Rating Methodology - Non-Banking Finance Companies

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Background

Non-banking finance companies (NBFCs) have grown in stature over the years and have gained systemic importance in the Indian financial landscape with growing share in credit vis-à-vis banks. The NBFCs operate in a wide variety of asset classes ranging from granular retail loans (e.g., personal loans, vehicle loans, small business loans, gold loans, microfinance loans, etc.) to large-ticket wholesale loans (e.g., lending to corporates, infrastructure, real-estate and structured credit). The NBFCs operate under the regulatory ambit of the Reserve Bank of India (RBI) and the level of regulation and supervision for NBFCs is relatively moderate when compared to banks. However, the regulatory requirements for NBFCs have been increasing in the recent past to structurally strengthen the sector, especially towards liquidity risk management. Recently, RBI has come up with new regulations on digital lending space. Also, the regulator has come up with the Scale-based Regulation framework in which NBFCs have been divided into four layers, viz., Base Layer, Middle Layer, Upper Layer and Top Layer, based on their asset size and activities to strengthen governance standards, capital requirements and provisioning norms.

NBFCs have carved a niche for themselves in the Indian financial sector through their differentiated business models, credit appraisal methods targeting the relatively un-banked borrower segments with niche domain expertise, providing last mile credit delivery and significant usage of technology for achieving better operational efficiency and risk management. CARE Ratings Limited (CARE Ratings) assigns ratings to various debt instruments and bank facilities of NBFCs based on this methodology.

Methodology

CARE Ratings' rating methodology for NBFCs is applied to the companies registered as NBFCs with the RBI. This methodology highlights the parameters considered by CARE Ratings for a standalone assessment of NBFCs. The final rating also factors in any additional notching that is applicable for parent/promoter group linkages, which is carried out as per CARE Ratings' methodology of 'Factoring Linkages in Ratings'. The key parameters considered for a standalone assessment of NBFCs are depicted below:

Business Mix and Growth Trend

Capital & Leverage

Asset Quality

Profitability

Liquidity

Resource Profile

Management and Systems

Size, Vintage and Market Presence

The above-mentioned parameters are elaborated in the sections below.

1. **Business mix and growth trend**

NBFCs lend to various retail loan segments, such as personal loans, gold loans, microfinance, consumer loans, vehicle finance, housing loans, small business loans and wholesale loan segments like corporate loans, infrastructure loans, real estate loans, structured credit, etc. The business mix through different loan products offered by the NBFC is the key determinant of the risk and returns for the entity in conjunction with the operating environment. The prevailing economic scenario for the asset classes being financed has significant impact on the growth potential and asset quality of the NBFC.

In case of retail NBFCs in particular, the products offered are assessed on key parameters, such as loan tenor, ticket size, yields and loan to value. Each parameter is seen in relation to the relevant asset class. For example, riskier asset classes like unsecured micro small and medium enterprises (MSME) loans tend to have higher yields.

The proportion of unsecured loans in the outstanding advances is also considered along with the borrower segments and geographical diversification of the portfolio. Higher proportion of unsecured funding to the borrowers with marginal credit profile increases the vulnerability of the NBFC to change in business cycles. A higher geographical diversification is often viewed favourably as it limits the exposure to the event-based risks in specific geographies, particularly in asset classes such as microfinance loans.

In case of wholesale NBFCs, the sectors financed and major exposures are seen.

CARE Ratings also monitors the trend in disbursements made by the NBFC in light of the economic scenario for the asset classes in which it operates. Inability to scale up operations might impact the future sustainability of the NBFC. The growth rate of disbursements also indicates the level of seasoning of the portfolio.

2. **Capital and leverage**

The level of capital determines the ability of the NBFC to absorb losses arising out of its business activities and provides cushion to its lenders against such losses. Capital adequacy ratio (CAR) is a measure of the degree to which the company's capital is available to absorb unexpected loss; high CAR also indicates the ability of the company to undertake additional business.

While NBFCs are required to comply with a minimum CAR stipulated by the RBI, CARE Ratings observes the management's approach towards maintaining a cushion over regulatory CAR in light of the asset-class mix of its lending portfolio along with the corresponding trend in delinquencies and portfolio concentration. Sensitivity analysis on the CAR of the NBFC is also carried out if required for various scenarios like increase in credit cost, which might affect the CAR. A higher Tier-I CAR is viewed favourably, as it reflects the core capital of the NBFC.

CARE Ratings also monitors the debt-equity ratio of the NBFC as a leverage measure. NBFC's leverage is a function of its business mix, asset-class-wise growth potential, delinquency trends and portfolio concentration among other factors. While relatively higher leverage is acceptable for granular and stable asset classes like retail home loans, a lower leverage may be warranted for portfolios which are either more concentrated (e.g., corporate or builder loans) or the ones which exhibit higher risk of delinquencies like micro finance loans, unsecured small medium enterprises (SME) loans, etc. CARE Ratings looks at the leverage in light of these underlying factors along with any synergies derived from parentage or group linkages. In case of significant exposure to the group entities, adjusted standalone leverage is calculated by reducing the amount of such exposure from the tangible net worth of the entity.

The demonstrated ability of an NBFC to raise adequate equity capital from varied set of investors is viewed favourably. Similarly, demonstration of support to an NBFC through equity infusion by a strong promoter group or parent company with good credit profile is also viewed favourably.
For NBFCs resorting to securitisation of their assets, CARE Ratings assesses leverage, asset quality and profitability on the basis of assets under management (AUM) by treating such off-balance sheet assets as on-balance sheet.

CARE Ratings follows a consolidated approach when the group companies are engaged in similar business (lending) but operate through different entities due to different asset class and corresponding regulatory compliances to be followed. In such case, CARE Ratings considers the capital adequacy of the holding company at standalone level as per regulatory requirements. Furthermore, the overall gearing and net non-performing assets (NNPA)/net worth ratios are analysed to ascertain whether the entity has sufficient level of capitalisation at the consolidated level.

3. Asset quality

Asset quality is one the most critical parameters while assessing NBFCs. Asset quality is dependent on the asset class in which an NBFC operates. The business of NBFCs is to assume credit risk and earn a profit after factoring in the expected level of credit costs. Such credit costs depend on the nature of the asset class and are built into the pricing of loans in that segment. NBFCs strive to keep the credit costs in check within the expected levels through efficient risk management, collection and recovery framework. Credit costs are primarily impacted by the level of delinquencies observed in the loan portfolio. Worsening of the delinquencies in the loan portfolio not only suppresses profitability through higher credit costs, but also puts pressure on the capital cushion available to absorb losses and can lead to restricted access to funds from the market resulting in subdued growth prospects. Given that NBFCs primarily are dependent on wholesale funding, worsening of key parameter like gross NPA (GNPA) level can quickly and severely impact the access to funds, which in turn can threaten the viability of the operations of an NBFC.

The overall asset quality of NBFCs is assessed by evaluating the asset-class-wise exposures and days-past-due (DPD) bucketing of the outstanding advances. In case of wholesale assets, large vulnerable exposures are evaluated since the same can impact capital position in case of stress. In case of retail loan book (vehicle, housing, SME, etc.), the empirical trend in delinquencies exhibited for the entity is examined for each retail asset-class, and the trend is also compared with the industry peers.

The historical collection efficiency and the company's experience of loan losses and write-off/provisions are studied. Under Ind AS reporting, NBFCs must report the amount of stage 3 assets. The provisions created for these as well as other standard assets are analysed to ensure they are adequate to cover the losses. The portfolio diversification and exposure to vulnerable sectors is evaluated to assess the level of vulnerable assets. In case of high-ticket size loans like corporate or real estate loans, the top exposures are observed. The proportion of such wholesale loans in the overall portfolio is considered. Furthermore, such exposures are also viewed in relation to the company's net worth so as to assess the extent of concentration and vulnerability to any of the large exposures turning delinquent. The asset quality of individual product classes is viewed in tandem with the seasoning of the loan book. NBFCs with short track record would have seen limited seasoning of its portfolio so as to make any meaningful assessment of its steady state asset quality. NBFCs which report an aggressive growth rate of loan book year-on-year also have a large part of their loan book remaining unseasoned and hence assessment of its steady state asset quality becomes difficult. The GNPA is looked at on a lagged basis to negate the effect of growth on the asset quality parameters.

Exposure to group entities, in the form of lending or investment, is examined to understand the loss potential of such assets. The same is subject to stress test in the same way as any other asset and the impact is evaluated on level of NPA and provisioning needs.

4. Profitability

CARE Ratings analyses the composition of the income of the company by segregating it into fee-based and fund-based activities. Core earnings are also identified by excluding non-recurring income from the total income. Each business area that contributes to the core earnings is assessed for the risks as well as for its earnings prospects and growth rate. It is examined whether the interest yields are commensurate with the asset class and nature of operations.

The profitable operations are essential for NBFCs to operate as a going concern and generate internal capital, which can be deployed for future growth. Historical trend in declaring dividend and the dividend policy is studied as this would determine the extent of profits retained and available for plough back in the business. Profitability is gauged through trend in return on total assets (ROTA) and return on net worth (RONW). The contributing factors to NBFC's profitability are assessed to study the overall impact. The ROTA chain (both on balance sheet and adjusted for off-book portfolio) is analysed through interest spread, net interest margin (NIM), other income, operating expenses and credit costs.

Interest spread and NIM are determined by average yield earned on assets and average cost of funds raised by an NBFC. While interest rates charged on loans is a function of the asset class and NBFC's competitive positioning, interest expense is driven by the liability profile and borrowing mix of an NBFC. Apart from the interest income, many NBFCs also have a fee income component, which adds to the total income and is intended to cover up for operating expenses.

The operating expenses (opex) are dependent upon the nature of operations and business model deployed by an NBFC. Retail lending is generally more opex intensive as it involves setting up branches and deploying manpower for various functions like origination, underwriting and collections. On the contrary, opex is relatively low for wholesale lending operations. Within retail lending also, some products require higher opex vis-à-vis others. The trend in the pre-provisioning operating profit earned by the NBFC is observed. The ratios, such as, operating expenses/average total assets and cost to income (net of interest expenses) are looked at in order to understand its impact on the overall profitability of an NBFC.

Finally, the credit cost is driven by provisioning and write-offs made by the NBFC and is dependent on the asset quality of the underlying portfolio. The overall impact of the above factors on the RoTA is studied to gain an understanding about profitability. Furthermore, the RoNW is also looked at and is impacted by the extent of leverage of an NBFC.

5. Liquidity

The lack of liquidity can lead an NBFC towards failure, while, strong liquidity can help even an otherwise weak company to remain adequately funded during difficult times. CARE Ratings evaluates the internal and external sources of funds to meet the company's requirements. The liquidity risk is evaluated by examining the stated liquidity policy, the assets liabilities maturity (ALM) profile, collection efficiency, deposit renewal rates (based on empirical evidence) and proportion of liquid assets in relation to its total borrowings. The contractual liabilities like commercial papers (CP), short-term loans are not assumed to be rolled over. The short-term external funding sources in the form of unutilised lines of credit available from banks, etc., along with direct and other investments if any are important sources of reserve liquidity. While considering unutilised bank lines as back up, the availability of such lines is also assessed in a scenario of change in sentiments towards the sector or the promoters or due to overall tight liquidity scenario in the system.

CARE Ratings observes the debt repayment obligations of NBFC over the next 12 months and the extent to which cash and liquid assets are available to cover it. Furthermore, the scheduled inflows from credit assets (adjusted for collection efficiency) over the next 12 months are compared with the 12-month debt obligations to arrive at a cover based on such asset inflows. For NBFCs running a negative ALM mismatch in one-year bucket, such cover will tend to be below 100%, thereby increasing the refinancing risk. A stress test on the inflows is also done to evaluate the impact on liquidity in case the contracted inflows are lower than expected.

In case there are significant inflows considered from group entities, the possibility of rescheduling of such inflows and the liquidity profile of the borrower is evaluated considering that the lender may require the continue to support the group entity. This may result in the cash flow being delayed, impacting the ALM profile of the NBFC.

From liquidity perspective, NBFCs adopting a liability maturity profile which is consistent with the asset maturity are viewed favourably. Any negative mismatch without proper backup is viewed as a risk. In case of entities belonging to large groups, demonstrated support from group will be considered as backup.

In case of presence of any acceleration clauses embedded in borrowing agreements with lenders/investors which are linked to downgrade in external credit ratings, the ALM profile of an NBFC can be severely distressed in case of such rating downgrades. CARE Ratings, in its assessment of liquidity, does not take into account the presence of such rating-linked acceleration clauses. However, NBFCs have witnessed severe liquidity mismatches in such events which have translated into sharp deterioration in their liquidity profile upon trigger of such clauses. In such cases, the ratings will see a much sharper migration than otherwise.

6. Resource profile

Resource base of the NBFC is analysed in terms of cost and composition. The proportion of deposits/ loans/ bonds in funding mix is examined along with the investor type. CARE Ratings also looks at the trend of raising resources through securitisation. The ability to diversify funding sources is a key factor in rating of NBFCs. Generally, the entities having major funding from different segments of the capital markets and overseas markets are considered having better diversification of resources. Average as well as incremental cost of funds are examined in the context of prevailing interest rate regime. Interest rate sensitivity analysis in terms of fixed and floating interest rate in borrowing mix is also done. The ability of the company to raise additional resources at competitive rates is considered. Stability of sources of finance and trend in funding mix is also an important indicator of the resource raising ability of the NBFC. The managements' strategy for funding is examined in light of its appropriateness with its growth strategy, the assets class, maintaining buffer/head room for raising capital in the form of securitisation, Tier-II capital, etc. The funding mix should be prudent to the nature of assets.

7. Management and systems

The track record of the promoters, experience of the management team and the organisational structure of the company are considered. Industry experience of board of directors of a company from the point of view of strategic decision making is also taken into consideration. If the shareholding of the company is fragmented without a clear majority, it would entail further analysis on commitment of the individual shareholders to support the company.

The company's strategic objectives and initiatives in the context of resources available, its ability to identify opportunities and track record in managing stress situations are taken as indicators of managerial competence. Market reputation of the promoters of an NBFC is also a key factor in its ability to access various funding sources at competitive rates. Adequacy of the information systems used by the management is evaluated. CARE Ratings focuses on modern practices and systems, level of technology deployed, capabilities of senior management and personnel policies. In case of shared resources by group companies, the strength and quality of group companies/businesses is considered while assessing the management strength. Furthermore, the proven capabilities of the NBFC in its asset class and peer group is also examined.

The management's stance (both stated and exhibited) on the risk and risk management framework is considered. Credit risk management is evaluated by assessing the appraisal, monitoring and recovery systems and prudential lending norms of the company. CARE Ratings also analyses the sourcing mix in terms of own sourcing/direct selling agents (DSAs) and the trend thereon. The companies who have their own sourcing and collection teams tend to have a better control on their loan origination and quality of customers. The company's policy on the liquidity risk and interest rate risk is considered. CARE Ratings monitors the track record of the company in complying with the regulatory requirements of RBI.

8. Size, vintage and market presence

Size is reflected through the level of capital and level of total assets of an NBFC. Large size would generally be associated with long operating track record, significant market presence, demonstrated ability to raise resource from varied source and asset quality and profitability performance established over time through the cycles. Management's strategy for profitable growth and their ability to navigate through difficult business environment is better assessed for an NBFC, which has a long track record of operations and has grown to a relatively large size. While large size by itself is not a direct determinant of the ratings, it does provide an indication of the competitive strength and financial flexibility of an NBFC. Large NBFCs can have a diversified portfolio or could be a sizeable player in a single asset class. In either case, the ability to compete and generate risk-adjusted returns over time is better gauged for NBFCs which have a long track record.

CARE Ratings monitors the market position of the NBFC in individual asset classes and an understanding about its competitive position is developed. Market position is also assessed in terms of scalability of a particular asset class. Some asset classes might have a limited scope, while some have a huge scope for scalability. Market presence is gauged through the extent of its branch network and geographical spread of operations.

The track record of an NBFC in a given asset class is viewed in order to assess the experience of the company in operating in a given asset class and its ability to perform steadily through various asset cycles. Portfolio seasoning is critical for assessing the asset quality and profitability parameters on a steady state basis. NBFCs with low vintage or very rapid growth in loan book lack adequate portfolio seasoning and might not reflect steady state asset quality and profitability parameters. Hence, vintage is an important parameter, which is considered while assessing critical parameters like asset quality and profitability.

Additional considerations

- **Peer group analysis**
  CARE Ratings analyses various financial and non-financial parameters of an NBFC under the overall framework mentioned above. The quantitative factors are evaluated based on the absolute level of numbers and ratios as well as their volatility and trends exhibited over time. CARE Ratings also compares the company's performance on each of the above-discussed parameters with its peers. Detailed inter-firm analysis is done to determine the relative strengths and weaknesses of the company in its present operating environment and its prospects.

- **Market-based indicators**
  CARE Ratings tracks market-based indicators like market capitalisation and price/book value for equity-listed NBFCs and compares the same with other listed NBFCs to gain a sense of relative valuation as viewed by the equity market. Furthermore, CARE Ratings also keeps a track of bond yields and spreads of NBFC debt instruments in order to gain an understanding of the market's view about its risk perception. The reasons for sharp changes in yields vis-à-vis similarly rated peers are examined. CARE Ratings tracks these market indicators to understand the market's perception of the value and risk of an NBFC and also to assess the ability of the NBFC to raise resources (equity and debt) at competitive rates to support its business model.

CARE Ratings observes the various financial ratios while analysing NBFCs. The description of such ratios can be found in the 'Financial Ratios – Financial Sector' document on CARE Ratings' website.

Criteria for rating of subordinated debt of NBFCs

CARE Ratings generally does not differentiate between the rating of senior and subordinated debt of a NBFC. This is on account of the inherent features of the subordinated debt as highlighted below.

- A subordinated debt instrument functions exactly similar to a senior debt instrument in a going concern scenario, i.e., servicing of the same (principal as well as interest) is purely cash flow driven. The servicing of this instrument is not dependent on the presence of profits or maintenance of any minimum capital adequacy parameter by the borrowing entity (unlike the case with other instruments like Upper Tier-II or innovative perpetual debt issues by the banks).
- Similar to other senior debt instruments, e.g., non-convertible debentures (NCDs), there are no regulatory restrictions with respect to servicing of a subordinated debt instrument in a going concern scenario. These instruments are in nature of medium to long-term instruments and are required to be issued for a minimum five-year tenor to qualify for capital adequacy computation.

- The instrument derives its 'subordinated' nature only in the event of liquidation of the issuer, wherein it would rank lower to the claims of other senior creditors. This would affect the loss given default (LGD). However, it would not lead to any difference in the probability of default (PD) between senior and subordinated instruments.

The seniority of claim of a senior debt over subordinated debt comes into picture only in case of a liquidation scenario, and on a going concern basis, the repayments for both types of debt instruments happen simultaneously and is a matter of liquidity risk. For highly rated NBFCs and HFCs, the liquidity risk is typically minimal. Therefore, the long-term probability of default for senior and subordinated debts of a company are similar, and the same should reflect in their long-term ratings. However, CARE Ratings might choose to differentiate between senior and subordinated debt on a case-to-case basis on the basis of credit strength, liquidity profile and any issuer-specific circumstances that might prevail.

Criteria for rating of perpetual debt instruments of NBFCs

RBI allowed systemically-important non-deposit taking NBFCs (NBFC-ND-SI) to issue perpetual debt instruments in FY09 in order to augment their capital base. Such instruments have some unique features which alter their risk profile vis-à-vis the senior debt issued by NBFCs. Key features of such instruments are as below.

Maturity Period	Perpetual maturity
Options	May have embedded 'Call' option subject to the instrument having ran for at least 10 years from date of issue. Call option shall be exercised only with the prior approval of RBI. Key consideration for RBI would be NBFC's CRAR position at the time of exercise of the call option and after the exercise.
Lock-in clause	NBFCs may defer the payment of interest, if: the NBFC's CRAR is below the minimum regulatory requirement prescribed by RBI; or the impact of such payment results in NBFC's CRAR falling below or remaining below the minimum regulatory requirement.
Interest payment	Interest payment requires prior approval of RBI when the impact of such payment may result in net loss or increase the net loss, provided the CRAR remains above the regulatory norm.
Claim seniority	Claims of the PDI investors shall be superior to the claims of equity shareholders and subordinated to the claims of all other creditors.
Capital treatment	PDI shall be eligible to be treated as Tier-I capital upto 15% of the total Tier-I capital. The amount of PDI in excess of amount admissible as Tier-I shall qualify as Tier-II capital.

The 'Lock-in' clause introduces additional risk to the servicing of interest on perpetual debt instruments by NBFCs. Given the above features, such instruments are generally notched down by least one notch than the rating of senior debt in view of their increased sensitivity to the NBFC's CAR, capital-raising ability and profitability during the long tenure of the instruments. Any delay in the payment of interest/principal (as the case may be) following the invocation of the lock-in clause would constitute an event of default as per CARE Ratings' definition of default and as such, these instruments might exhibit a somewhat sharper migration of the rating compared with conventional debt instruments.

Analysis of environmental, social and governance risk factors:

Over the past few years, environmental, social and governance (ESG) risks have started gaining importance across the globe and are increasingly influencing investment decisions. The companies might have to incur operational or capital costs towards mitigating these risks. CARE Ratings analyses the impact of ESG risks on the credit profile of an entity by assessing the expected impact of these costs on the future earnings/revenue/cash flows of entities. As the appreciation of ESG risks increase, the company's ability to raise capital might be affected as higher scrutiny from the investors in terms of ESG compliance will increase, especially for the players who raise funds from overseas markets.

The considerations with respect to ESG aspects are an integral part of assessing credit risk and get addressed under various parameters wherever relevant. For example, the environmental risk is factored in credit risk assessment of polluting sectors wherein the expected cost to be incurred towards mitigants in the form of pollution control certifications, effluent treatment measures, etc., and the impact of those on future cash flows is evaluated. The social risk would play out prominently in a labour/manpower intensive services industry like banks and financial services or hospitality, where social issues like employee policies or customer relationships are important factors. Similarly, governance parameters like transparency, adherence to applicable regulations, public disclosures and costs towards these objectives form part of the credit risk analysis. The importance of each risk might vary from sector-to-sector.

As compared to the environmental and social risk, which arises from external factors, governance risk is based on the internal factors. Governance refers to how effectively an entity is controlled and run in a way, thereby safeguarding the interests of all the stakeholders.

Accounting Quality

A review of accounting quality and adherence to prudential accounting norms (prescribed by local regulations) are examined for measuring the entity's performance. Accounting policies relating to depreciation, inventory valuation, income recognition, valuation of investments, provisioning/write-off, etc., are given special attention. Prudent disclosures of material events affecting the entity being reviewed. The impact of the auditors' qualifications and comments are quantified to the extent possible and analytical adjustments are made to the accounts, if material. The rating team interacts with the auditors to understand their comfort level with the accounting policies, systems and controls within the entity and his assessment of the management of the entity. Also, a change of accounting policy in a particular year which results in improved reported performance is analyzed more closely. However, CARE Ratings does not conduct an audit of the financial statements of an entity and relies upon the judgement and financial prudence of the auditors.

[For previous version please refer 'Rating Methodology – Non-Banking Finance Companies' issued in October 2020**]**

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About:

CareEdge is a knowledge-based analytical group that aims to provide superior insights based on technology, data analytics and detailed research. CARE Ratings Ltd, the parent company in the group, is one of the leading credit rating agencies in India. Established in 1993, it has a credible track record of rating companies across multiple sectors and has played a pivotal role in developing the corporate debt market in India. The wholly-owned subsidiaries of CARE Ratings are (I) CARE Advisory, Research & Training Ltd, which offers customised advisory services, credible business research and analytical services (II) CARE Risk Solutions Private Ltd, which provides risk management solutions.