Acuité
RATINGS & RESEARCH

Criteria for Rating of Non-Banking Financing Entities

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Executive Summary

The domestic financial sector landscape has evolved considerably over the past decade in terms of increased diversity of financial sector participants, emergence of newer and more complex products, increasing trend towards adoption of digital technology amongst the existing players and emergence of a new class of players based on digital platforms. These developments resulted in better penetration of financial products across the economy. The gradually increasing role of the NBFC (Non-banking Finance Companies) segment in catering to the credit needs of a growing economy puts the focus on this important segment of the financial sector. As per a recent RBI report on Trend and Performance in Banking, December 2020, the credit intensity as measured by NBFCs' Credit to GDP increased from 8.8% in 2014 to around 12.2% in 2019 before moderating to 11.6% in 2020. The NBFC credit growth rate outstripped SCB Non-food credit growth over the period from 2014 to 2019.

In terms of sectoral deployment, the Industry was the largest recipient of credit by the NBFC sector followed by retail loans and services. Within the Industry, the MSME segment has been a focus area with the players targeting niche areas and developing their business models and expertise in the chosen segments. In the service segment, sectors like commercial real estate and retail trade have been key target segments, whereas in the retail segment, housing loans, consumer durable loans and vehicle loans have been the major product categories

As of July 2020, based on an assessment of ~ 9618 NBFCs, it has been observed that the NBFC-ND-SI (Non-Banking Finance Company-Non Deposit taking-Systemically Important) segment comprising 292 entities contributed more than 85% of the total assets of the segment (An NBFC with assets size exceeding Rs.500 cr is categorised as Systemically Important). The NBFC segment comprises a wide spectrum of activities. Based on activity-wise classification, there are currently 11 categories of NBFCs which primarily include –NBFC-Investment & Credit Company (ICC), NBFC-Infrastructure Finance Company (IFC), NBFC Systemically Important Core Investment Company, NBFC-Infrastructure Development Fund, NBFC-Micro Finance Institution, etc. As of September 2020, of the total assets of Rs.30.87 trillion of NBFCs-ND-SI, around 47% of the assets were held by ICC & around 39% held by Infrastructure Finance Companies.

On the resources side, besides the capital base, NBFCs have been traditionally relying mostly on capital market instruments and bank borrowings to support their business growth. As of September 30, 2020, debentures and bank borrowings contributed around 39% and 31% of the borrowings of NBFCs, respectively. Besides conventional long term and short term borrowings, from banks, institutions and capital market investors, NBFCs have also been raising resources by borrowing from other NBFCs and through instruments such as Securitization and Direct Assignment transactions.

NBFCs have increasingly positioned themselves as a segment well equipped for last-mile credit delivery - i.e. a bridge between unorganised lenders and banks. Their strength lies in the ability to consistently develop and deliver unique financial solutions to their borrowers in an efficient and effective manner. This has placed

them at an advantage over conventional banks which may not be able to respond to clients' needs to intrinsic differences in the style of operations. Besides competing with banks to meet the credit requirements of the conventional salaried borrowers, it has been observed that most of the NBFCs (especially in the retail NBFC segment) have been largely identified the unserved/ underserved borrower like self-employed businessmen, unorganised workers etc. as a target segment which has traditionally encountered challenges to access credit from traditional banking channels due to factors like higher operational / documentation requirements. In order to cater to such borrower segments, the NBFCs have developed credit capabilities based on alternate / surrogate measures and extensively relied on digital technology to sharpen their credit processes. Apart from the growth in the retail segment, the NBFCs catering to the corporates mid to medium to large segment, especially in segments like real estate & services, have been fairly successful in offering innovative financial products to meet the requirements of the borrowers across various segments depending on their business requirements and cash flow profiles.

Acuité's rating criteria for assessment of for NBFCs is largely in consonance with its rating criteria for banks and institutions in view of the considerable degree of alignment in the risk profiles of these two segments. While the financial and non-financial parameters to be assessed are similar, there are certain nuances that need to be considered in respect of any NBFC. These nuances currently stem from factors like differentiated regulatory framework, resource profile, differentiated product offerings etc. Acuité observes in this regard that recent high profile credit incidents in the NBFC sector has triggered a radical relook at the regulatory arbitrage between banks and NBFCs. Against this backdrop, it is expected that going forward, the regulatory and supervisory dispensation especially for larger NBFCs will be closely aligned to banks. Hence, it is envisaged some of the players may have to revisit their business models in view of these changes in the overall environment.

Market Position

A. Scale of operations & Asset class

Acuité believes that the ability of the management to scale up the assets under management (AUM) in a prudent, profitable and sustainable manner is one of the major performance indicator of an NBFC. Size confers a resilience to business in terms of its ability to absorb external shocks and hence Acuité considers size of AUM as an important parameter in its assessment of NBFCs.

Size of AUM and its growth rate are dependent on factors such as asset class, tenure of loans, management approach to growth, etc. The business model of the NBFC is relevant in this regard. An NBFC engaged in wholesale lending, wherein the loan book comprises a few large exposures, may be able to scale up quickly. Such business models require moderate physical and human infrastructure to scale up, however on the flip side, there are elevated risks since delinquencies in respect of one or two large exposures can impact the profitability and performance metrics. Conversely, an NBFC with a presence in granular retail asset classes such as vehicle loans, microfinance loans, small ticket LAP, MSME lending, etc. is able to scale up only gradually as it entails an extensive branch and establishment network for an

organic growth. Management may, in addition to the organic growth options, prefer to adopt inorganic growth opportunities through buyout of asset pools from other NBFCs or entering into arrangements such as business correspondent relationships/ co-origination, etc. In a nutshell, more granular the loan portfolio, the lower is the risk profile of the NBFC.

The advent of fintech-based lending especially in areas of unsecured personal loans, has reduced the requirements of an extensive establishment network as most of the underwriting and monitoring is generally based on digital apps. Most of these apps rely on credit surrogates to arrive at the credit decision. Within the granular asset classes, each asset class may display different risk-return behaviour. An MFI, which typically lends in low ticket sizes on an unsecured basis to the lowest economic strata, may be more influenced by the local factors, such as natural calamities, lockdowns, etc than may be an NBFC with a presence in MSME lending against security of property. The nature of the security and buffers available (LTV ratios at origination) also has a bearing on the risk profiles of the lenders. A housing finance company with a large portfolio of retail housing loans typically will display lower delinquency rates vis-à-vis other asset classes, even in periods of high economic stress, due to high economic involvement of the borrower (Lower LTV ratios at inception), as also the moral pressure of avoiding defaults on the housing loans. In case of a gold loan company, the liquid nature of the collateral and the ability to auction the gold jewellery to recover the dues, has a bearing on the level of delinquencies. In a vehicle finance company, the nature of the vehicle, i.e. cars, two wheelers, LCV MCV or HCV, will exhibit differential risk dynamics. The asset quality performance of an NBFC engaged in financing heavy commercial vehicles will be more influenced by the level of economic activity vis-à-vis a player engaged in two-wheeler financing.

B. Geographical & Product Diversity

Higher the geographical diversity of the underlying asset portfolio, the higher is the risk mitigation. Typically, in the initial stages, any NBFC will develop in its core area of operation and then gradually expand to other areas after gaining the initial experience. By ensuring adequate diversification of the loan book across geographies, the NBFC will effectively diversify its risk. Since the credit profiles of the borrowers are largely linked to the level of economic activity in their region, achieving a geographically dispersed portfolio is a sound de-risking strategy. An MFI with an excessive concentration on 3-4 districts in one state, will be more vulnerable to business shocks vis a vis a diversified MFI. From risk assessment standpoint, a product diversity is more preferred than a dependence on a single product line is vulnerable to business shocks than an NBFC with presence across multiple lines. The external shocks can be in the form of regulatory changes, disruptive changes in markets with the emergence of newer players/newer technologies, increased competition, etc. Dependence on a single product line exposes the NBFCs to the cyclicality in the product cycle. A diversified product portfolio with synergies across products imparts stability to the earnings profile and also supports the mitigation of possible asset quality pressures in any specific segment. Acuité observes that while product diversity is desirable from a risk standpoint, the success of the diversification

strategy depends on the ability to develop the requisite capabilities across diverse product lines keeping in mind the specificities of each product vertical.

C. Product Portfolio

Product innovation and customisation have not only aided NBFCs in creating a niche position in urban and semi-urban areas but also in gaining an edge over banks. Thus, product innovation and customisation are key determinants of the market position enjoyed by an NBFC.

The company's presence in various segments is required to be analysed in the light of segmented concentration and stability of earnings. The majority of the NBFCs operate as uni-product model companies to concentrate on their core competencies. However, the same also exposes these companies to the cyclical dynamics of the segment. A vehicle finance company with proven capabilities in pre-owned commercial vehicle financing over a long period may be a preferred lender for most of the SRTO (Small Road Transport Operator) segment, a factor which will support their business volumes during an economic boom. Similarly, an established gold loan financier who is able to offer competitively priced credit products with a quick turnaround to their clients by virtue of their systems and processes will see great business prospects in times of rising gold prices. Their unique product-based capabilities support their competitive positioning vis-à-vis generalist players like banks which are more universal in their suite of product offerings. However, the flip side is that in the event of a sharp contraction in economic activity or events like a declining trend in gold prices, the business profiles of such players are more vulnerable. The business profiles impact them in terms of their volumes, asset quality and earnings. A moderate degree of diversification across segments helps them mitigate the impact of business cycle risk.

D. Market Presence or Distribution Network

The conventional NBFCs operating in the retail segment operate through a network of branches in their area of operations. Most of the credit-related functions of loan origination, monitoring and collection efforts are at the branch level under the overall supervision OF & inputs from the zonal/ head office level. The advancements in technology have shifted the model towards a "phygital" approach (physical + digital), however, the importance of having a wide physical branch network for retail NBFCs is expected to continue over the foreseeable future especially considering the current level of digital penetration. In this regard, Acuité also attempts to understand the branch expansion policy, hierarchy and functions carried out at a branch target time expected for a branch to attain break-even business volumes, policy on continuation of suboptimal branches, etc., vintage of the branches and the dependence or otherwise on a few legacy branches. Ideally, for a growing business, it is expected that the newer branches start contributing to the overall AUM & disbursals, thereby de-risking the dependence on the earlier established legacy branches. The contribution of AUM from newer, recently opened branches determines the efficacy of the branch expansion network. The opex intensity of the branches vis-à-vis the business generation from branches has a direct bearing on the profitability of the operations. The ability of the branches to achieve break-even business volumes in an optimal time frame is critical. An excessive churn

in branches will be evaluated in terms of its potential impact on future business growth. Besides the business generated from other branches, the volumes of business generated through alternate channels like Direct Selling Agents (DSAs) and other channels like business correspondents is also assessed. A high dependence on outside channels like Business Correspondent relationships with other entities, to grow the business, reduce opex intensity. It has been observed that generally companies try to strike a balance between self-originated (own branch) and externally generated business from a business stability standpoint.

Operating Efficiency

A. Appraisal and Monitoring Systems

Acuité's assessment and understanding of the credit and underwriting processes of the NBFC is a part of the overall rating process. In this regard, Acuité attempts to understand the overall credit philosophy, credit policies, procedures, and other attendant aspects like sanctioning architecture, monitoring and collection systems, recovery and provisioning policies and dependence on in-house and external expertise, etc. Especially in case of an NBFC operating in retail segment, the dependence on IT systems for origination, monitoring and collection is assessed to understand the robustness of the processes. The flip side of having efficient systems – both physical and human structure is high operating expenses. The opex cost as a percentage of the average AUM and other related metrics like cost to income ratio are monitored over a period of time to understand the extent of operational efficiency. These metrics are compared with other peers to understand the relative operating efficiency. Adherence to Regulatory Requirements & Disclosures.

The extent of regulation and supervision of entities in the financial sector has been increasing over the recent past, especially after a few high-profile credit incidents entailing some large entities. From a rating standpoint, a continued adherence of the NBFCs to the regulatory prescriptions by the various regulators like SEBI, RBI, IRDA or others becomes important. The extent of compliances may be with regard to operational, accounting, financial or legal aspects. The disclosures in the financial statements (including auditor observations) along with discussions/ undertakings of management become important inputs in appreciation of these compliance aspects. Acuité's view is that compliance with regulation is a hygiene factor which is expected of any entity, hence any instances of continued noncompliance of a material nature is more likely to have an impact on the final rating outcome.

Asset Quality: The ability to maintain a healthy asset quality on a consistent basis is among the most critical parameters influencing the profitability and overall credit profile of a well-performing NBFC. Besides credit risk, the NBFCs in general are required to manage a wide gamut of risks like liquidity risk, interest rate risk. ALM risk, legal risk, operational risk, etc. However, among all these risks, credit risk assumes importance in terms of an NBFC's profitability and financial health. It has been observed that the management of credit risk, i.e. asset quality parameter, stands out as A SINGLE MOST critical variable which has a high bearing weightage in the overall rating process. It is intuitive to expect moderation in asset quality, with gradual scaling of operations and seasoning of the loan book. The key point is the extent of credit costs vis-à-vis the scale. Acuité's approach in this regard is to understand the

movements in the non-performing asset levels (GNPA & NNPA) or the Stage 2 & Stage 3 levels (under Ind As). Acuité also examines the incremental slippages, segment-wise slippages, etc. to understand the historical asset quality movements and possibility of future trends. The write-offs also have an impact on the GNPA/ NNPA levels, hence policy regarding write-off is also assessed. Acuité observes that the adoption of an eclectic approach has become imperative in the current operating environment, wherein traditional credit appraisal and monitoring mechanisms are complemented with an extensive use of technology-driven tools so as to contain asset quality pressures. Besides the underwriting architecture and processes followed by the NBFC, other extraneous factors having a bearing on the long-term asset quality trends include the nature of the asset class, client profile, refinancing environment and the overall legal environment for recovery of dues. The strength of underwriting mechanisms, early warning systems, control and recovery measures go a long way in building a company's asset quality.

B. Resource Raising Ability

The growth potential of any NBFC is inextricably linked to its resource-raising ability. The resource mix of the NBFCs and their capital structure assumes relevance in this regard. From a resource profile standpoint, the level of gearing and cost of debt are two major variables which have a significant bearing on any NBFC's profitability and performance. The funding profile has to be aligned to the asset profile of the NBFC from an ALM perspective. An NBFC engaged in providing long-term finance like housing finance will necessarily have a long-term funding/borrowing profile as any attempt to fund long term assets with short term funding may will result in mismatch risks which will have to be managed. These aspects make resource raising ability a critical monitorable.

Acuité observes that resource raising ability of NBFCs generally moves in tandem with their track record and their scale. An NBFC with a limited track record may have to rely on equity funding in its initial stages before the prospective lenders develop the requisite comfort in initiating exposure to the NBFC. Such challenges may constrain their growth in the initial stages. The nature of the business also has a bearing on the resource-raising ability. An NBFC engaged in high-risk unsecured personal lending may initially have to depend more on equity funding as lenders may not be forthcoming, considering the high-risk perception, at least in the initial stages. On the contrary, larger established NBFCs with a presence in secured products and a seasoned loan book, with the benefit of an established track record of performance may enjoy higher resource raising ability. Such an NBFC may have a wide choice of funding options such as additional equity issuance, private equity, domestic borrowings from banks, capital market instruments like NCDs (both long term and short term), ECBs and other off balance sheet options like securitization, direct assignment transactions, structured products, etc. Besides the standalone profile and performance of the NBFC, the resource-raising ability may also be influenced by factors like association with a large group corporate/ financial services.

C. Technology

Technology and IT infrastructure play an important role in the smooth operations of an NBFC. Retail financing implies a smaller ticket size and large volumes, necessitating NBFCs to invest significantly in technology. Greater technological integration enables the company to remain cost effective. In the context of fintech based lending wherein the underlying application is owned by some other entity. Acuité assesses the nature of the arrangement between the NBFC & the entity owning the application and the extent of investment.

Financial Risk

A. Capital Adequacy

The need for lending institutions like NBFCs to have a strong capital base emanates from their requirement to have adequate buffers to absorb any potential losses. The underlying principle is that any lender is exposed to various risks like credit risk, market risk, operational risk, etc. & higher the level of risk assumed by the NBFC, the higher should be the capital base maintained by the lender. The concept of risk weighted exposures is critical to understand in this regard. The current regulatory prescription is 15% of risk weighted assets for NBFCs as the minimum threshold. The extant regulatory dispensation for adherence to capital adequacy norms is quite elaborate and covers various aspects such as the nature of capital eligible for consideration as Tier 1 capital, distinction between Tier 1 & Tier 2 capital, the sub-limits between these categories of capital, the risk weightages to be assigned to the exposures, etc. From a rating standpoint, Acuité assesses the existing level of capital & also compares it with its future capital requirements keeping in mind the growth plans of the NBFC. The evaluation of capital position is not only based on the current capital adequacy levels of the rated entity but will also factor in the ability to bring in equity capital through its parent or other stakeholders.

Besides assessing the adequacy of capital in normal scenarios, Acuité assesses the capital adequacy in stress scenarios and the possibility of a reduction in buffers due to high asset impairment charges. In case of a significant reduction in buffers vis-à-vis regulatory thresholds, Acuité discusses with the management the plans to augment the capital base in such scenarios. Acuité observes that NBFCs also adopt an off-balance sheet approach to business growth to keep their capital requirements at optimal levels, considering the return expectations of the stakeholders.

B. Earnings Quality

Earning quality assessment essentially focusses on the stability and sustainability of the earnings and the building blocks of the earnings profile. The assessment includes movements in Net interest margins, trends in Pre-Provisioning Operating Profits, contribution of fee-based income, non-recurrent incomes, trends in credit costs, etc. At a granular level, the earnings quality assessment focusses on movement in average yields on various product lines, and its comparison with the average cost of funds, segment-wise operating expenses and credit costs. Such granular assessment helps in a better appreciation of the contribution of each segment.

C. Liquidity

The assessment of liquidity parameter in case of NBFCs focusses on the ALM statement and the extent of mismatches across various time buckets. While mismatches are to be expected, the quantum of mismatch and availability of adequate credit lines to plug the gaps are aspects to be studied. The quantum of on-balance sheet liquidity and unutilised bank lines/ fresh sanctions in hand are key monitorables. The ability to enter into securitisation/ structured asset sale transactions to manage liquidity is also studied in this regard. The possibility of equity infusion is also discussed.

Acuité shall study the maturity profile of assets and liabilities, board-approved policies of the company with respect to liquidity management, minimum unencumbered liquidity buffers and its access to funds from diverse sources, including its parent (if any), during any exigency.

D. Accounting Quality

Accounting quality to be assessed in terms of conformance with Generally Accepted Accounting Practices IGAAP/Ind AS. Standard accounting practices facilitate comparison across the industry. In India, NBFCs are required to follow the accounting standards prescribed by the Institute of Chartered Accountants of India (ICAI). Acuité shall review the company's accounting policies, notes to accounts, and auditors' qualification if any, thoroughly.

Management Risk

A. Integrity

Integrity of the management is a qualitative trait indicated by track record with lenders, investors, government authorities, and other stakeholders. Any instances of defaults/delinquencies of a continuing nature will have a bearing on the parametric assessment of promoters. Any perceptions regarding the integrity of the promoter can impact the funding plans, as the bankers have been adopting a cautious approach to this sector, especially after certain high-profile defaults in the financial sector.

B. Competency

Competence of the management is assessed based on the management credentials and its track record across a cycle to navigate and scale up the business in an increasing volatile operating environment.

C. Risk Appetite

Risk Appetite of the management is an important parameter in determining management risk. The management's philosophy on lending / investing and its approach towards other aspects, such as gearing, hedging of forex exposures, are the key variables which are reckoned. Besides these, the management's approach to growth – aggressive or conservative is also considered in risk appetite assessment.

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