this sector for long-term sustainable operations and is a key determinant of the credit rating.

Non-financial disclosures are still evolving. Some of the large corporates have been early adopters, voluntarily tracking and disclosing their ESG-related parameters and policies. Disclosure levels in India are, however, expected to improve—the Securities and Exchange Board of India (SEBI) circular on Business Responsibility and Sustainability Reporting dated May 10, 2021, requires the top 1,000 listed corporates to disclose significant non-financial information on a voluntary basis in fiscal 2022 and compulsorily from fiscal 2023. Improving data availability and ability to benchmark non-financial parameters will help suitably factor in ESG risks in credit assessment and other investment decisions.

Factoring the impact of ESG in credit ratings:

As investors begin to screen investments through the ESG lens, Crisil Ratings believes the ability of an issuer to manage ESG related risks will have a bearing on its resource profile. This will specifically hold true for issuers that are accessing the global pool of capital to meet their funding needs. Based on materiality, Crisil Ratings will endeavor to assess the impact of the ESG risk of issuers, subject to availability of information. Parameters such as proportion of foreign investment holding and reliance on external market borrowings will be considered in assessing the materiality of ESG for an issuer.

Crisil Ratings will assess parameters, such as emissions and energy consumption, water usage, waste management for assessment of the environmental impact. In addition, the sectors to which finance companies lend will also be assessed as such lending can have an indirect bearing on the environment. Under social assessment, information pertaining to human capital, product and customer management, vendor management and community engagement will be evaluated. Under governance, the board performance, ownership concentration, shareholder relations, and disclosures and financial statements will be assessed. Crisil Ratings may look at a specific combination of these parameters based on the materiality and availability of information.

Crisil Ratings believes improvement in non-financial disclosures will be critical to increase the scope of integrating ESG into credit risk assessment.

Management

The dynamic environment in the industry in the past two decades resulted in significant and frequent changes in the risk profile of finance companies as new business opportunities arose. Consequently, analysis of the quality of a company's management, its business strategies, ability and track record of responding to changes in market conditions, risk appetite and competency form a central input in credit assessment.

As part of the evaluation of a company's management, Crisil Ratings assesses the goals, philosophies and strategies that drive the company's business and financial performances.

Liquidity/asset liability management

Assessment of liquidity risk of finance companies involves a comprehensive evaluation of structural and contingent liquidity plans. Structural liquidity is key and is analysed from the asset and liability maturity profiles. The Crisil Ratings assessment of structural liquidity involves analysing the statement of structural liquidity, making appropriate adjustments, evaluating cumulative gaps across maturity buckets, and analysing funding options available to bridge gaps, if any.

The statement of structural liquidity is prepared by scheduling all assets and liabilities according to the stated or anticipated re-pricing date or maturity date. Assets and liabilities are divided into various maturity buckets, based on the remaining or residual maturity. All the liability figures are outflows while the asset figures are inflows. The difference in inflows and outflows for each maturity bucket reflects the positive or negative gap. The cumulative gaps in maturity buckets indicate liquidity risk for the entity.

NBFCs involved in shorter-tenure asset classes, such as gold loans and microfinance, have relatively more comfortable asset liability maturity profiles. On the other hand, some finance companies (specifically those involved in long-tenure loans such as HFCs and infrastructure finance companies) may be inherently exposed to large liquidity mismatches because of unavailability of longer-tenure debt in the Indian financial market. Some companies retain sizeable on-balance sheet liquidity to manage gaps. When the gap is negative, Crisil Ratings assesses the ability of the finance company to manage liquidity. The factors evaluated include: i) Quality and quantity of unutilised bank lines; ii) Access to securitisation lines and track record of securitising assets; iii) Ability and ease of liquidating investments before their maturity; iv) Relationship with the lending community; v) Ability to avail of refinance limits from financial institutions, such as the NABARD, SIDBI and NHB.

Analysis of liquidity risks involves sensitising maturing assets and liabilities to evaluate the entity's ability to manage potential liquidity challenges if there is a squeeze on systemic liquidity.

The analysis also includes assessment of liquidity or asset liability maturity management policies and processes. The ability to track and manage asset liability maturity positions and negative mismatches is considered. Diversity in resource pool, reliance on short-term funding and extent of staggering in repayment also play a crucial role in the analysis of liquidity risks.

Conclusion

The Crisil Ratings analysis of finance companies focuses on all the factors in the CRAMEL framework. Crisil Ratings considers asset quality, capitalisation and earnings as the core parameters that drive the rating of a finance company. These parameters determine the company's ability to underwrite, price and manage its risks, generate sufficient returns, and maintain adequate capital for loss-absorption and growth. The supplementary parameters considered are market position, resource profile, management and liquidity. Crisil Ratings also includes securitised assets as part of the assessment.

Annexure 1: Rating factors for IDF-NBFCs

IDF-NBFCs were conceptualised by the Government of India to channel long-term funds to the infrastructure sector. These vehicles are designed to facilitate the flow of low-cost, long-term funds from domestic and global investors to capital-intensive infrastructure projects.

IDF-NBFCs are permitted to invest in operational infrastructure projects (both PPP[4] as well as non-PPP). By refinancing the bank loans of such projects, IDF-NBFCs are expected to release bank resources to fund new infrastructure projects, as well as shift source of infrastructure funding from bank debt to capital market debt.

While the Crisil Ratings CRAMEL framework for assessing the risks pertaining to financial institutions is also applicable to IDF-NBFCs, capital adequacy and asset quality assume special significance for such institutions. Crisil Ratings evaluates the underlying asset portfolio of the IDF-NBFC in terms of credit quality and recovery potential. For operational infrastructure projects, although timely debt servicing may be impacted by temporary liquidity mismatches, impacting probability of default, they do have structural features that lead to high recovery rates.

These features include low future capital spending needs (lower operation and maintenance expenses), usually monopolistic market position, possibility of a stronger counterparty in certain cases and longer debt tenure which offers enough opportunity to refinance.

Therefore, while assessing the underlying portfolio of IDF-NBFCs, Crisil Ratings assesses the expected portfolio loss based on:

- Credit rating of the projects
- Recovery aspects
- Extent of diversification in the portfolio (due to multiplicity of projects – both sector-wise and geographically; not all projects are expected to default at the same time)

Once the expected portfolio loss is calculated, it is measured against the capital available to absorb the loss. Adequacy of this capital in the context of the leverage level of the IDF-NBFC, therefore, forms a critical input into the IDF's credit rating.

The other aspects of CRAMEL framework are evaluated too, but they usually are not strong differentiators. As IDF-NBFCs exclusively tap the debt capital market for funds, they are usually floated by entities with strong reputation in the capital market, hence, their resource-raising ability is usually high. Similarly, liquidity risk is low on account of the long-term nature of both asset and liabilities. With the IDF-NBFC model still in the nascent stage, their market position is evolving. Lastly, asset quality has direct bearing on earnings of IDF-NBFCs—entities with strong asset quality are likely to have stable, non-volatile interest income.

[4] *PPP refers to Public Private Partnership*

Section II.

Crisil Ratings methodology for rating hybrid instruments of NBFCs and HFCs

Executive summary

Non-banking financial companies (NBFCs) and housing finance companies (HFCs) have been raising additional capital through perpetual debt instruments or upper Tier II bonds (referred to as hybrid instruments) since fiscal 2009.

The risk features of hybrid instruments are similar to those of upper Tier II bonds issued by banks under Basel II. However, these instruments carry added risks because they are restricted from debt servicing if the capital adequacy ratio (CAR) falls below the regulator-stipulated minimum. Also, in the event of losses or insufficient profits, NBFCs and HFCs are required to seek the approval of the Reserve Bank of India (RBI) and National Housing Bank (NHB), respectively, to service these instruments.

The rating of hybrid instruments starts with the assessment of the credit quality of the NBFC or HFC—through the corporate credit rating that is normally the same as the rating assigned to its senior bonds, bank loan facilities, or lower Tier II bonds. The hybrid instruments are then tested for additional risks to determine whether the rating should be the same as, or lower than, the corporate credit rating. Earlier, the extent of notch-down from the corporate credit rating used to be higher for NBFCs than for banks, given the potential risk that the regulatory approval for debt servicing may not be as easily forthcoming for NBFCs as for banks.

However, the extent of a notch-down for NBFCs was subsequently lowered or aligned closer to the framework used for bank hybrids because of the increasing systemic importance of NBFCs, measures to align their regulatory framework with those of banks, and recent instances of NBFCs receiving regulatory approval for servicing their hybrid instruments even in the event of losses.

Crisil Ratings factors in the additional risks by evaluating the cushion in CAR that NBFCs and HFCs maintain over the regulator-specified minimum, their expected growth rates over the medium term, asset quality position, asset composition, and financial flexibility.

Scope

This section[5] covers the rating methodology for hybrid instruments issued by NBFCs and HFCs.

Background and comparison with Basel II

The features of hybrid instruments that can be issued by NBFCs and HFCs are broadly similar to those of upper Tier II bonds issued by banks under Basel II, and are subordinated to depositors and general creditors as Table 1 indicates.

Table 1: Comparison on features of hybrid instruments

Key aspects	Banks (Basel II upper Tier II instruments)	NBFCs (perpetual debt instruments)	HFCs (upper Tier II bonds)
Maturity	Minimum maturity of 15 years	Perpetual	Similar to upper Tier II instruments for banks
Seniority of claims	Supersede those of investors in instruments eligible for Tier I capital, but subordinated to the claims of all other creditors	Claims of holders of these instruments will supersede those of equity shareholders, but subordinated to the claims of all other creditors	Similar to upper Tier II instruments for banks

[5] *Link to previous criteria:* *https://www.crisilratings.com/content/dam/crisil/criteria_methodology/financials/archive/criteria-for-rating-hybrid-instruments-issued-by-nbfcs-and-hfcs-dec2022.pdf*

Key aspects	Banks (Basel II upper Tier II instruments)	NBFCs (perpetual debt instruments)	HFCs (upper Tier II bonds)
Deferability	Servicing of these instruments to be deferred if CAR is below, or such payment results in CAR falling/remaining below, the regulatory minimum	Similar to upper Tier II Instruments for banks	Similar to upper Tier II instruments for banks
Capital treatment	Upper Tier II instruments and other Tier II capital should not exceed 100% of Tier I capital	Eligible for inclusion as Tier I capital—up to 15% of the Tier I capital. The quantum of hybrids in excess of this will be treated as Tier II capital within the eligible limits.	Similar to upper Tier II Instruments for banks
Regulatory requirements for dividend and/or interest payments[6]	CAR is to exceed the regulator-specified minimum	Similar to upper Tier II instruments for banks	Similar to upper Tier II instruments for banks
	In the event of losses, all debt servicing will need the RBI's approval	Similar to upper Tier II instruments for banks	In the event of losses, all debt servicing will need NHB's approval

Closer alignment of notch-down framework for bank hybrids

The methodology for upper Tier II instruments for banks stipulates a notch-down—by 0-3 notches—from the corporate credit rating, depending on factors such as current and expected Tier I and total CAR of the bank, the regulator- specified minimum, and ability to raise capital (refer to section III of Crisil Ratings criteria for Banks and Financial Institutions).

While the hybrid instruments of NBFCs and HFCs have features similar to the upper Tier II instruments of banks, the notch-down framework differed till recently. That was because in the event of losses, regulatory approval could be accorded to NBFCs and HFCs on a selective basis for servicing these instruments, even if the CAR exceeded the regulatory requirement. Numerous developments in recent years, however, indicate a need for closer alignment of the notch-down framework for these companies to that of the upper Tier II instruments of banks:

1. NBFCs have grown considerably in size and scale, and have, therefore, gained importance in the financial system.
2. The regulator, the RBI, has also sought to increasingly align the regulatory framework for NBFCs with that of banks. Over the past few years, the RBI has introduced changes, such as the following, in the regulatory guidelines for NBFCs:
   - Minimum Tier I capital requirement for deposit-accepting NBFCs and systemically important non-deposit-accepting NBFC is 10%
   - Provisioning on standard assets should be done on the basis of asset category (as per the RBI's regulation) which might range 0.25-2.0%
   - CAR required for NBFCs and HFCs is 15%
   - Guidelines on liquidity risk management framework for NBFCs were introduced; the framework is closely aligned to the liquidity risk management framework in Basel III

The RBI has also allowed a leading NBFC that reported losses, but had maintained CAR above the regulator- specified minimum, to service its hybrid instruments. Crisil Ratings, therefore, believes most NBFCs will get the regulator's approval to service their hybrid instruments even in the event of losses, subject to maintaining CAR above the regulatory

[6] *The risk of non-payment of principal and interest on these instruments is linked to the CAR of NBFCs and HFCs falling below the regulatory minimum threshold. Payment on these instruments also requires regulatory approval in the event of a loss.*

requirement. The notch-down framework for hybrid instruments issued by NBFCs, therefore, is aligned closer to that used in rating bank hybrids.

Methodology for rating hybrid instruments of NBFCs and HFCs

Rating on lower Tier II instruments

Crisil Ratings' methodology on hybrid instruments to be issued by NBFCs and HFCs starts with an assessment of their credit quality—as indicated by their ability to meet obligations. Lower Tier II bonds (usually referred to as subordinate debt) issued by these companies have no restrictions on servicing instruments linked to their CAR or profitability, and therefore have no loss-absorption capacity. The rating on these instruments is, therefore, equated to the corporate credit rating of the NBFC or HFC.

The methodology for arriving at the corporate credit rating of NBFCs and HFCs is based on a comprehensive study of the risks involved in their business. This requires analysis of the capitalisation level, asset quality, earnings profile, market and liquidity positions, resource profile, and management quality *(refer to section I - Crisil Ratings methodology for Finance Companies)*. Support of the parent or group is also factored in to arrive at the corporate credit rating: such support is assessed by evaluating the economic rationale and moral obligation of the parent to support the subsidiary *(refer to Crisil Ratings criteria for factoring parent/ group/ government linkages).*

Analysing risks associated with hybrid instruments of NBFCs and HFCs

The hybrid instruments are evaluated for inherent risks such as the following:

- **CAR falling below the regulator-specified minimum:** NBFCs and HFCs have to maintain CAR (15% for NBFCs and HFCs) as specified by the regulator. If CAR falls below the regulatory requirement, companies may not be allowed to service their hybrid instruments even if they have adequate resources to do so. As per Crisil Ratings' methodology for recognition of default, an event resulting in non-servicing of hybrid instruments on a timely basis constitutes default.
- **Servicing instruments in the event of loss:** NBFCs and HFCs will need to get an approval from the RBI and NHB, respectively, to service their hybrid instruments in the event of losses, even though their CAR meets the regulatory requirement.

In recent years, the RBI has permitted several banks and a leading NBFC to service their regulatory capital instruments despite reporting losses. The approvals were granted where the CAR exceeded the regulatory requirement (9% for banks, and 15% for NBFCs and HFCs). It is, therefore, likely that the RBI/NHB will allow most NBFCs and HFCs to service these instruments even in the event of losses or inadequate profits, subject to maintaining CAR as stipulated.

Therefore, the primary risk in hybrid instruments is of non-payment if CAR falls below the regulatory requirement in the event of loss.

Framework for rating hybrid instruments of NBFCs and HFCs

Crisil Ratings' methodology to rate hybrid instruments begins with assessment of the corporate credit rating, or rating on the lower Tier II bonds and subordinate debt of the NBFC or HFC. This rating acts as the cap for the rating on hybrid instruments, as events forcing default on lower Tier II bonds will invariably affect the payment on hybrids.

The rating will then be notched down or equated with the corporate credit rating depending on an assessment of the following:

- **The cushion in CAR above the regulator-specified minimum for the NBFC or HFC:** The expected cushion will be validated against any historical volatility in CAR, and factors such as growth plans and a possible erosion in capital due to deteriorating asset quality or very high losses. The proportion of Tier II capital maintained over a period of time will also be factored in.
- **Financial flexibility of the NBFC or HFC:** This will be driven by factors such as the extent of parental support, valuations, return on equity, current shareholding pattern, ability and willingness of the promoter to dilute its stake, and demonstrated access to capital markets. These factors help assess the ability to raise capital and improve the cushion in CAR over the regulatory requirement.

The rating of hybrid instruments for most NBFCs and HFCs will be a notch lower than the corporate credit rating. However, the rating may be equated with the corporate credit rating, or even be significantly lower (by up to three notches) in exceptional circumstances, depending on the capital buffer and financial flexibility.

Conclusion

Crisil Ratings recognises the unique credit risks associated with the hybrid instruments issued by NBFCs and HFCs. The extent of notch-down in rating from the corporate credit rating will depend on the financial flexibility of these companies and the cushion in CAR above the regulatory requirement.

Section III.
Crisil Ratings methodology for securities companies

Executive summary

Crisil Ratings rates securities firms, such as primary dealers (PDs) and brokerage firms, for their long-term and short-term debt and commitments to counterparties. The analytical framework discussed here applies to the securities related businesses of banks and other financial institutions as well.[7]

Securities firms essentially act as agents or principals. Their business encompasses fund-based activities (such as government securities underwriting and trading, corporate debt underwriting and trading, and margin lending) and fee-based ones (for instance, equity and debt broking, equity and debt placement, advisory services and asset management).

Securities firms face market risk (arising from fluctuations in security prices or interest rate) and counterparty risk. For retail brokers, the large daily transaction volume entails operational and legal risks. Unlike for commercial banks and financial institutions, analysis of the balance sheets and financial ratios of securities firms does not entirely capture their risk profile. That's because the key risks these firms face are market and business risks, which are volatile and difficult to measure from year-end reports.

Hence, it is necessary to factor in the systems and processes put in place by these firms to mitigate these risks, as well as their ability to absorb losses arising from any adverse market movement.

Crisil Ratings' evaluation of securities firms comprises an analysis of:

- Business risk
  - Market position
  - Risk management systems (RMS)
  - Resources
- Financial risk
  - Capital position
  - Earnings
  - Liquidity
- Management risk

Scope

This section details Crisil Ratings' methodology in rating securities companies such as primary dealers and broking companies. The section also covers Crisil Ratings' methodology to financial ratios used for analysing securities companies, including adjustments it carries to the reported metrics in the financial statement.

[7] *For accessing the previous published document on 'Rating criteria for securities companies', kindly refer to the following link* https://www.crisilratings.com/content/dam/crisil/criteria_methodology/financials/archive/crisil-ratings-criteria-for-securities-firms-july2023.pdf

Business risk

A securities company's business risk is a function of the inherent volatility, cyclicality and unpredictability of the industry, the company's market position across business segments, and diverse environmental factors. Crisil Ratings tracks developments in the securities industry and gauges their impact on business conditions.

Crisil Ratings methodology to analysing a securities company's risk profile is to deconstruct its operations into its various lines of business, such as government securities underwriting and trading, corporate debt underwriting and trading, debt broking, equity broking (retail and institutional), equity trading, and investment banking. Many securities firms have a dedicated quant desk to trade using algorithms for institutional clients or on their own books (proprietary trading). As these algorithms run with minimal human intervention, operational risks arising due to improper input (*fat finger error*) or algorithm malfunctioning (*runaway-loop situation*) need to be addressed.

The risk profiles of the individual business lines are evaluated in terms of inherent business risks, the company's market position and its stability, track record, systems and processes (including RMS), skill of the staff, profitability, funding profile and the risk culture. The risk profiles of the individual businesses are then aggregated, not necessarily by an additive process.

A company with diverse businesses that are counter-cyclical to one another may achieve a lower aggregate risk profile. External factors such as regulations, state of the economy, government borrowing programme, capital needs of the corporate sector, and liquidity in the capital and money markets also have a direct bearing on business potential.

Market position

While there are only a few PDs, the broking business is highly fragmented and has various segments (such as cash and future & options [F&O]). The entity's market share in each segment is evaluated. Branch and franchisee network play a key role in enhancing market position. Sustainability and scalability also assume importance, as they ensure fixed costs are distributed better and bring in additional revenue streams such as distribution income. Other factors include the client mix (in terms of retail, high networth individuals [HNIs] and institutional) and the proportion of active clients.

Risk Management System (RMS)

In its assessment of RMS, Crisil Ratings evaluates business-specific systems, policies and practices as well as those pertaining to the general operations of the company.

Through management discussions and client interaction, Crisil Ratings ascertains the risk policies and how well they are adhered to.

Securities companies face numerous risks, including market, credit, operational, legal, regulatory, and business risks. While some risks can be quantified, Crisil Ratings goes beyond quantitative parameters to evaluate whether the company has taken appropriate steps and established systems to address the risks.

Crisil Ratings assesses a securities company's ability to define, measure, monitor and control market, credit and operational risks and lay out clear guidelines for traders and staff. The independence of the risk management process–in terms of reporting lines and ability to overcome subtle pressures to co-opt its independence–is very important. In this context, the following factors are analysed[8]:

[8] *Presents only an indicative list of factors considered by Crisil Ratings*

Business segments	RMS factors assessed
Equity broking, loan or margin against shares	• Margin policy – Stated margin policies and practices followed by the company, including the thresholds beyond which exposures will be automatically squared off. • Debtor policy – What is the policy regarding collection of dues from clients? • Hair-cut policy – While extending margin or loans against shares in the client's depository account, what kind of hair-cuts does the company apply? Are they as stipulated by regulations?
Proprietary trading	• Factors taken into account while assigning limits to a trader • Systems to prevent traders from exceeding limits or breaching securities they are allowed to invest in
Primary dealership	• Models used for measuring and reporting market risks • Capital adequacy to absorb the impact of market-related factors and interest rate shocks
Operational risk assessment	• Systems and processes to implement risk management policies. This includes real-time monitoring of exposures, automation of margin calls, and squaring off of exposures. • Organisational structure and decision making that enables independence of risk management functions; autonomy granted to the risk management function from the trading desk • Business continuity/disaster recovery plans • Adherence with compliance policies, such as know-your-customer and anti-money laundering policies • For brokerage firms engaged in algorithmic trading, whether systems and the associated infrastructure have been audited by the exchange, or if there have been materially adverse observations in the systems audit report.

Crisil Ratings notes that the models to evaluate market risks and the assumptions underlying the models are not standardised across Indian securities firms. For instance, the different risk monitoring tools used by debt traders include calculation of modified duration of the portfolio (weighted average maturity), value at risk calculations, and daily earnings at risk calculations. Similarly, sensitivity to interest rate is measured by using various types of interest rate shocks by different debt traders: some consider a non-uniform shift in yield curve while others assume a uniform (or parallel) shift. As a result, Crisil Ratings closely analyses the market risk models used by debt traders and looks at the result of back testing these models with actual historical data. This is done to assess the efficacy of the models.

Resources

It is important that funding sources for securities firms be diversified in terms of fund and non-fund based avenues. PDs, given the nature and tenure of their investments, typically rely on short-term borrowings, including systemic sources of funding. Broking firms borrow mainly for margin requirements and rely on nonfund-based or short-term borrowings. Having multiple investor/lender relationships ensures there is no excessive dependence on a single funding source.

Financial risk

Crisil Ratings assesses the financial risk associated with a securities firm on three parameters: capital position, earnings and liquidity. The amount of capital in relation to business size is an important indicator of the ability to absorb losses. Earnings indicate the efficacy of the cost structure. Liquidity is critical to meet short-term needs.

Capitalisation

Crisil Ratings assesses a securities company's capital position in conjunction with its risk culture. The extent of proprietary trading vis-à-vis capital is also a critical factor. A large networth provides the strength to withstand shocks from trading and other losses. The traditional methods of measuring capitalisation, include absolute networth and gearing (debt-to-equity ratio).

Gearing = adjusted total debt/ networth

In adjusted borrowings, Crisil Ratings includes all forms of on-balance sheet debt (including bank loans, debentures, deposits etc) and off-book securitised[9] assets, if any.

However, there are limitations in realistically reflecting capitalisation of securities firms using gearing. Therefore, for PDs and brokerage firms, Crisil Ratings may use networth coverage in addition to the traditional capitalisation metrics. For brokerage firms, Crisil Ratings may evaluate the net-worth available to set off losses at a short notice. Therefore, fixed assets, doubtful debts and similar such illiquid assets are excluded.

Networth coverage:

For broking companies, networth coverage is a parameter to understand the adverse impact on net-worth due to credit risk (non-realization of receivables). Higher networth coverage reflects the resilience of the securities firm to continue its operations unabated during adverse conditions.

$$\text{Networth coverage} = \frac{\text{Networth (adjusted for illiquid, risky and bad asset or investment in group companies)}}{\text{Receivable risk}}$$

For Primary dealers (PDs), the Reserve Bank of India (RBI) has stipulated a minimum capital adequacy of 15% of risk-weighted assets (RWAs). This takes into account the underlying credit risk as well as market risk (based on the value-at-risk approach). PDs have the flexibility to use their own internal risk management framework or adopt the standardised approach prescribed by the RBI for arriving at RWAs. Additionally, Crisil Ratings takes into account the ability to withstand a shock to interest rates[10], that is, networth coverage for portfolio losses assuming a 100 basis point parallel shift in yield curve. Higher the ratio, better equipped the company is to absorb such losses.

$$\text{Networth coverage} = \frac{\text{Networth (adjusted for credit risk charge)}}{\text{Loss in portfolio value on account of a 100-basis point shift in yield curve}}$$

Earnings

The volatility, cyclicality and unpredictability of the industry is best reflected in the earnings of securities firms. To get a true sense of the size and stability of a firm's returns, Crisil Ratings examines performance over a longer market cycle period. It is essential to examine these returns in light of the company's risk appetite.

Better-managed firms handle the inherent volatility by diversifying into different segments and controlling their fixed cost. Therefore, Crisil Ratings focuses on the cost to income ratio of these companies on a steady state basis. This ratio indicates the ability to counter the volatility in income streams inherent in the business. Hence, Crisil Ratings analysis includes an understanding of the management's strategy to address the inherent volatility.

[9] Securitisation here refers to securitising assets via both the trust route as well as direct assignment route
[10] PDs are exposed to marked-to-market (MTM) losses (on account of drop in prices of held securities) if the systemic interest rates undergo an upward shift.

- **Cost to Income Ratio:**

Cost to Income ratio is an important determinant for securities firms as it gives a reflection of cost optimization to improve on the margins/profitability. Lower the ratio, better managed the operations are in order to reduce the cost vis-à-vis income. Cost to income ratio is calculated after adjusting for non-regular streams of income. Operational cost includes employee cost, administrative cost, and selling & distribution cost for securities firm. However, cost-to-income may not be appropriate for securities firm which have recently commenced their operations as they will have relatively high operational cost in the initial period, since their operational income is yet to scale

$$\text{Cost to income ratio} = \frac{\text{Total operating cost}}{\text{Total income (net of market related income and other adjustments)}}$$

- **Average return on equity (RoE):**

Return on equity for broking firms may vary across years due to market related factors. Hence, average of RoE is considered to understand the performance of broking firm over a medium-term. A high average RoE reflects that the firm is providing good returns to equity holders on their investments.

$$\text{Return on equity} = \frac{\text{Net Income}}{\text{Shareholders' equity}}$$

- **Return on assets (ROA)**

Return on assets (ROA) assesses the ability of a firm to manage its assets efficiently to generate profits over the period. A high ROA reflects better efficiency of the firm. While RoE is typically used to assess earnings profile, for some entities which are also active in lending (Margin Trade Financing or Loan against securities), RoA metric may also be evaluated.

$$\text{Return on assets} = \frac{\text{Profit after Tax}}{\text{Total average assets}}$$

Liquidity

Securities businesses are based on confidence—even a perception of trouble in the market can impact a company significantly. To the extent that the firm depends on confidence-sensitive financing, it is exposed to the risk of funding disruptions. Many firms manage this risk by maintaining adequate alternative liquidity (in the form of unencumbered assets) that can be quickly pledged in return for secured loans. Many also maintain committed bank lines. To be effective, these sources require good operational systems that permit the pledging of assets and the drawing-down of committed bank lines, regardless of market conditions. Securities firms may also use extended debt tenure to lower funding risks. In the Indian scenario, however, very few securities firms have raised long-term debt.

Crisil Ratings reviews a company's contingency liquidity plans, the feasibility of such plans, the liquidity of assets funded, and access to repo/call or securities lending markets. For PDs, especially, Crisil Ratings factors in their strong liquidity (in terms of the reasonably liquid nature of government securities and access to RBI refinance and call and repo markets).

Management quality

Crisil Ratings considers management quality an important credit consideration for securities firms. Even at large firms, business units may depend on a few individuals. As a result, the ability to attract, develop and retain quality professionals can provide an important competitive edge.

Crisil Ratings evaluates the experience and stability of the management team, its track record in responding to market changes and the company's risk culture in terms of the management's risk appetite and risk mitigation strategies. The size of trading operations vis-à-vis the company's capital and income is a significant factor in assessing the management's risk appetite.

Conclusion

Crisil Ratings rates securities entities based on their business, financial and management risks. RMS across various business lines (such as broking, lending and arbitrage trading) and market position form an integral part of the business risk assessment. This is complemented by the ability to tap diversified sources of funds. The financial risk is evaluated on the basis of capitalisation, earnings and liquidity. While traditional gearing metrics are also used, networth coverage assumes prominence. Ability to tide over cycles and a lean cost structure are beneficial as far as earnings are concerned. A securities firm should have ample liquidity to meet short-term needs. Finally, a strong management profile is critical in such a regulated and confidence-sensitive industry.

About Crisil Ratings Limited (A subsidiary of Crisil Limited, a company of S&P Global Company)

Crisil Ratings pioneered the concept of credit rating in India in 1987. With a tradition of independence, analytical rigour and innovation, we set the standards in the credit rating business. We rate the entire range of debt instruments, such as, bank loans, certificates of deposit, commercial paper, non-convertible / convertible / partially convertible bonds and debentures, perpetual bonds, bank hybrid capital instruments, asset-backed and mortgage-backed securities, partial guarantees and other structured debt instruments. We have rated over 35,000 large and mid-scale corporates and financial institutions. We have also instituted several innovations in India in the rating business, including rating municipal bonds, partially guaranteed instruments and infrastructure investment trusts (InvITs). Crisil Ratings Limited ("Crisil Ratings") is a wholly-owned subsidiary of Crisil Limited ("Crisil"). Crisil Ratings Limited is registered in India as a credit rating agency with the Securities and Exchange Board of India ("SEBI").

For more information, visit CrisilRatings.com.

About Crisil

Crisil is a global, insights-driven analytics company. Our extraordinary domain expertise and analytical rigour help clients make mission-critical decisions with confidence.

Large and highly respected firms partner with us for the most reliable opinions on risk in India, and for uncovering powerful insights and turning risks into opportunities globally. We are integral to multiplying their opportunities and success.

Headquartered in India, Crisil is majority owned by S&P Global.

Founded in 1987 as India's first credit rating agency, our expertise today extends across businesses: Crisil Ratings, Crisil Intelligence, Crisil Coalition Greenwich and Crisil Integral IQ.

Our globally diverse workforce operates in the Americas, Asia-Pacific, Europe, Australia and the Middle East, setting the standards by which industries are measured.

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