Rating Methodology - Non-Banking Finance Companies

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Background

Non-banking finance companies (NBFCs) have grown in stature over the years and gained significant importance in the Indian financial landscape with growing share in credit vis-à-vis banks. NBFCs operate in a wide variety of asset classes ranging from granular retail loans (personal loans, vehicle loans, small business loans, gold loans, and microfinance loans, among others) to larger ticket wholesale loans (lending to corporates, infrastructure, real estate, and structured credit among others). 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 compared to banks. However, regulatory requirements for NBFCs have been increasing in the recent past to structurally strengthen the sector, especially towards liquidity risk management. With introduction of scale-based regulation framework, NBFCs have been divided into four layers: 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. Recently, RBI also introduced regulations for the digital lending space.

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

Methodology

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



These parameters have been explained in sections below:

1. **Business mix and growth trend**

   NBFCs offer retail segment products, such as personal loans, gold loans, microfinance, consumer loans, vehicle finance, housing loans, small business loans among others and wholesale segment products including corporate loans, infrastructure loans, real estate loans, structured credit, among others. The mix of loan product offerings of an NBFC is the key determinant of risk and returns for the entity in conjunction with the operating environment. Prevailing economic scenario for asset classes being financed also have significant impact on growth potential and asset quality of an NBFC.

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

   The proportion of unsecured loans in the outstanding advances is also considered and the borrower segments and geographical diversification of the portfolio. Higher proportion of unsecured lending to the borrowers with weak/marginal credit profile increases vulnerability of the NBFC to change in business cycles. A higher geographical diversification is often viewed favourably, as it limits exposure to event-based risks in specific geographies, particularly in asset classes such as microfinance loans.
   In case of wholesale NBFCs, sectors financed, and major exposures are seen.

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

2. **Capital and leverage**

   Capital level determines an NBFC's ability to absorb unexpected losses. Capital adequacy ratio (CAR) and Tier I CAR are parameters used to measure the degree to which the company's capital is available to absorb these losses; higher CAR and Tier I CAR also indicate availability of growth capital for the company and are viewed favourably.

   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 and the corresponding trend in delinquencies and portfolio concentration. Sensitivity analysis on the CAR of the NBFC is also carried out, if required for scenarios such as increase in credit costs, which might materially affect the CAR.

   CARE Ratings also monitors debt-equity ratio of an NBFC as a measure of leverage. Since off-book exposure of NBFCs has increased with time, which is a key operational parameter and a funding support for entities, CARE Ratings also factors in assets under management (AUM)-to-net worth ratio, while assessing an entity's leverage. An NBFC's leverage is viewed in relation to its business mix, asset-class-wise growth potential, delinquency trends and portfolio concentration among other factors. While relatively higher leverage is acceptable for granular, secured and stable asset classes such as retail home loans, a lower leverage may be warranted for portfolios, which are either more concentrated (corporate or builder loans), or ones which exhibit higher risk of delinquencies including microfinance loans, unsecured small medium

enterprises (SME) loans, among others. CARE Ratings looks at leverage in light of these underlying factors and 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 entity's tangible net worth.

The demonstrated ability of an NBFC to raise adequate equity capital in a timely manner from investors is viewed favourably. Similarly, demonstration of support to an NBFC through equity infusion by a strong promoter group or parent company with strong credit profile is also viewed favourably.

For NBFCs resorting to securitisation of their assets and/or involved in co-lending, CARE Ratings assesses leverage, asset quality and profitability based on 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 cases, CARE Ratings considers capital adequacy of the holding company at standalone level per regulatory requirements. Overall gearing and net non-performing assets (NNPA)/net worth ratios are analysed to ascertain whether the entity has sufficient capitalisation at a consolidated level.

3. Asset quality

Asset quality is one the most critical parameters, while assessing NBFCs. Asset quality is also viewed in relation to the asset class(es) in which an NBFC operates. Business of NBFCs is to assume credit risk and earn a profit after factoring in expected level of credit costs. Such credit costs depend on nature of the asset class and are built in pricing loans in that segment. NBFCs strive to keep the credit costs in check within expected levels by deploying adequate risk management systems and collection & recovery framework. Credit costs are primarily impacted by level of delinquencies observed in the loan portfolio. Increasing 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 lenders and investors, impacting its growth prospects and liquidity profile. Given that NBFCs primarily depend on wholesale funding, weakening key parameters such as gross NPA (GNPA)/ gross stage 3 assets (GS3) among others can quickly and severely impact access to funds, which can threaten viability of operations of an NBFC.

Overall asset quality of NBFCs is assessed by evaluating the asset-class-wise exposures and days-past-due (DPD) bucketing outstanding advances. In case of wholesale assets, large vulnerable exposures are evaluated since it can impact capital position in case of stress. In case of retail loan book (vehicle, housing, and SME, among others), empirical trend in delinquencies exhibited for the entity is examined for each retail asset-class, and the trend is also compared to peers. For NBFCs with significant exposure to off-balance sheet portfolios, such as securitization and co-lending, it is also crucial to assess their asset quality based on total AUM. Apart from delinquencies and GNPA/GS3, CARE Ratings also factors in other stressed assets on the entity's balance sheet such as security receipts (SRs), non-performing investments, and repossessed assets, among others.

AUM= On-balance sheet advances (and lending in from of investments) + Off-book Securitisation portfolio + Co-lending + Business Correspondent.

Historical collection efficiency and the company's experience of loan losses and write-off/provisions are studied. CARE Ratings also factors in the provision created for GNPA or Gross stage 3 (GS3) assets and standard assets to check for adequacy of provision cover of expected losses. Portfolio diversification and exposure to vulnerable sectors is evaluated to assess the level of vulnerable assets. In case of high-ticket size loans such as corporate or real estate loans, performance and credit profile of top exposures are also factored in. Proportion of such wholesale loans in the overall portfolio is considered. Such exposures are also viewed in relation to the company's net worth to assess the extent of concentration and vulnerability to large exposures turning delinquent. Asset quality of individual product classes is viewed in tandem with seasoning of the loan book. NBFCs with short track record would have seen limited seasoning of its portfolio to make meaningful assessment of its steady state asset quality. NBFCs reporting 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. GNPA is looked at on a lagged basis and static pool analysis is done in some cases to negate the effect of growth on asset quality parameters, especially for entities growing at a relatively higher pace.

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

4. Profitability

CARE Ratings analyses the composition of the company's income 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 risks, earnings prospects and growth rate. It is examined whether interest yields are commensurate with the asset class and nature of operations. 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.

Profitable operations are essential for NBFCs to operate as a going concern and generate internal capital, which can be deployed for future growth, while maintaining capital buffer. Profitability is gauged through trend in return on total assets (ROTA) and return on net worth (RONW). Contributing factors to NBFC's profitability are assessed to study the overall impact. The ROTA chain (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 on debt funds raised by an NBFC. While interest rates charged on loans is viewed in relation to 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 net interest income, NBFCs also have another income component, which adds to the total income and is intended to cover up operating expenses. However, it is important to assess income stability and impact of volatile components of income (such as direct assignment, among others), which may temporarily inflate the company's profitability.

Operating expenses (opex) depend on nature of operations, business model and life cycle of an NBFC. Retail lending is generally more opex intensive, as it involves setting up physical branches and deploying manpower for functions such as origination, underwriting, and collections among others. On the contrary, opex is relatively low for wholesale lending operations. Increasing digitisation plays a vital role, as it helps improve operational efficiency of a company, though requires an increase in expenses at initial stage of deployment. Trend in pre-provisioning operating profit earned by the NBFC is observed, which indicates NBFC's credit loss absorbing capacity. Financial ratios, such as operating expenses to average total assets and cost to income (net of interest expenses) are looked at to gauge operational efficiency of an NBFC. Finally, the credit cost is driven by provisioning and write-offs made by the NBFC and depend on asset quality of the underlying portfolio. Overall impact of these factors on RoTA and RoNW are studied to gain an understanding on profitability.

5. Liquidity

Lack of adequate or sufficient liquidity can lead an NBFC towards failure, while strong liquidity can help even an otherwise weak company to remain afloat even in difficult times. CARE Ratings evaluates internal and external sources of funds to meet the company's liquidity requirements. Liquidity risk is evaluated by examining the stated liquidity policy, 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. Contractual liabilities such as commercial papers (CP), short-term loans are not assumed to be rolled over. Short-term external funding sources in the form of unutilised lines of credit available from banks, among others, and direct and other investments are important sources of reserve liquidity. While considering unutilised bank lines as back up, availability of such lines are also assessed in a scenario of change in sentiments towards the sector, promoters or due to overall tight liquidity scenario in the system.

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

In case there are significant inflows considered from group entities, possibility of rescheduling such inflows and liquidity profile of such group companies are evaluated. Delay in cash flows from Group Company may impact the NBFC's liquidity profile.

From a liquidity perspective, NBFCs adopting a liability maturity profile, which is consistent with asset maturity are viewed favourably. 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 acceleration clauses embedded in borrowing agreements with lenders/investors, which are linked to downgrade in external credit ratings, ALM profile of an NBFC can be severely distressed in case of such rating downgrades. In its assessment of liquidity, CARE Ratings does not consider such rating-linked acceleration clauses. However, NBFCs have witnessed severe liquidity mismatches in such events, which have translated to sharp deterioration in their liquidity profile on trigger of such clauses. In such cases, ratings will see a much sharper migration than otherwise.

6. Resource profile

Resource profile of an NBFC is analysed in terms of cost and composition. Proportion of deposits/ loans/ bonds in funding mix is examined and investor type. CARE Ratings also looks at the trend of raising resources through securitisation and considers co-lending as a source of funding. The ability to diversify funding sources is a key factor in rating NBFCs. Generally, entities having major funding from different segments of capital markets, banks and overseas markets are considered having better diversification of resources. Average and 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 company's ability to raise additional resources at competitive rates is considered. Stability of finance sources and trend in funding mix is also an important indicator of the NBFC's resource raising ability. The management's strategy for funding is examined in light of its appropriateness with its growth strategy, assets class, maintaining buffer/head room for raising capital in the form of securitisation, Tier-II capital, among others. The funding mix should be prudent to the nature of assets.

7. Management and systems

The promoters' track record, experience of management team and the company's organisational structure are considered. Industry experience of board of directors of a company from strategic decision making the point of view is also considered. If the company's shareholding is fragmented without a clear majority, it would entail further analysis on commitment of 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 NBFC's promoters is also a key factor in its ability to access funding sources at competitive rates. Adequacy of 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 terms of level of technology, CARE Ratings assesses dimensions across a company's operations, technology, innovation, data security, competitive advantage and regulatory stance, as companies navigate their digital transformation journeys. In case of shared resources by group companies, strength and quality of group companies/businesses is considered, while assessing the management strength. Proven capabilities of the NBFC in its asset class and peer group is also examined.

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

8. Size, vintage and market presence

Size is reflected through level of capital and 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 credit 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 for ratings, it provides an indication on the NBFC's competitive strength and financial flexibility. 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 NBFC's market position 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.

An NBFC's track record in a given asset class is viewed to assess the company's experience in operating in a given asset class and its ability to perform steadily through asset cycles. Portfolio seasoning is critical for assessing 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 such as asset quality and profitability.

Additional considerations

- **Peer group analysis**

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

- **Market-based indicators**

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

- **Regulatory Inspection/due diligences**

  Regulatory inspection and due diligence are critical aspects for assessing a company's compliance with industry regulations and standards. During such inspections, regulators evaluate whether the company is adhering to legal requirements, reporting standards, and best practices. It is essential to take an understanding from the management about recent regulatory inspections, observations by regulators, whether penalties were imposed, or warnings were issued by the regulator. By proactively gathering this information, CARE Ratings assesses the company's risk exposure to potential legal or regulatory issues that may arise. This understanding helps identify areas where the company might be vulnerable to fines, operational restrictions, or reputational damage due to non-compliance. Having a clear picture of the

company's regulatory standing provides confidence that it is operating within framework of laws, reducing the likelihood of future legal challenges or disruptions in business operations.

CARE Ratings observes financial ratios while analysing NBFCs. Description of such ratios can be found in the 'Financial Ratios – Financial Sector' document on CARE Ratings' website www.careratings.com.

Criteria for rating of subordinated debt of NBFCs

CARE Ratings generally does not differentiate between rating senior and subordinated debt of an NBFC. This is considering inherent features of subordinated debt as highlighted below.

- A subordinated debt instrument functions similar to a senior debt instrument in a going concern scenario, servicing it (principal and interest) is purely cash flow driven. Servicing this instrument does not depend on the presence of profits or maintenance of minimum capital adequacy parameter by the borrowing entity (unlike the case with other instruments such as upper tier-II or innovative perpetual debt issues by banks).

- Similar to other senior debt instruments such as non-convertible debentures (NCDs), there are no regulatory restrictions with respect to servicing a subordinated debt instrument in a going concern scenario. These instruments are 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 during liquidation of the issuer, where it would rank lower to claims of other senior creditors. This would affect the loss given default (LGD). However, it would not lead to difference in the probability of default (PD) between senior and subordinated instruments.

Seniority of claim of a senior debt over subordinated debt comes in the picture only in case of a liquidation scenario, and on a going concern basis, repayments for both types of debt instruments happen simultaneously and is a matter of liquidity risk. For highly rated NBFCs and HFCs, liquidity risk is typically minimal. Therefore, long-term probability of default for senior and subordinated debts of a company are similar, which 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 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 to augment their capital base. Such instruments have some unique features, which alter their risk profile against 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 capital to risk (weighted) assets ratio (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 up to 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. Considering these features, such instruments are generally notched down by at 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 in long tenure of instruments. Delays in payment of interest/principal (as the case may be) following invocation of lock-in clause would constitute an event of default per CARE Ratings' definition of default and as such, these instruments might exhibit a somewhat sharper migration of the rating compared to conventional debt instruments.

Analysis of environmental, social and governance risk factors:

In the last few years, environmental, social and governance (ESG) risks have started gaining importance across the globe and are increasingly influencing investment decisions. 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 expected impact of these costs on future earnings/revenue/cash flows of entities. As appreciation of ESG risks increase, the company's ability to raise capital might be affected as higher scrutiny from investors in terms of ESG compliance will increase, especially for players raising funds from overseas markets.

Environmental Risk:

Environmental risk is a critical factor in assessing credit risk, especially for sectors that have a significant environmental impact. Typically, NBFCs are not directly exposed to environmental risks, however, through their assets they have an indirect exposure to environmental risk. These indirect risks could affect the business' future cash flows and are therefore factored in the overall credit risk analysis.

Social Risk:

Social risk plays a prominent role in industries that are labour-or service-intensive, such as banking, financial services, and hospitality. In these sectors, factors such as employee policies, workplace conditions, and customer relationships are critical components of credit risk assessment. Social considerations include how a company manages its workforce, its corporate social responsibility practices, and its interactions with the community. Issues related to social risks can have a significant impact on a company's reputation and financial stability, influencing its credit risk profile.

Governance Risk:

Governance risk refers to internal factors related to how a company is managed and controlled, which directly impacts safeguarding stakeholders' interests. Key governance parameters include transparency, adherence to applicable regulations, public disclosures, and costs associated with maintaining strong governance structures. Companies with strong governance practices are generally considered to have lower credit risks, as they are better equipped to handle regulatory challenges and protect investor interests. The governance framework is a vital aspect of credit risk assessment, ensuring long-term sustainability and compliance.

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, and provisioning/write-off, among others, are given special attention. Prudent disclosures of material events affecting the entity are also reviewed. Impact of 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 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. A change of accounting policy in a particular year, which results in improved reported performance, is analysed more closely. However, CARE Ratings does not conduct an audit of financial statements of an entity and relies on the judgement and financial prudence of auditors.

[For previous version please refer 'Rating Methodology – Non-Banking Finance Companies' issued in November - 2022**]**

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About:

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