

ICRA Lanka's Credit Rating Methodology for Non-Banking Finance Companies

Non-Banking Finance Companies (NBFCs) play an important role in the Sri Lankan financial market. While the Central bank of Sri Lanka regulates both NBFCs and banks, there are some significant differences in the regulatory treatment, with NBFCs being given greater flexibility in governance structure and operational matters and not being subject to statutory reserve requirements. However, at the same time, there are regulatory restrictions on the bouquet of services that NBFCs can offer and on their funding options. Typically, NBFCs extend the following types of loans:

- Vehicle loans
- Equipment loans
- Personal loans
- Micro credit
- Loans against property
- Loans against shares
- Corporate loans

In rating an NBFC, ICRA Lanka evaluates the company's business and financial risks, and uses this evaluation to project the level and stability of its future financial performance in various likely scenarios. The ratings are determined on a "going concern" basis rather than being based on a mere assessment of the company's assets and debt levels as on a particular date. The broad parameters for assessing the business and financial risks of an NBFC (as in the bullet list below) are discussed at length in the next two sections. This methodology note does not purport to be an exhaustive discussion on all the rating parameters involved in the credit rating of NBFCs, but presents a broad framework for the exercise.

- **Business Risk**
 - Operating Environment
 - Ownership Structure
 - Franchise and Size, competitive position
 - Management, Systems and Strategy, governance structure
- **Financial Risk**
 - Asset Quality
 - Liquidity
 - Profitability
 - Capital Adequacy

While several parameters are used to assess an NBFC's business and financial risks, the relative importance of each of these parameters can vary across companies, depending on its potential to change the overall risk profile of the company concerned. For instance, in a benign operating environment, a relatively new "personal loan finance company" may show very good profitability, but may be unable to sustain the same through several life cycles. Therefore, in this case, higher weight would be attached to the company's business risk profile than to its financial performance. Further, an NBFC with a strong business profile and stable financial performance would be viewed

more favourably than another with comparable or better financial numbers, but with a weaker business risk profile.

BUSINESS RISK

ICRA Lanka makes an assessment of an NBFC's business risk by analysing, among other factors, the company's operating environment, franchise, asset quality, and management and systems. As many of these parameters are qualitative, ICRA Lanka tries to remove the subjectivity in its analysis by capturing and assessing information on defined sub-parameters, and using these to make a comparison across various companies. This analysis also incorporates ICRA Lanka's assessment of the performance of various sectors, its outlook on the economy, and its views on issues related to the operating environment.

- **Operating Environment**

The operating environment has a significant bearing on an NBFC's credit rating as it can impact its growth prospects and asset quality quite considerably. In assessing the operating environment, ICRA Lanka looks at the overall economic conditions, prospects of the industry related to the asset class being financed, and the regulatory environment. For instance, in the case of a commercial vehicle (CV) financing NBFC, the level of economic activity and freight rates are very important, just as the outlook on real estate is important for a home finance company, from the perspective of both asset creation and asset quality.

For an NBFC, regulatory changes can also significantly impact (either positively or negatively) credit losses.

Intensity of competition has a significant bearing on the credit profile of an NBFC, given that the prevailing or anticipated competitive intensity would influence the company's growth prospects, earnings and management strategy. ICRA Lanka's evaluation focuses on the current level of competition as well as the attractiveness of the segment for potential competition by assessing several factors including growth potential, entry barriers and risk-adjusted returns.

- **Ownership Structure**

Ownership structure could have a key influence on an NBFC's credit profile in that a strong promoter and strategic fit with the parent can benefit an NBFC's earning, liquidity and capitalisation, and hence its credit profile. In assessing an NBFC's ownership structure, the parameters examined include, among others: the credit profile of the promoter, shareholding pattern of the NBFC, operational synergies of the NBFC with its promoter, level of involvement of promoter in the NBFC and level of commitment, and track record of the promoter in providing fund support.

- **Governance Structure**

ICRA Lanka believes that an appropriate Governance structure is important to ensure that the powers given to line managers at an NBFC are exercised in accordance with the established procedures and that these procedures are in harmony with the broad policy guidelines and strategic objectives of the NBFC. ICRA Lanka's evaluation of an NBFC's Governance structure involves an assessment of the structural aspects of the Board and Board level committees and of the functioning of the various Board committees.

- **Franchise and Size**

For an NBFC, its franchise strength determines its capacity to grow while maintaining reasonable risk adjusted returns and to maintain resilience of earnings, thereby facilitating predictability of its future financial performance. It may be noted that an NBFC with a significant market share and a niche player can both have a defensible franchise¹, which could in turn benefit their credit profile. As for size, typically it is seen in relation to an NBFC's loan mix and has a bearing on the company's competitive position, diversity, credit risk concentration, stability of earnings, and financial flexibility.

- **Management, Systems and Strategy**

Quality of management, systems and policies, shareholder expectations and the strategy followed to manage these expectations, and accounting quality are the foundation stones on which an NBFC's credit risk profile is built. The importance of these factors is even higher for a new NBFC, one with a shorter track record or one with a changing business profile.

In evaluating an NBFC's management, systems and strategy, ICRA Lanka assesses the company's competitive position (ability to change lending norms and/or yields), reliance on outsourcing, pace of growth and responsiveness to market changes, track record, and management experience (in relation to growth plans and the lifecycle of the loans extended), besides the extent of diversification in its loan book.

As for track record, this is evaluated in relation to completed business cycles. Thus, while a five to six year old finance company, whose lending is primarily short to medium term (the typical loan tenure being three to four years) is considered to have a reasonable track record, a finance company of the same vintage, which may be engaged in longer term financing such as Housing finance (where the typical loan tenure being 15 to 20 years) would be said to have an average track record. Further, if an NBFC is expanding into new products and geographies, its track record and management experience may not provide the same level of comfort as those of another NBFC with a stable growth rate and growing within existing geographies with the same loan mix.

All credit ratings, including those in the NBFC sector, necessarily incorporate an assessment of the quality of the issuer's management, as well as the strengths/weaknesses arising from the issuer's being a part of a "group". This part of the exercise is mostly subjective, although the actual track record of the management is a supporting factor. Usually, a detailed discussion is held with the management of the issuer NBFC to understand its business objectives, plans and strategies, and views on past performance, besides the outlook on the industry. Some of the other factors assessed are:

- Experience of the promoter/management in the NBFC's line of business.
- Commitment of the promoter/management to the NBFC's line of business.
- Attitude of the promoter/management to risk taking and containment.
- The NBFC's risk management policies (credit risk and market risk).
- Strength of the other companies belonging to the same group as the NBFC.
- The ability and willingness of the group to support the NBFC concerned through measures such as capital infusion, if required.

¹ The bigger company on the strength of its standing in the overall market and the smaller one on account of its unique offering or its strong relationship with the key participants in the credit chain of the target segment.

A careful evaluation of the risk management policies of the NBFC is done as that provides important guidance for assessing the impact of stress events on the liquidity, profitability, and capitalisation of the company concerned. ICRA Lanka compares the underwriting policies of the NBFC concerned with the best practices in the industry to make an assessment of the company's risk profile. The process of risk profiling also involves evaluating the NBFC's business sourcing practices (in-house vs. outsourced), besides its recovery and monitoring systems.

ICRA Lanka also evaluates the strategy and business plans of the NBFC, along with the shareholders' expectations from the company. Although ICRA Lanka - assigned ratings are for debt holders, meeting shareholders' expectations is imperative as otherwise the company's strategy itself could undergo a change (to meet shareholders' expectations), which in turn could alter its credit profile.

FINANCIAL RISK

- **Asset Quality**

Asset quality plays an important role in indicating the future financial performance of an NBFC. The focus of asset quality evaluation is on lifetime losses, variability in losses under various scenarios, the impact of likely credit costs on profitability, and the cushions available (in the form capital or provisions) to protect the debt holders from unexpected deterioration in asset quality.

In evaluating an NBFC's asset quality, ICRA Lanka assesses the quality of the company's credit appraisal process and lending norms, the riskiness of its loan mix, its risk appetite, the availability of data to facilitate credit decision making, and its track record in managing its loan book through lifecycles. Assessment is also made of credit risk concentration, trend in viability of customers, trend in delinquencies (adjusted for vintage of the book), Gross NPA² percentage, Net NPA percentage, and Net NPAs in relation to Net Worth.

Further, the extent of diversification is also an important indicator of an NBFC's asset quality. In assessing diversification, the factors generally looked at include loan mix, credit risk, portfolio granularity, geographical diversification, and borrower profile. High levels of diversification can shield an NBFC from the impact of downturn in any one segment. At the same time, diversification into riskier segments may not improve resilience and therefore may not translate into superior ratings. However, an NBFC's ability to manage diversification, especially in multiple businesses and/or new geographies is a very important issue, just as management depth and the ability to adopt the skills and techniques needed to run different businesses are.

As asset quality indicators can vary, depending on the asset class, borrower profile, NPA recognition norms, and the accounting policy on write-offs, comparing these indicators across NBFCs operating in different asset classes may not yield meaningful results. ICRA Lanka therefore makes a comparison of the delinquency levels (at 30days+, 60days+, 90 days+) for the same asset class and borrower profile across players, adjusted for write-offs. When available, static pool analysis is done as this gives a meaningful estimate of the losses at various stages in the loan cycle as well as of the overall lifetime losses, and is free from the distortions caused by a high growth rate.

² Non-Performing Assets

- **Liquidity**

It is important for an NBFC to maintain a favourable liquidity profile for the smooth functioning of its funding activity (fresh asset creation) and to honour its debt commitments in a timely manner. It is also important that an NBFC manage its interest rate risk, as the same could impact its future profitability.

In assessing an NBFC's liquidity profile, ICRA Lanka evaluates the company's policy on liquidity, the maturity profiles of its assets and liabilities, the asset-liability maturity gaps, and the backups available to plug such gaps. The evaluation also focuses on the diversity of the NBFC's funding sources and their quality (i.e. availability of these sources in a stress situation).

- **Profitability**

An NBFC's ability to generate adequate returns is important from the perspective of both its shareholders and debt holders. The purpose of ICRA Lanka's evaluation here is to assess the level of future earnings and the quality of earnings of the NBFC concerned, which is done by looking closely at the building blocks: interest spreads, fee income, operating expenses, and credit costs.

The evaluation of an NBFC's profitability starts with the interest spreads (yields minus cost of funds) and the likely trajectory of the same in the light of the changes in the operating environment, the company's liquidity position, and its strategy. The ability of the NBFC to complement its interest income with fee income is also assessed. A large fee income allows greater diversification, which in turn can improve the resilience of earnings, thereby improving an NBFC's risk profile. After assessing the income stream, ICRA Lanka evaluates the NBFC's operating efficiency (operating expenses in relation to total assets, and cost to income ratio) and compares the same with that of its peers. Finally, the credit costs are estimated on the basis of the company's asset quality profile, and the profitability indicators³ compared across peers. Importantly, a very high return on equity may not necessarily translate into a high credit rating, given that the underlying risk could be very high as well, and being so it could be more volatile or difficult to predict.

- **Accounting Quality**

Consistent and fair accounting policies are a prerequisite for financial evaluation and peer group comparisons. By virtue of being incorporated under the Companies Act, 07 of 2007, NBFCs are required to follow the Accounting Standards prescribed by the Institute of Chartered Accountants of Sri Lanka. Further, the Central Bank of Sri Lanka has also issued prudential norms for NBFCs specifying the accounting methods to be used for income recognition, provisioning for bad and doubtful advances, and valuation of investments. In evaluating an NBFC's accounting quality, ICRA Lanka reviews the company's accounting policies, notes to the accounts, and auditors' comments in detail. Deviations from the Generally Accepted Accounting Practices are noted and the financial statements of the NBFC adjusted to reflect the impact of such deviations.

³ Profit after Tax as a percentage of Average Total Assets, and Profit after Tax as a percentage of Average Net Worth

- **Capital Adequacy**

An NBFC’s capital provides the second level of protection to debt holders (earnings being the first) and therefore its adequacy (in relation to the embedded credit, market, and operational risk) is an important consideration for ratings. Riskiness of the product and granularly of the portfolio are factors that have a significant bearing on the amount of capital required to provide the desired degree of protection to an NBFC’s debt holders. The requirement of risk capital varies with the concentration and the riskiness of the product mix, as the following chart shows.

Chart 1: Risk Capital Requirement Matrix

		Expected credit Losses and variability	
		Low	High
Portfolio Concentration	High	Moderate	High
	Low	Low	Moderately High

ICRA Lanka starts with the adjusted capital (as discussed in the section on Accounting Quality) and considers the internal capital generation and possible support from a strong parent/group company while evaluating the adequacy of an NBFC’s risk capital for a particular rating category. Typically, capital adequacy analysis is done for the individual business lines (including off-balance sheet portfolio’s) of the NBFC and the “aggregated capital required” compared with the actual capital available as well as with the minimum capital that the company is expected to maintain. ICRA Lanka also evaluates the quality of an NBFC’s capital, apart from the level of capital. A higher percentage of Tier I capital is viewed more favourably, given its greater permanence. Besides, an NBFC’s ability to meet regulatory capital adequacy requirement is also evaluated.

SUMMING UP

The credit ratings assigned by ICRA Lanka are a symbolic representation of its current opinion on the relative credit risk associated with the instruments rated. This opinion is arrived at following a detailed evaluation of the issuer’s business and financial risks and on using such evaluation to project the level and stability of its future financial performance in various likely scenarios. While several parameters are used to assess an NBFC’s risk profile, the relative importance of each of these parameters (qualitative as well quantitative) can vary across companies, depending on its potential to change the overall risk profile of the company