CRISIL
An S&P Global Company

Rating criteria for finance companies

February 2019

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Executive summary

Finance companies are institutions that 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. Wholesale financing includes financing of medium and large companies, including infrastructure and real estate entities. Securities companies have been excluded from this definition.

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

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

i. Ability to customise credit appraisal for borrowers in the unorganised sector

ii. Robust collections architecture

iii. Faster turnaround times.

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

The RBI (Amendment) Act in 1997 formalised the regulatory regime for the NBFC sector. Under the Act, RBI was authorised 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 initially, RBI's regulatory oversight was primarily covering the deposit-taking NBFCs, over the years, RBI has not only increased its regulatory coverage to the non-deposit-taking NBFCs, but also brought out sector-specific regulations such as asset finance companies, microfinance companies, gold loan companies, IFC, and IDF. Furthermore, the RBI has increasingly aligned the regulatory requirement of NBFCs with that of banks with respect to their asset classification norms, capital requirement and corporate governance. This has structurally strengthened the NBFC sector.

The housing finance industry remains intensely competitive with banks once again focusing on this segment, given the slowdown in corporate credit. NHB was set up in 1988 to act as the principal agency to regulate housing finance institutions, both at the local and national levels, and provide financial and other support to them. NHB regulates the HFCs and follows prudential norms similar to those proposed by the RBI for the home loan portfolio of banks.

The last few years have seen the entry of several new NBFCs and HFCs. CRISIL has evolved its rating criteria that are specific to the business characteristics of NBFCs and HFCs.

[1] *IFC refers to infrastructure finance companies*
[2] *IDF refers to infrastructure debt funds*

Scope

This criteria[3] document highlights CRISIL's approach in assessing the credit quality of finance companies (NBFCs and HFCs). CRISIL uses the 'CRAMEL' framework to rate finance companies. This is the same framework CRISIL employs in rating banks and financial institutions. It entails assessing the following parameters: capital adequacy, resource-raising ability, asset quality, management, earnings, and liquidity. In addition, CRISIL factors in issues specific to finance companies.

Methodology

CRISIL's approach to rating finance companies involves a comprehensive assessment of the following parameters:

Market position

With virtually all business lines of finance companies facing increasing competition, strong origination skills are imperative for survival. Thus, a company's distribution network, in terms of branch or direct sales/marketing agent network, is critical. The other aspects assessed are the company's brand equity, service standards, track record, customer relationships and product portfolio.

In the vehicle/consumer durable financing segments, tie-ups with manufacturers and dealers are key determinants of origination capabilities. The subventions (equivalent to capital subsidy) provided by several manufacturers to large financiers of their products have increased the latter's competitive strengths. On the other hand, relationships with dealers give financiers access to customers at the dealer locations. Captive finance companies benefit from the manufacturer's brand equity, lower establishment costs, preferred financier status, and asset quality support. Support from the manufacturer has a strong impact on business growth and profitability for captive finance companies.

The housing finance segment has grown at over 18-20% annually in recent times owing to the increased affordability, rising incomes, demand-supply gaps, and tax benefits on home loans. Given the significant unmet demand, the key determinant of an HFC's market position is the access to low-cost, long-term funding and geographical reach.

Only a few NBFCs lend to the corporate sector today. The market position of finance companies is weaker in this segment than those of banks and financial institutions, which benefit from size and lower cost of funds. However, some NBFCs have created niches for themselves in segments such as structured lending and real estate financing.

Capital adequacy

Capital represents the level of protection available to the company's creditors to absorb losses from credit and other risks. Analysis of capital adequacy incorporates 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. CRISIL believes the leveraging ability of a housing loan portfolio exceeds that of commercial vehicle, construction equipment, or corporate finance portfolios.

[3] For accessing previously published document on "*Rating criteria for finance companies*", follow the link: https://www.crisil.com/content/dam/crisil/criteria_methodology/financials/CRISIL-Ratings-crieria-finance-companies_2018.pdf

CRISIL 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 pay-out ratio) and stock performance, if listed, become relevant.

CRISIL's ratings of some large finance companies continue to be in the high-safety rating categories, despite significant changes in operating environment and profitability. This is because the conservative leveraging policies adopted by them mitigate the increased risks.

In the Indian context, finance companies securitising their assets retain significant risks with themselves. Hence, any assessment of capital levels of finance companies should include a study of all their outstanding securitisation transactions. For companies that undertake securitisation of assets, CRISIL evaluates asset quality, capital adequacy and earnings on an 'assets under management' basis. Securitised assets are considered to be in the balance sheet, and funds raised through securitisation are considered as borrowings raised to fund these assets.

Resource-raising ability

Since funds are a finance company's raw material, the ability to mobilise them is a crucial element of the operating model. Excessive reliance on retail deposits, for instance, has resulted in a liquidity crunch for several small finance companies in the past. Over the years, finance companies have been looking to diversify their resource base by increasingly approaching the capital markets for funds.

CRISIL's 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. The resource-raising ability of finance companies (including HFCs), unlike that of banks, is constrained by the lack of an extensive branch network and inability to provide cheque-issuing facilities.

Larger finance companies are able to access funds from the capital markets at competitive rates. The resource-raising ability of smaller NBFCs and HFCs, however, is a key constraining factor in their ratings. Ability to securitise assets is also viewed favourably in analysing a finance company's resource profile.

Asset quality

Asset quality is a primary consideration in assessing credit risk in finance companies, as in banks. In analysing asset quality, CRISIL reviews a company's credit risk management system and evaluates its portfolio quality. CRISIL evaluates the company's underwriting standards, approval authorities, collection procedures, and management information systems that allow it to monitor and address potential credit problems and loss-mitigation strategies.

The quantitative analysis encompasses asset diversity in terms of asset classes and geographic distribution, delinquency trends, weak asset levels, write-off and recovery levels.

CRISIL compares available information on all the above-mentioned parameters to make an assessment of portfolio quality and also adjusts for differences in calculation methodologies. Since asset quality indicators can be distorted by growth, CRISIL analyses NPA levels on a lagged basis as well as on a static pool basis to measure the asset quality of different vintages.

CRISIL's rated companies cover above 85% of the outstanding portfolio in most asset classes. This gives CRISIL good industry-wide data to benchmark a company's portfolio quality.

Management

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

The current operating environment for finance companies is more competitive than in the past. In this context, CRISIL evaluates the management's strategies of balancing business and financial risk.

Earnings

Earnings are key to augmenting the capital required to support growth and absorb losses. Earnings also directly influence a company's ability to attract equity and debt. CRISIL views profitability as an outcome of a company's management strategy as reflected in its business position, funding structure, operational efficiencies and portfolio quality.

Stability and sustainability of earnings is also a key parameter considered. The analysis begins with the income statement build-up, which provides insights into the economics of the business model. Earnings for finance companies are driven by the net profit margin. CRISIL's analysis is forward looking and the relevance of past profitability performance is only a base for estimating future profitability.

While analysing a company's profitability on a historical basis and in relation to peers, CRISIL adjusts for changes/differences in accounting policies, securitisation gains and the like.

Liquidity/asset liability maturity[4]

The assessment of liquidity risk of finance companies involves a comprehensive evaluation of structural and contingent liquidity plans.

The driver of liquidity risk in a finance company is its structural liquidity, which is analysed from the asset and liability maturity profiles. CRISIL's assessment of structural liquidity involves analysing 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. These cash flow mismatches (referred as 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, as the asset maturities are shorter. However, 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 Indian financial markets.

[4] *Any regulatory development on liquidity risk management for NBFCs and HFCs shall be appropriately factored into the existing liquidity risk assessment methodology, as in when introduced.*

Some companies retain sizeable on-balance sheet liquidity to manage their gaps. When the gap is negative, CRISIL assesses the ability of the finance company in managing liquidity. The factors evaluated include:

i. Quality and quantity of unutilised bank lines available

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 refinance limits from financial institutions like Small Industries Development Bank of India/NHB etc.

Analysis of the finance companies' liquidity risks, involves sensitising maturing assets and liabilities to evaluate their ability to manage potential liquidity challenges in the event of a squeeze in systemic liquidity.

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

Conclusion

CRISIL's rating analysis of finance companies focuses on all the factors in the CRAMEL framework. No single factor is of overriding importance, or is considered in isolation. All six factors are viewed in conjunction.

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.

The IDF-NBFCs are permitted to invest in operational infrastructure projects (both PPP[5] 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 CRISIL's CRAMEL framework for assessing the risks pertaining to financial institutions is applicable to IDF-NBFCs also, for such institutions, capital adequacy and asset quality assume special significance. CRISIL evaluates the underlying asset portfolio of the IDF-NBFC in terms of credit quality and recovery potential. For operational infrastructure projects, although the repayment of timely debt obligations may be impacted due to 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 tenures that offer enough opportunity to refinance.

Therefore, while assessing the underlying portfolio of IDF-NBFCs, CRISIL 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 expected portfolio loss is calculated, it is measured against the capital available to absorb these losses. Adequacy of this capital in the context of the leverage levels 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. Since IDF-NBFCs exclusively tap into the debt capital market for their funding, they are usually floated by entities with strong reputation in the capital market – hence, the resource-raising ability is usually high. Similarly, liquidity risk is low owing to the long-term nature of both asset and liabilities. With IDF-NBFC model still in nascent stage, market position of the IDF-NBFCs is still evolving. Lastly, asset quality has direct bearing on earnings profile of the IDF-NBFCs; IDF-NBFCs with strong asset quality are expected to witness stable, non-volatile interest income.

[5] *PPP refers to Public Private Partnership*

About CRISIL Limited

CRISIL is a leading, agile and innovative global analytics company driven by its mission of making markets function better.

It is India's foremost provider of ratings, data, research, analytics and solutions, with a strong track record of growth, culture of innovation and global footprint.

It has delivered independent opinions, actionable insights, and efficient solutions to over 100,000 customers.

It is majority owned by S&P Global Inc, a leading provider of transparent and independent ratings, benchmarks, analytics and data to the capital and commodity markets worldwide.

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