

Rating Criteria for Finance Companies

The broad analytical framework used by CRISIL to rate finance companies is the same as that used for banks and financial institutions. In addition, CRISIL also addresses certain issues that are specific to finance companies.

Finance companies refer to asset finance, mortgage finance and personal finance companies that are not registered as banks or financial institutions. Securities companies have been excluded from this definition. The businesses undertaken by these companies range from retail finance to commercial finance. While the former encompasses cars, two-wheeler, commercial vehicles, housing and construction equipment financing, personal loans, and loans against shares, the latter includes financing of small and medium-sized companies and dealer financing. (See the chapter on 'Risk spectrum in asset financing' for CRISIL's categorisation of risks in different business segments.)

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 plant and machinery. NBFCs are registered with Reserve Bank of India (RBI) and HFCs with National Housing Bank (NHB).

While the banking sector remained highly regulated in the early 1990s, simplified sanction procedures, flexibility and timeliness in meeting niche credit needs and low-cost operations saw the NBFC sector flourish, drawing a number of new entrants in the process. The NBFCs exhibited high growth rates in the first half of the 1990s especially in their corporate finance portfolio even though many of them lacked the credit appraisal, monitoring and recovery skills required for the same. When the subsequent recession and tight liquidity conditions saw several companies defaulting, it affected the solvency of several NBFCs as well. The high-profile collapse of a large NBFC, which ushered in tighter prudential norms and regulatory changes, led to a period of rationalisation and consolidation, with several small players exiting the business.

The NBFC industry is dominated by a handful of players today. These include MNC players, captive finance companies and a few large stand-alone finance companies. Banks, especially private sector banks, have also increased their presence in the retail finance sector.

On the other hand, the housing finance industry has been more stable and has traditionally been dominated by the Housing Development Finance Corporation (HDFC). In the 1980s and 1990s, public insurance companies and several nationalised banks floated separate housing finance arms to avail of the NHB's refinance facilities and also the tax concessions that were available to HFCs. But few private players entered the business because of the low margins. As a result, there were only about 30 HFCs registered with NHB in 2002. Of late, public sector banks have become more aggressive in this arena because of the segment's good asset quality experience, which has intensified the competition.

The RBI (Amendment) Act in 1997 formalized the regulatory regime for the NBFC sector. Under the Act, the RBI was authorized 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.

The NHB was set up in 1988 to act as the principal agency for promoting housing finance institutions, both at the local and regional levels and for providing financial and other support to such institutions. The NHB is also the regulator of HFCs and has followed similar prudential norms for HFCs as those proposed by the RBI for NBFCs.

The consolidation in the industry has resulted in some trends, which CRISIL believes are structurally positive for finance companies. These are:

Strengthening of credit appraisal and monitoring systems

With pressure on margins, industry players have increased their focus on controlling asset quality costs and expense levels to maintain overall profitability. While large players have made significant investments in info-tech and management information systems (MIS), MNC entrants have borrowed from their parent's international systems. Older Indian players also revised their credit underwriting norms in the late 1990s. Such efforts have significantly strengthened the industry's credit origination and monitoring systems, and consequently the performance of contracts.

Increasing reliance on capital markets for meeting resource requirements

The industry's funding profile has shifted in favour of capital market instruments. MNC players raise most of their resources from the capital markets and do not access retail deposits. Indian players too have reduced their reliance on bank funding and fixed deposits.

Increased use of securitisation

Securitisation is gaining popularity with finance companies having strengths in origination. Because of the diversification of a securitised pool of assets, as well as structural and credit enhancement features, asset securitisation can be an attractive funding alternative, especially for lower rated companies. Securitisation began in early 1990s and even today, the most dominant asset class securitised continues to be retail assets. The

cost of funds advantage and capital relief achieved by the originating NBFCs have been key drivers for the growth in securitisation market. Mortgage securitisation, which is the largest component of securitisation market internationally, has also become popular recently. In mortgage securitisation, while the cost of funds advantage has been limited, the asset liability matching enabled by securitisation is the key attraction.

CRISIL has evolved rating criteria that are specific to the business characteristics of NBFCs and HFCs. These include:

■ Market position

With virtually all the business lines of finance companies coming under greater competitive pressures, strong origination skills have become imperative for survival. In this regard, a company's distribution network, in terms of a 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 durable financing segments, tie-ups with manufacturers and relationships with dealers are key determinants of origination capabilities. The subventions (equivalent to interest subsidy) provided by several manufacturers to the largest financiers of their products have increased the latter's competitive strengths. On the other hand, relationships 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 the business growth and profitability of such captive finance companies.

The housing finance segment has grown at over 30% a year in recent times on the back of low interest rates, stable property prices, demand-supply gaps and government initiatives in the form of greater tax benefits on housing loans. Given the significant unmet demand, the key determinant of a HFC's market position is availability and cost of funds.

Only a few NBFCs lend to the corporate sector today. CRISIL believes that finance companies have a weaker market position in this segment than banks and financial

institutions, which have the size and cost of funds advantage.

■ Management

The dynamic environment in the industry in the 1990s 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 its ability and track record in responding to changes in market conditions form a central input in the credit assessment. CRISIL also analyses the management's risk appetite in terms of its growth and diversification philosophy, provisioning and capitalization policies.

CRISIL evaluates the management's strategies of balancing business and financial risks. For instance, the current operating environment for finance companies is more competitive than in the early 1990s and the management of several large companies have responded to it by reducing their leveraging levels. The gearing levels of leading players have come down to three-four times in recent years from around eight-nine times in the early 1990s.

■ Asset quality

As with banks, asset quality is a primary consideration when assessing credit risk in a finance company. In analysing asset quality, CRISIL reviews a company's credit risk management strengths and evaluates its portfolio quality. CRISIL evaluates the company's underwriting standards, approval authorities, collection procedures, 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, NPA levels, write-off and recovery levels.

Finance companies in India use different asset quality indicators. These include collection efficiencies, days past due portfolio levels, debtors as days billings, NPA levels and the like. There are also differences in NPA recognition and provisioning norms. For instance, most MNC players follow 90-day NPA recognition and 180-day write-off

policies, which are more conservative than the RBI norms followed by most Indian finance companies. CRISIL compares the available information on all these parameters to make an assessment of the portfolio quality and also adjusts for differences in calculation methodologies. Since asset quality indicators can be distorted by growth, CRISIL performs an analysis on a static pool basis to measure asset quality of different vintages. CRISIL's rated companies cover more than 70% of the outstanding portfolio in most of the asset classes. This gives CRISIL good industry-wide data to benchmark an individual company's portfolio quality.

CRISIL notes that mortgages have been the best performing asset class in terms of asset quality. The proposal to enable easier foreclosure laws for HFCs would further strengthen the HFCs' ability to maintain 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, risk-adjusted capital levels and its management's capitalisation philosophy. The analysis also goes beyond regulatory capital requirements and looks at the company's leveraging ability based on the asset class that 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.

Although the reported capital adequacy of most finance companies is over 20%, much higher than that of banks, CRISIL considers the capital position of most finance companies to be weak. This is on account of the small capital base and weak recapitalisation prospects of most of these entities. 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 payout 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. CRISIL looks at each transaction to evaluate the extent of risk retained and the commensurate capital requirement. For details of CRISIL's treatment of securitisation transactions, see the chapter *Treatment of Securitisation in CRISIL's Ratings of Finance Companies*.

■ Resource raising ability

Since funds are a finance company's raw material, its ability to generate them is essential for its operating model. The events in the last decade have exhibited the need for a balanced, diversified funding strategy. The liquidity of several small finance companies that relied heavily on retail deposits was hit by the loss of confidence among investors. Consequently, 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 to banks due to the lack of an extensive branch network and inability to provide cheque-issuing facilities. A few large finance companies are, however, able to access funds from the capital markets at competitive rates. But the resource-raising ability of the smaller NBFCs and HFCs is a key constraining factor in their ratings.

■ Earnings

Earnings are a key input to augment capital required for supporting 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 profits. CRISIL's analysis starts with the income statement build-up, which provides insights into the economics of the business model. Earnings for finance companies are driven primarily by net interest margins and the difference between the yield generated by the assets and the cost of debt. CRISIL's analysis is forward looking and the relevance of past profitability performance is only a base for estimating future profitability.

While viewing a company's profitability on a historical basis and in relation to its peers, CRISIL adjusts for changes/differences in accounting policies, securitisation and the like. For instance, many MNC-promoted finance companies follow international NPA recognition and provisioning norms, which are more stringent than those stipulated by the RBI. Hence, CRISIL adjusts for such differences in its peer-comparison of profitability.

CRISIL notes that increasing competition in retail asset financing due to the entry of strong players (MNC-promoted entities and foreign and new private sector banks) has had the most visible impact on the players' profitability. Interest spreads in the business have come down to between 3-4% in the early 2000s from over 8% in the early 1990s. Consequently, players have had to improve efficiencies and control asset quality costs to maintain overall profitability. CRISIL assesses the management's ability to respond to such changes in the operating environment.

■ Liquidity/ Asset liability management

Unlike commercial banks, finance companies do not have access to the call market or RBI refinance facility in the event of a liquidity crisis. In the recent past, 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 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. This is because while the average tenure of housing loans is over 10 years, most of the borrowings (fixed deposits, bank borrowings and debentures) are for much shorter tenures. Only the NHB refinance facility is for a comparable tenure. However,

the proportion of NHB refinance in the total resource mix of HFCs has been on a decline. Hence, HFCs are exposed to significant interest rate risks. To overcome this, several industry players are increasingly looking at securitisation.