Ratings

CRISIL
An S&P Global Company

Rating criteria for finance companies

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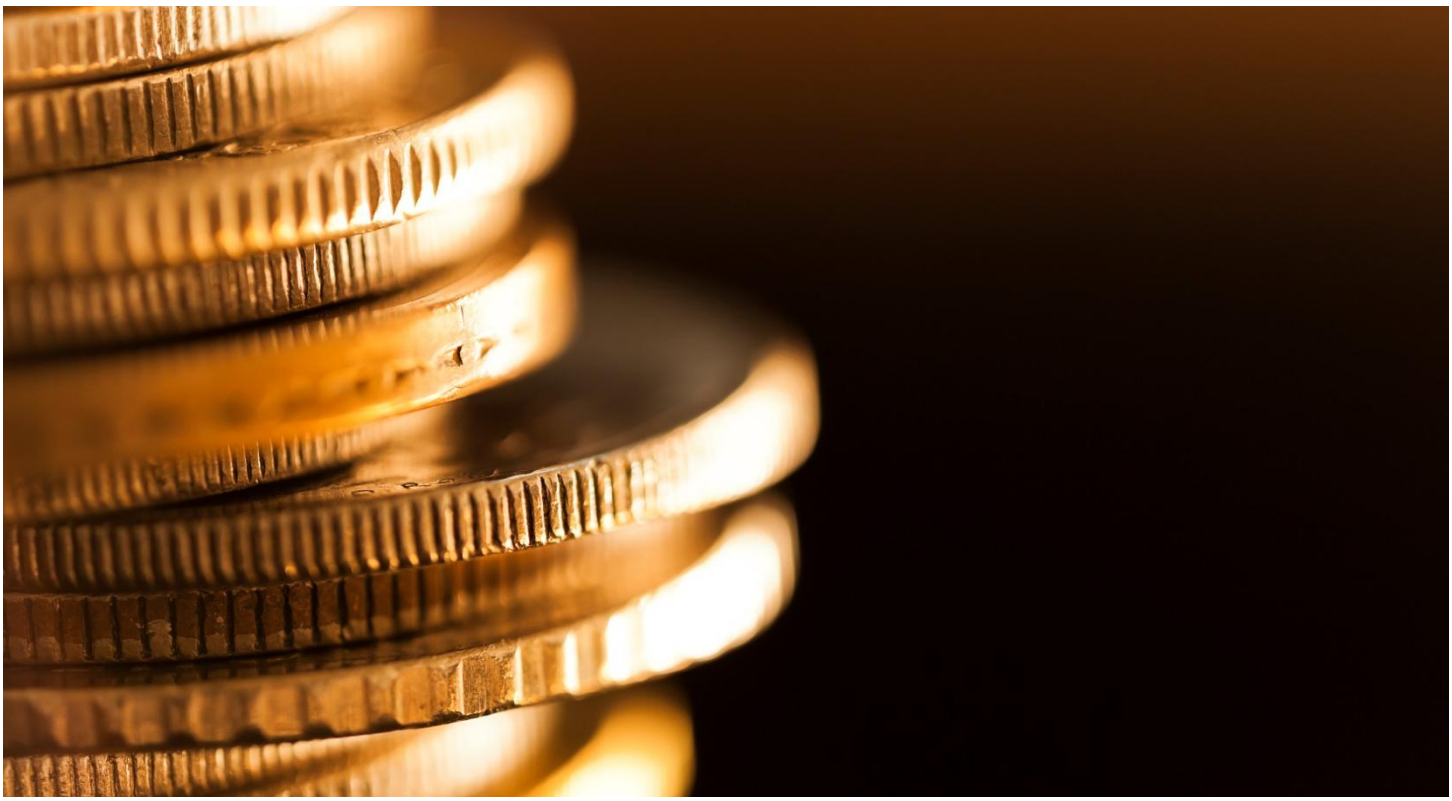

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Executive summary

CRISIL uses the 'CRAMEL' framework to rate finance companies. This is the same framework employed by CRISIL for rating of banks and financial institutions. It entails an assessment on the following parameters: Capital, Resource raising ability, Asset quality, Management, Earnings and Liquidity). In addition, CRISIL also addresses issues specific to finance companies.

Finance companies are those that are into retail and wholesale finance and that are not registered as banks or financial institutions. Securities companies have been excluded from this definition. These companies offer retail loans to buy cars, two-wheelers, commercial vehicles, and houses and construction equipment; unsecured personal loans, loans against property, and loans against shares. Wholesale financing includes financing of medium and large companies, including in infrastructure and real estate.

The industry can be broadly classified into 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. NBFCs are registered with the Reserve Bank of India (RBI) and HFCs with the National Housing Bank (NHB). Within the former, there is also NBFC-IFC[1] and NBFC-IDF[2] which specialise in infrastructure financing.
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NBFCs continue to play a critical role in the Indian financial sector. They benefit from their

- Ability to customise credit appraisal for borrowers in the unorganised sector
- Robust collections architecture, and
- Faster turnaround times.

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

The RBI (Amendment) Act in 1997 formalised the regulatory regime for the NBFC sector. Under the Act, the 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, the 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 (AFC), Microfinance companies (MFI), gold loan companies, IFC, IDF, etc. Further, the RBI has also increasingly aligned the regulatory requirement of NBFCs with that of banks with respect to their asset classification norms, capital requirement and corporate governance. CRISIL believes this structurally strengthens the NBFC sector.

The housing finance industry remains intensely competitive with banks once again focusing on this segment given the slowdown in corporate credit. The 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. These include:

[1] IFC refers to Infrastructure Finance Company

[2] IDF refers to Infrastructure Debt Fund

Market position

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

In the vehicle/consumer durables financing segments, tie- ups with manufacturers and relationships with 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, good relationship with dealers gives financiers access to customers at the dealer's locations. Captive finance companies enjoy the advantage of the manufacturer's brand equity, lower establishment costs, preferred financier status and asset quality support in various forms. The extent of linkage and support from the manufacturer has a strong impact on business growth and profitability for such captive finance companies.

The housing finance segment has grown at an annual rate of over 18-20% in recent times on the back of increased affordability because of 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, and CRISIL believes that finance companies have a weaker market position in this segment than banks and financial institutions, which have the advantages of size and lower cost of funds. However, some NBFCs have created space for themselves in niche segments such as structured lending and real estate financing.

Management

The dynamic environment in the industry in the last two decades has 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 risks.

Asset quality

As with banks, asset quality is a primary consideration in assessing credit risk in a finance company. 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.

While there have been differences in NPA recognition and provisioning norms, the revision in asset classification norms by the RBI will result in all NBFCs moving to the 90-dpd NPA recognition norm by March 31, 2018. 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 more than 85% of the outstanding portfolio in most asset classes. This gives CRISIL good industry-wide data to benchmark an individual company's portfolio quality.

Capital adequacy

Capital represents the level of cushion or protection available to the company's creditors to absorb losses from credit and other risks. CRISIL's analysis of a company's capital adequacy incorporates the absolute quantum and quality of capital, cushion over regulatory capital requirements, risk-adjusted capital levels and management's capitalisation policy. The analysis also goes beyond regulatory capital requirements and looks at the company's leveraging ability based on the asset class it focuses on as well as the asset quality outlook for the company. For instance, CRISIL views the leveraging ability of a housing loan portfolio to be higher than that of a commercial vehicle, construction equipment or corporate finance portfolio.

CRISIL also factors in the growth outlook of the company's asset base and its ability to generate capital internally or by accessing capital markets. In this regard, 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 for some large finance companies continue to be in the high safety rating categories despite the significant change in their operating environment and profitability. This is primarily on account of the conservative leveraging policies adopted by these companies, which have partially mitigated the increased risks.

CRISIL believes that in the Indian context, finance companies securitising their assets retain significant risks with themselves. Hence, an assessment of capital levels of a particular finance company includes a study of all its outstanding securitisation transactions. For companies that undertake securitisation of assets, CRISIL evaluates asset quality, capital adequacy and earnings on an 'assets under management' basis. As a part of this, securitised assets are considered to be in the balance sheet. The 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 resulted in liquidity crunch for several small finance companies in the past. Over the years, finance companies have been attempting to diversify their resource base by increasingly accessing the capital markets for resources.

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. CRISIL notes that the resource-raising ability of finance companies (including HFCs) is constrained compared with banks, owing to the lack of an extensive branch network and inability to provide cheque-issuing facilities. Larger finance companies are, however, able to access funds from the capital markets at competitive rates. But the resource-raising ability of smaller NBFCs and HFCs is a key constraining factor in their ratings. The ability to securitise assets is also viewed favourably in terms of the assessment of the analysis of a finance company's resource profile.

Earnings

Earnings are key to augmenting capital required to support growth and absorbing 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.

CRISIL also evaluates the stability and sustainability of the company's earnings. CRISIL's analysis begins with the income statement build-up, which provides insights into the economics of the business model. Earnings for finance companies are driven primarily 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 its peers, CRISIL adjusts for changes/differences in accounting policies, securitisation gains and the like.

Liquidity/ Asset liability management

Unlike commercial banks, finance companies do not have access to the call money market or the RBI's refinance facility in the event of a liquidity crisis. In the late 1990s, several NBFCs faced a liquidity crunch as a result of asset quality problems. Systemic illiquidity and negative shifts in sentiment toward companies and sectors also tend to suck out liquidity. CRISIL evaluates a finance company's contingent liquidity plans to take care of such eventualities. CRISIL also assesses the maturity profile of assets and liabilities to form an opinion on the company's liquidity and interest rate risks.

In general, NBFCs have relatively matched asset liability maturity profiles and hence, are exposed to limited liquidity or interest rate risks. Most HFCs, on the other hand, face significant liquidity mismatches. That's because, while the average tenure of housing loans is over 10 years, most of the borrowings (fixed deposits, bank borrowings and debentures) are of much shorter tenures. Only the NHB refinance facility is for a comparable tenure. Hence, HFCs are exposed to significant interest rate risks. To overcome these, some industry players have resorted to securitisation as an alternative.

About CRISIL Limited

CRISIL is a global analytical company providing ratings, research, and risk and policy advisory services. We are India's leading ratings agency. We are also the foremost provider of high-end research to the world's largest banks and leading corporations.

CRISIL 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.

About CRISIL Ratings

CRISIL Ratings is part of CRISIL Limited ("CRISIL"). We pioneered the concept of credit rating in India in 1987. CRISIL is registered in India as a credit rating agency with the Securities and Exchange Board of India ("SEBI"). With a tradition of independence, analytical rigour and innovation, CRISIL sets the standards in the credit rating business. We rate the entire range of debt instruments, such as, bank loans, certificates of deposit, commercial paper, non-convertible / convertible / partially convertible bonds and debentures, perpetual bonds, bank hybrid capital instruments, asset-backed and mortgage-backed securities, partial guarantees and other structured debt instruments. We have rated over 24,500 large and mid-scale corporates and financial institutions. CRISIL has also instituted several innovations in India in the rating business, including rating municipal bonds, partially guaranteed instruments and microfinance institutions. We also pioneered a globally unique rating service for Micro, Small and Medium Enterprises (MSMEs) and significantly extended the accessibility to rating services to a wider market. Over 95,000 MSMEs have been rated by us.

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