CRISIL
An S&P Global Company

Rating criteria for finance companies

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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. Wholesale financing includes financing of medium-sized 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. HFCs, typically, are engaged in 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). The NBFCs also include NBFC-IFCs[1] and IDF-NBFCs[2] that specialise in infrastructure financing. The factors considered while assessing the credit quality of IDF-NBFCs are listed in Annexure 1.

NBFCs and HFCs 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 collection architecture

iii. 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. 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, the nodal body 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, IFCs (infrastructure finance companies), and IDFs (infrastructure debt funds). Furthermore, 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.

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

CRISIL has revised its rating criteria[3] to factor in the recent market developments in the NBFC/HFC space. The key revisions pertain to considering asset quality, capitalisation, and earnings as core parameters in 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 ensure growth. Hence, these

[1] *IFC refers to infrastructure finance companies*
[2] *IDF refers to infrastructure debt funds*
[3] For accessing previously published document on "*Rating criteria for finance companies*", follow the link: *https://crisil.com/content/dam/crisil/criteria_methodology/financials/Rating-criteria-for-finance-companies-feb-2019.pdf*

are reflective of the business and financial risk appetites of the entity, and are considered the key determinants of rating. Earnings indicate the ability to price the risks and generate sufficient returns to augment the capital base for loss absorption as well as future growth. Other parameters, namely, market position, resource profile, liquidity and management are considered supplementary parameters. Nevertheless these will be closely analysed. Enhanced focus will be placed on the analysis of liquidity profile and asset liability maturity management.

Scope

This criteria 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 the market position of the NBFC/HFC, and other issues specific to finance companies.

The methodology outlined in this document is used to arrive at the standalone rating of an NBFC/HFC. For entities that are subsidiaries of other companies or belong to large corporate groups, CRISIL may notch up the standalone rating for support from parent company/group/government. The relevant criteria outlining these notch-up frameworks can be found on the CRISIL website, www.crisil.com.

Methodology

CRISIL's approach to rating finance companies involves a comprehensive assessment of several parameters. Some core parameters are considered to have a high influence on the credit quality of an NBFC/HFC, while others are considered supplementary parameters.

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**

CRISIL takes a forward looking view on the performance of the NBFC/HFC on these parameters while evaluating its 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

CRISIL considers asset quality, capitalisation, and earnings profile 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 ensure profitable growth. The standalone rating of the finance company will be typically anchored around the assessment on the core parameters.

Asset quality

Asset quality is a primary consideration in assessing credit risk in finance companies, as in banks. NBFCs/HFCs inherently cater to relatively 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 that can impact returns, and also eat into the headroom available in the capital structure to absorb losses. Eventually, these can impact growth prospects, and can potentially curtail availability of funds, thereby endangering the solvency of the entity.

The portfolio quality can 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 is considered to be of higher risk due to concentration risks, and the typically low credit quality of the target customer segments of many NBFCs.

In analysing asset quality, CRISIL assesses a company's credit risk management system and evaluates its portfolio quality. CRISIL 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 geographic distribution, delinquency trends, weak asset levels, credit costs, write-offs, and recovery levels are analysed.

CRISIL compares available information on 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.

In the case of wholesale lending books that are less granular, CRISIL factors in concentration risks; asset-specific characteristics such as credit quality of the borrower, collateral cover, and recovery prospects; and the extent of portfolio diversification, credit appraisal, and recovery mechanisms of the NBFC/HFC.

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 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 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. A forward-looking view is taken on the leverage levels, and the steady state gearing expected to be maintained by the NBFC/HFC is considered while evaluating capital adequacy.

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 payout ratio) and stock performance, if listed, become relevant.

In the Indian context, finance companies securitising[4] their assets typically retain risks of varying degrees with themselves. Hence, CRISIL's assessment of leverage levels of finance companies also includes a study of their outstanding securitisation transactions. For companies that undertake securitisation of assets, CRISIL evaluates asset quality, leverage and earnings on an 'assets under management' basis. Securitised assets are typically considered to be on the balance sheet, and funds raised through securitisation are generally considered as borrowings raised to fund these assets.

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 vis-à-vis the risk levels can help mitigate the entity's risk position. Also, stable earnings directly influence an entity's ability to attract both debt and equity.

CRISIL considers return on managed assets as a critical indicator of the earnings profile. This ratio encompasses all the various building blocks of the profitability of an NBFC/HFC that indicate how efficient the NBFC/HFC 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
- fund raising (as indicated by the cost of funds)

Stability and sustainability of earnings are also considered key parameters. Earnings also need to be viewed in conjunction with the asset quality of the finance company. The earnings are typically higher for entities operating in riskier asset classes, in order to cushion against potential volatilities and build up capital to absorb losses.

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. CRISIL's analysis is forward looking and the relevance of past profitability performance is only a base for estimating future profitability.

[4] *Securitisation here refers to securitising assets via both the trust route as well as direct assignment route*

Supplementary parameters

CRISIL considers market position, resource profile, management, and liquidity as supplementary parameters that can influence the credit profile of the NBFC/HFC.

Market position

Market position assesses the predictability of business volumes in the face of potential economic and market fluctuations. A strong market position provides benefit 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 also 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 in which it operates. CRISIL 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 in which the entity operates is also considered. For instance, the market size for tractor finance is limited, while housing loans market is much larger; entities will, therefore, be able to achieve only a limited scale in tractor finance, while they can scale up their housing loan book to a much larger extent.

A company's distribution network, in terms of branch or direct sales/marketing agent network, the company's brand equity, service standards, track record, customer relationship, and product portfolio are analysed. Diversification across product, customer, or geographical segments that provide cross-selling opportunities are also considered in the assessment.

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. 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.

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 finer interest rates. However, if the resource profile is weak with limited diversification, it can potentially hamper the performance of the entity, especially in case of a liquidity squeeze at the funding source.

NBFCs/HFCs with access to a diverse set of credit markets (capital market, money market, banking sector, external market, deposits) are considered to be better placed compared with others having limited access to credit markets. The ability and track record in switching the funding sources are also considered. For instance, a squeeze in systemic liquidity may hinder easy access of funds from money market; the entity's ability to switch to other sources (banking sector or external borrowing) in such a situation will define its strength in resource profile. The ability to securitise assets is also factored in the resource profile assessment.

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

relatively smaller branch network. They are, therefore, heavily dependent on wholesale funding, which leads to a certain degree of risk in their funding profile.

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, risk appetite and competency form a central input in credit assessment.

CRISIL's evaluation of a company's management entails understanding the goals, philosophies, and strategies that drive the company's business and financial performances.

Liquidity/asset liability maturity[5]

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. The 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 the Indian financial market. 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

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 Small Industries Development Bank of India and NHB.

[5] *The RBI has released draft circular on "Liquidity Risk Management Framework for Non-Banking Financial Companies and Core Investment Companies" for public comments on May 24, 2019. The draft proposes, among other measures, the introduction of Liquidity Coverage Ratio (LCR) for all deposit taking NBFCs, and non-deposit taking NBFCs with an asset size of Rs 5,000 crore and above. The final guidelines on the same and any other regulatory development on liquidity risk management for NBFCs and HFCs shall be appropriately factored into the existing liquidity risk assessment methodology, as and when introduced.*

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

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[6] 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.

[6] *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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