RATING METHODOLOGY FOR NON-BANKING FINANCE COMPANIES

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This rating methodology updates and supersedes ICRA's earlier methodology document covering non-banking finance companies (NBFCs), published in December 2021. While this revised version incorporates a few modifications, ICRA's overall approach towards rating NBFCs[1] remains materially similar. This document does not include an exhaustive discussion of all the rating factors that our analysis considers but provides an overall perspective on the considerations that are usually the most important. While it provides an overview of the salient rating considerations, for more details, readers may refer to the other cross-sector methodologies[2] available on ICRA's website.

Overview

NBFCs play an important role in the Indian financial market. While the Reserve Bank of India (RBI) regulates NBFCs and banks, there are a few significant differences in the regulatory treatment. NBFCs have relatively greater flexibility in their governance structure and operational matters and can take exposures independent of priority sector targets and statutory reserve requirements. However, at the same time, there are regulatory restrictions on the range of services (like transaction services/cash credit lines, etc) that can be provided by NBFCs and on their funding options (such as access to the call money market, savings and current accounts, etc). NBFCs typically extend the following types of loans.

- Vehicle loans (for purchase of commercial vehicles (CVs), cars, tractors, two-wheelers, three-wheelers, etc) and construction equipment loans
- Personal/education/other consumer loans
- Loan against gold jewellery
- Microfinance
- Loan against property
- Loan against shares/initial public offering (IPO) financing
- Corporate loans
- Business and small and medium enterprise (SME) loans
- Real estate loans/construction finance
- Infrastructure loans
- Project finance loans
- Home loans

[1] *Reference made to NBFCs, henceforth in this document, can be construed as a reference made to all categories of NBFCs as per the RBI, including NBFC-investment and credit company (NBFC-ICC), NBFC-infrastructure finance company (NBFC-IFC), NBFC-core investment company (NBFC-CIC), NBFC-infrastructure debt fund (NBFC-IDF), NBFC-microfinance institution (NBFC-MFI), housing finance companies (HFCs), NBFC-non-operative financial holding company (NBFC-NOFHC), mortgage guarantee company (MGC), and NBFC-peer to peer lending platform (NBFC-P2P), unless stated otherwise*

[2] *In various instances, our analysis is guided by considerations that are not specific to a given sector but find relevance across sectors. Examples of such considerations include how parent or group support impact an entity's rating, approach to consolidation, the impact of structural features or explicit third-party support on an entity's rating, holding company methodology, and so on. Methodology documents that describe our approach towards such cross-sector analytical considerations are available on ICRA's website www.icra.in.*

For rating an NBFC, ICRA evaluates its business risk, ownership, management risk and financial risk, and uses this to assess the level and stability of the NBFC's future financial performance in various scenarios, as required. The ratings are determined on a going concern basis rather than on a mere assessment of the assets and the debt levels on a particular date. The broad parameters for assessing an NBFC's business and financial risks are presented below and discussed in the sections that follow.

Business Risk Assessment

- Business Profile
- Operating Environment

Financial Risk Assessment

- Profitability
- Liquidity and Financial Flexibility
- Capital Adequacy
- Asset Quality

Management Risk

Ownership/Parentage

While several parameters are used to assess business and financial risks, an NBFC with a strong business profile and a stable and healthy financial performance is viewed more favourably than one with comparable or better financial numbers but with a moderate business profile. Therefore, more weight is given to the company's business risk assessment compared to its financial risk assessment. To elaborate the above, in a benign environment, an entity present in riskier segments such as a personal/unsecured loan finance company may show very good profitability, but it may be unable to sustain the same through business cycles.

ICRA broadly applies the same methodological principles to assess the risk profiles of other entities in the lending business like trusts, cooperative societies, nidhi companies, asset reconstruction companies (ARCs), etc.

Business Risk

Business Profile

ICRA's analysis of an NBFC's business profile involves the assessment of the product offerings, asset mix, borrower profile, geographical presence, size of the franchise/portfolio, track record of operations, underwriting processes and controls, and the envisaged pace of growth. The assessment of these parameters provides an insight into the NBFC's risk appetite, experience and responsiveness to adverse market-related changes and the competitive position.

Product Mix and Riskiness

The target asset segments, the overall asset mix and the borrower profile indicate the lender's risk appetite. NBFCs lend to various asset segments, namely vehicle finance, equipment finance, mortgage, business loans, corporate loans, infrastructure loans, real estate loans, microfinance, loan against shares, gold loans, personal loans, consumer loans, etc, while HFCs generally extend home loans, loans against property and construction finance loans. Product riskiness is evaluated based on a confluence of factors, namely the prevailing operating environment, historical and recent trends in the asset quality, loan granularity, strength of the loan security and recoverability in case of overdue build-up or default. While each asset segment entails a certain amount of credit risk, the target borrower profile is also a factor for assessing the overall credit risk. NBFCs typically cater to non-salaried customers and small businesses, with either limited credit history or lower loan eligibility from other larger lending institutions like banks while HFCs (especially larger ones) have a fair mix of both salaried and self-employed borrowers.

NBFCs with a high share of unsecured credit to borrowers, who have limited credit history, are expected to be more vulnerable in case of any adverse changes in the business or operating environment. Also, higher dependence on one asset segment is deemed riskier as any unforeseen changes in the market or regulatory dynamics could impact the performance of those NBFCs. This analysis incorporates ICRA's assessment of the NBFC's assets and its performance through business cycles.

Track Record, Competitive Position and Sustainability

The track record of operations is evaluated in the context of completed loan cycles. Thus, while a five-to-six-year-old two-wheeler finance company and/or microfinance loan company is considered to have a reasonable track record (typical loan tenure of two to four years), a mortgage finance company of the same vintage would be said to have a moderate track record (typical loan tenure of 12-15 years). The competitive position of NBFCs reflects their ability to respond to market changes by way of changing their lending norms, sourcing strategies, yields, etc, while ensuring that the loan pricing remains commensurate with the risks.

A diversified geographical presence and product offerings not only reduce concentration risk but also enhance the competitive position of an NBFC. NBFCs, which are in the early phases of expansion into new products and geographies, generally face higher credit-related challenges and the same becomes a monitorable from a rating perspective.

Size too has a bearing on an NBFC's competitive position. Larger NBFCs generally operate across multiple states and exhibit greater product diversity. They also have higher financial flexibility in terms of pricing their loans as well as fund raising. An NBFC's franchise[3] strength determines its capacity to grow while maintaining reasonable risk-adjusted returns and resilient earnings. It may be noted that two NBFCs, one with a significant market share and another with a niche product offering, can both have an established franchise[4], which could benefit their individual credit profiles.

[3] Typically refers to branch strength and/or customer base

[4] The bigger company on the strength of its standing in the overall market and the smaller on account of its unique offering or strong relationship with the key participants in the credit chain of its target loan segment

Optimal portfolio growth and control over business sourcing and collections are key for business sustainability. While aggressive portfolio growth is more likely to reflect as a risk because of a possible leniency/dilution in the underwriting norms over a period, slower growth vis-à-vis the industry level could indicate a weakened competitive profile. ICRA also notes that entities with fully in-house sourcing and collection teams are likely to have stronger control on the loan origination, monitoring and collection process than entities dependent on external agencies for some of their business processes.

Operating Environment

The operating environment has a significant bearing on an NBFC's credit rating as it can materially impact its growth prospects and asset quality. For assessing the operating environment, ICRA looks at the overall economic conditions including liquidity conditions, interest rate cycle, the growth prospects of the gross domestic product (GDP), the outlook for credit growth, the prospects of the NBFC industry (including the competitive intensity), headwinds faced by specific asset classes, and the regulatory environment.

The intensity of competition has a significant bearing on an NBFC's credit profile as it can change its growth prospects, earnings and management strategy.

Summary of Salient Business Risk Factors

	Strongest		Weakest
Assets under management (AUM)	More than Rs. 20,000 crore	→	Less than Rs. 1,000 crore
Product mix and riskiness	Housing loans Largest product (or asset class) less than 20% of AUM	→	Unsecured financing, real estate financing, security receipts, etc Largest product accounting for more than 90% of AUM
Geographical diversification	Concentration in single state <15%		Concentration in single state >80%
Track record *(loan tenor and vintage in newer asset segments are factored in)*	>15 years; established track record of market responsiveness	→	< 3 years; no track record to establish market responsiveness
Pace of growth *(past and projected)*	Growth largely around the industry average	→	Very high or low growth vis-à-vis industry average

ICRA's assessment of the regulatory system involves the evaluation of the norms related to capital, the extent of regulatory supervision and the changes in response to the macroenvironment, key norms (such as provisioning, capital adequacy, liquidity, risk weights) and prospective regulatory changes. Regulatory changes can significantly impact the performance of an NBFC. Some of the regulatory developments could seem adverse in the near term, impacting the sectoral growth or earnings, but are deemed favourable in the longer term for the sector's sustainability and for improving its resilience to unfavourable market developments/movements. The establishment of a credit information bureau has helped lenders take informed credit decisions, while the applicability of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act (SARFAESI) to NBFCs helps them recover loans more efficiently. Similarly, the Insolvency and Bankruptcy Code (IBC) is intended to support recoveries from the defaulting entities. Similarly, the RBI has implemented scale-based regulations for NBFCs according to which NBFCs have been classified into top, upper, middle, and base layers, with entities in the upper layer being subjected to relatively tighter regulations and supervision compared with the middle and base layer NBFCs.

Financial Risk Assessment

Profitability

An NBFC's ability to generate adequate returns is important from the perspective of its shareholders as well as debtholders. The purpose of ICRA's evaluation here is to assess the level of the future earnings of the NBFC concerned, which is undertaken by looking closely at the building blocks of profitability, viz. interest spreads, fee income, operating expenses, and credit costs. ICRA also analyses the NBFC's historical performance for stability and diversity of earnings and to understand the impact of the various market, regulatory, operational and business risks on the earnings.

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 changes in the operating, regulatory and funding environment, and the NBFC's own business/growth strategy. It is important for an NBFC to manage its interest rate risk (arising from the share of fixed versus floating rate assets and liabilities, investment book repricing risk, etc) as this could impact its future profitability. The NBFC's ability to complement its interest income with fee income is also assessed. Sizeable fee income provides some diversification to the income stream, which can improve the resilience of earnings. ICRA also assesses the impact of one-time income (such as upfront income on direct assignment transactions, trading/investment gains, etc) on the profitability. Other than assessing the income stream, ICRA 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. ICRA also analyses the components of the NBFC's credit costs (provisions and write-offs) in relation to the asset mix. Future credit costs are estimated on the basis of the company's asset quality profile to arrive at the projected net profitability[5].

Leverage plays a crucial role in the earnings performance of NBFCs; an optimally leveraged (or at steady-state management guided leverage) entity is viewed favourably vis-à-vis an entity with low leverage despite having the same net profitability. ICRA notes that the leverage is expected to increase as the company grows and this could put pressure the margins. Assuming that the credit cost remains stable, entities could witness a moderation in their earnings performance unless the benefits of scale improve commensurately to offset the margin pressure on account of the higher leverage.

Profitability Metrics

[Indicative Metrics[6]]

	Strongest	Weakest
Past average and projected RoMA	**>2.75%**	**<1.25%**

[5] *Profit after tax (PAT) as a percentage of average total managed assets*

[6] *The indicative financial metrics mentioned here and elsewhere in the document are intended to provide a broad overview to the readers regarding what ICRA generally considers as 'relatively strong' or 'relatively weak' metrics. It is, however, possible that an entity has relatively weaker metrics on one or more financial parameters, but its credit risk is assessed to be low because of other mitigating factors, including (but not limited to) stronger metrics on other financial parameters, a healthy business risk profile, strong financial flexibility or a strong promoter group that is willing to extend distress support to the entity*

Liquidity and Financial Flexibility

It is important for an NBFC to maintain a favourable liquidity profile for the smooth functioning of its business (fresh asset creation) and for honouring its debt commitments in a timely manner.

For assessing an NBFC's liquidity profile, ICRA evaluates the maturity profile of its assets and liabilities, the resulting asset-liability maturity gaps, the availability of assets which can be securitised/assigned, and the other backups available for plugging any gaps and meeting the near-term disbursement requirements. ICRA's evaluation also focusses on the diversity of the NBFC's funding sources and their quality (i.e. whether these sources will be available in a stress scenario). At the same time, the company's ability to continue raising funds for incremental growth from diverse sources is an important factor from a rating perspective. A high share of short-tenure borrowings (<1 year) exposes entities to refinancing and interest rate risks during adverse market liquidity conditions, especially NBFCs offering relatively longer-tenure loans. Increase in dependence on short-term market borrowings, beyond a certain level, depending on the credit profile of the entity, could adversely impact the liquidity profile and is a rating sensitivity.

The borrowing covenants agreed by the NBFCs with their lenders also have a bearing on their credit profile. Some covenants, especially financial covenants, might be close to the current performance levels and hence prone to a breach even with a minor deterioration in the operating environment. The breach of these covenants would warrant an increase in the borrowing rate or an early redemption, which could trigger cross-default clauses in some of the other borrowings. This would exert pressure on the overall liquidity profile. Therefore, entities/groups with a higher share of borrowings with strict covenants and with early/accelerated redemption clauses linked to these covenants are likely to face higher liquidity-related pressure as their ability to secure fresh funding in a weak operating environment would also be affected. ICRA tries to check for such covenants, wherever available, and accordingly account for these in the overall analysis.

ICRA also assesses the financial flexibility of the NBFC based on its past track record of raising commensurate funds when required and other factors including strong sponsors, access to group entity support, etc. The cost of funding also provides some insight into the financial flexibility of an NBFC. Entities with a bigger lender base (number of lenders) and a diverse resource (banks, fund houses, other financial institutions, insurance entities, etc) profile are more likely to have competitive borrowing rates compared to entities with a concentrated resource or lender profile. Further, these entities have better refinancing capabilities during a subdued liquidity environment. To the extent possible, the incremental borrowings are also compared with the borrowings of peers to understand the relative market position of the entity.

Capital Adequacy

An NBFC's net worth and leverage provides comfort to the debtholders as it gives the company the cushion to absorb asset-related shocks. Therefore, its adequacy (in relation to the embedded credit, market, and operating risks) is an important consideration for the rating exercise. As per RBI regulations for NBFCs, these entities have to adhere to a minimum prescribed Tier 1 capital percentage and capital adequacy requirements. The NBFC's ability to maintain adequate buffer over the regulatory capital adequacy requirement, going forward, is also evaluated.

The riskiness of the product and granularity of the portfolio have a significant bearing on the amount of capital required to provide the desired degree of comfort to an NBFC's debtholders. The requirement of risk capital varies with the product concentration and riskiness of the product mix. This portfolio mix also has a bearing on the reported capital adequacy of the NBFCs since the RBI-prescribed risk weights could vary across different asset classes and are subject to change by the RBI.

ICRA adjusts for intangibles, deviations in accounting, first loss guarantees given, investments in subsidiaries and other non-core activities, etc, while evaluating the adequacy of an NBFC's risk capital. ICRA looks at the managed gearing (calculated after taking the off-balance sheet portfolio as part of total borrowings) and/or adjusted gearing (calculated after adjusting the net worth for risk attributable to the off-balance sheet portfolio) to assess the capitalisation levels of the NBFC.

ICRA also analyses the incremental capital requirement, considering the growth plans, and it compares the computed capital requirement with the current capital position. Entities with higher growth rates vis-à-vis the levels that internally generated cashflows could support are likely to witness some moderation in their capital profiles. In such cases, the ability to raise capital from the market or the promoters is also factored in during the rating exercise. NBFCs, which provide visibility on maintaining a comfortable and risk-adjusted capital structure over the medium term, are viewed favourably. The risk-adjusted capital structure could vary depending on the target asset class, loan size and borrower profile.

In case of hybrid instruments such as a perpetual debt programme, ICRA typically notches down the rating of such instruments from the rating of the other long-term debt programmes of the NBFC. This notching reflects the lower seniority of these instruments wherein an NBFC may defer the payment of interest on these instruments if:

- its capital-to-risk weighted assets ratio (CRAR) is below the minimum regulatory requirement prescribed by the RBI; or
- the impact of such payment results in the NBFC's CRAR falling below or remaining below the minimum regulatory requirement prescribed by the RBI

Interest may be paid with the prior approval of the RBI when the impact of such payment may result in a net loss or an increase in the net loss, provided the CRAR remains above the regulatory norm. The extent of rating notching could vary depending on the likelihood of the deferment of the payments, which depends on the extent of capital buffers available with the entity and the expected profitability trajectory.

Asset Quality

The asset quality assessment covers, among other factors, the quality of the credit evaluation process and the lending norms, riskiness of the loan/investment mix, risk appetite, and track record in managing the loan book through lifecycles. The asset quality is also assessed for credit risk concentration, potential stressed exposures, delinquencies (adjusted for the vintage of the book, wherever required), gross NPA[†]/stage 3 percentage, net NPA/stage 3 percentage, and provision costs, write-offs, and net NPAs or stage 3 assets in relation to the net worth. Additionally, the impact of the operating environment and the expected trend in sectoral delinquencies in the various asset segments are also factored in.

The asset quality plays an important role in indicating the future financial performance of an NBFC. The focus of the asset quality evaluation is also on lifetime losses, the impact of likely credit costs on profitability, and the cushions available (in the form of capital or provisions) for protecting the debtholders.

Diversification is an important factor influencing an NBFC's asset quality. High levels of diversification (in the context of loan mix, credit risk, portfolio granularity, geographical presence, and borrower profile) can shield an NBFC from a downturn in any segment. At the same time, diversification into riskier segments may not improve resilience and can affect portfolio quality. However, an NBFC's ability to manage diversification, especially in multiple businesses and/or new geographies, is an important factor, as is management depth and the ability to adopt the skills and techniques needed to run different businesses.

Comparing asset quality indicators across NBFCs operating in different asset classes may not yield meaningful results as the indicators can vary, depending on the asset class, the borrower profile and the accounting policy for write-offs. ICRA, therefore, makes a comparison of the delinquency levels for the same asset class and borrower profile across players. ICRA also assesses the asset quality indicators on a lagged basis, whenever required. When available, a static pool and/or lagged analysis is done as this gives a meaningful estimate of the overdues and losses is free from the distortions caused by a high growth rate.

† *Non-performing assets*

Summary of Salient Factors Considered for Asset Quality of Some Asset Classes (as example)

90+dpd (including one-year w/offs)	Strongest		Weakest
NBFC-Retail loans*	<2.0%	→	>6.9%
HFCs	<1.5%	→	>5.5%

**Excluding microfinance entities; Dpd – Days past due; W/offs – Write-offs*

Solvency	Strongest		Weakest
Net NPA or Net stage 3/Net worth	<5.0%	→	>25%

Management Risk

The governance structure, quality of management, risk management processes, shareholder expectations and the strategy for managing these expectations are important building blocks for an NBFC's credit risk profile. These are generally supplemented by a comprehensive information technology (IT) and management information system (MIS) and conservative accounting and business policies, etc, which provide a more holistic perspective on the NBFC's performance in relation to the prevailing operating environment.

Governance Structure

ICRA's evaluation of an NBFC's governance structure involves the analysis of the structural aspects of the type of ownership structure, board and board-level committees, the functioning of these committees and the involvement of key stakeholders in strategic decision-making. The constitution of an entity's board and the entity's adherence to legal and statutory compliance requirements are factored in during the credit assessment. Adequate size (depending on the scale and complexity of operations), diversity and constitution of the board (sufficient number of Independent Directors and representation of key stakeholders) are viewed favourably.

Management

The quality of the senior management, extent of reliance on the promoter/key-man for taking strategic decisions, presence of a second line of management and the quality of disclosures are the key variables judged while measuring an NBFC's management quality. Although this part of the exercise is mostly subjective, the actual track record of the management in the same line of business is a supporting factor. Usually, a detailed discussion is held with the management of the NBFC to understand its business objectives, plans and strategies, and views on past performance, besides the outlook on the industry.

Risk Management Systems, Credit Policies and Processes

The NBFC's risk management policies are evaluated to get a view on the impact of stress events on the company's financial profile. Some of the key underwriting norms such as loan-to-value ratio, fixed obligation to income ratio, nature of the security, etc, are evaluated. Consistent and fair accounting policies are a prerequisite for financial evaluation and peer group comparisons. NBFCs are typically incorporated under the Companies Act and are required to follow the prescribed accounting standards. Further, the RBI has issued prudential norms for NBFCs. While evaluating an NBFC's accounting quality, ICRA reviews its accounting policies, notes to accounts, and auditor's comments. Adjustments, if required, are made in the reported financials for evaluating the key performance indicators and for comparison with peers. ICRA considers the control systems and processes of the NBFC while assessing the overall credit profile.

Other Elements of Credit Risk Assessment

Ownership/Parentage

The risk profile of an NBFC, which is a part of a large corporate group or has an established promoter, can benefit from its strategic fit with the group or from the experience of the promoter. Over and above the standalone credit considerations, the likelihood of extraordinary support from the parent to an entity or the support that an NBFC is likely to extend to other group companies is factored in while assessing its credit profile. This process involves the assessment of the ability and willingness of the parent to extend support to the NBFC in addition to the evaluation of the NBFC's own fundamental credit strength.

ICRA also evaluates the NBFC's strategy and business plans along with various other stakeholder expectations from the company and the possible impact of the same on its overall credit profile, going forward.

All credit ratings incorporate an assessment of the strengths/weaknesses arising from the issuer's status as a part of a group. Some of the other points that are assessed include:

- Experience and commitment of the promoter in the line of business concerned
- Attitude of the promoter to risk-taking and containment
- Strength of the other companies belonging to the same group as the issuer
- Ability and willingness of the group to support the issuer, if required. In this case, support means the financial support from the parent, which is expected to be available to the entity, such as loans and equity, in times of credit or liquidity stress on the entity.

If the parent's/Group's credit profile is relatively weaker than the rated entity, the entity's rating may be lower than what its standalone credit profile assessment would have merited. This is due to the possibility that the entity may, at some point of time, be bound to extend financial support to its weaker parent, possibly to the detriment of its own credit profile[7].

Assessing the Likelihood of Support from the Parent to the Rated Entity

Parameter	Description
Intent of support	• Has the parent expressed its intent to extend support to the rated entity if required? • Is there a past track record of support ensuing from the parent to the rated entity?
Reputation sensitivity	• Does the support provider have a high reputation sensitivity and would it be willing to extend extraordinary support to the rated entity when the latter faces stress?
Strategic importance	• Is the rated entity in a line of business that the parent considers to be a priority as it offers strong long-term strategic benefits in the form of business, product or geographical diversification? • Does the rated entity enhance the support provider's franchise and/or competitive position?
Business linkages	• Are the operations of the parent and the rated entity highly integrated, such that if there is a disruption in the operations of the rated entity, it would in turn lead to a disruption in the operations of the parent?

LOW	MODERATE	HIGH	VERY HIGH

[7] *For more details, readers may refer to the documents titled, 'Rating Approach – Implicit Parent or Group Support', available on ICRA's website.*

Assessment of ESG Risks

The assessment of environmental, social and governance (ESG) risks by ICRA involves a broad range of considerations that pertains to the sustainability of an entity with focus on aspects that can have a material impact on its credit quality. While the E&S risks tend to be sector-related as well as entity-specific and could be driven by external factors such as regulations or demographic changes, the G risks are largely entity-driven. The impact of the E&S risks on an entity's credit profile tends to be asymmetric. If the ESG risks are material but unmitigated, these generally pull down the rating, but the ratings are usually not pushed up even when the ESG context is favourable.

Environmental and Social Risks

While undertaking the credit assessment of entities, ICRA seeks to incorporate all relevant credit considerations into its rating decisions while taking a forward-looking view of the risks and mitigants. The relevant credit considerations include the E&S factors that could affect the rated entity/transaction. While ICRA's analytical approach does not explicitly disaggregate these risks to assess their impact on the rating, these risks are often assessed broadly. Further, it is not always feasible to fully or precisely disaggregate the sub-components of E&S risks while conducting the credit analysis as these considerations often tend to overlap.

While evaluating the E&S risks, ICRA's objective is to assess the direct and indirect risks that an entity faces and how it already is or is intending to mitigate the impact of such risks on its credit profile. Given the service-oriented business of the entities under consideration, their direct exposure to environmental risks is not material. However, for exposure to environmentally sensitive segments, indirect transition risks exist for the lender due to changes in regulations or policies concerning those assets.

The financial services sector also faces risks from a social standpoint. First, data breaches and cyberattacks could affect the large volume of customer data managed by such entities. ICRA evaluates the disclosures made by such companies outlining the key policies, processes, and investments made by them to mitigate the occurrence of such instances. Any material lapse on this front can result in substantive liabilities, fines or penalties and reputational impact. Secondly, the social impact of the entity's operations and business practices (instances of mis-selling, pricing and collection practices) on its target borrower segment and geographies is an important consideration.

Governance Risks

A sound corporate governance structure attempts to clearly distinguish the power and responsibilities between the board of directors and the management. The constitution of an entity's board and the board's participation in strategy formulation, besides the entity's adherence to legal and statutory compliance requirements, are factored in during the credit assessment. ICRA seeks to gain a qualitative understanding of the entity's commitment towards following transparent and credible practices from the way its financial statements are reported, its level of disclosures, consistency in communication and the openness about sharing information during the credit rating exercise. Besides the corporate group structure (whether simple or complex), the rated entity's related-party transactions and instances of supporting group entities at the expense of debtholders are assessed.

Key Assessment Factors for ARCs

ARCs acquire stressed assets from banks, NBFCs, and financial institutions at pre-agreed terms and endeavour to resolve these assets through different methods. They are governed by the RBI and are registered under and follow the guidelines laid out under the SARFAESI Act, 2002 of the RBI.

The approach for rating ARCs is largely in accordance with the Rating Methodology for NBFCs, with similar broad parameters considered for the assessment of business and financial risks. Additionally, the rating approach includes the assessment of certain factors, which are distinctive of ARCs. For example, while evaluating the granularity of the assets under management (AUM), the ARC's acquisition policy in terms of preferred segments, the transaction size, and its approach towards debt aggregation and co-investment are understood. Similarly, for assessing an ARC's track record, ICRA also considers the entity's acquisitions as well as recovery/resolution performance over the years. The key parameters considered include the trend in acquisitions, redemption ratio (ratio of security receipts (SRs) redeemed to SRs issued), and recovery ratio (recovery to acquisition value). The goal is to assess these parameters at the overall AUM level as well as for the ARC's own share in the AUM.

The nature of the underlying assets (i.e. stressed assets) and the uncertainty associated with the resolution process can lead to variability in the ARC's cashflows. Thus, the ability of the ARC to maintain adequate liquidity, given the lumpy nature of cashflows, remains critical to ensure smooth operations. To assess an ARC's financial flexibility, ICRA also evaluates its ability to mobilise funds from a diverse set of sources and at competitive rates. In this regard, as the nature of the assets to be offered as collateral poses a challenge in raising funds, an understanding of the borrowing ability of the entity is sought in terms of its potential drawing power, basis the nature and rating distribution of the underlying assets. Similarly, while assessing the capitalisation profile of ARCs, the volatility of the cashflows and the relatively lower borrowing ability are also factored in.

While assessing the asset quality of an ARC, ICRA considers the recovery rating profile of the AUM and the company's share of the AUM (i.e. SRs held by the ARC). For an ARC, the valuation of its assets and its fee income are linked to the recovery ratings of the SRs. Thus, any adverse movement in the recovery rating profile of the portfolio can have a bearing on the ARC's financial profile. As a part of the resolution process for the underlying assets, particularly corporate assets, an ARC may extend funding to its portfolio companies (i.e. the corporate debtors acquired by the ARC from banks against which SRs have been issued). The assessment of the asset quality would continue to factor in the asset quality of these loans (portfolio composition, concentration, gross NPAs, NPA provisions, etc) akin to the rating approach for NBFCs. ICRA's analysis also factors in the recovery performance over the life of the SRs, the corresponding trend in fair valuation/impairments and the outlook for the same, besides observing the frequent modes of resolution/settlement adopted by the ARC. As the period for the realisation of assets acquired by ARCs can be extended up to 8 years, the assessment of the vintage of the assets is imperative. The higher the vintage, more likely is the possibility of impairments/write-downs in the ensuing period, subject to the accounting policy adopted by the entity. Thus, the ability to ensure adequate and timely resolution is of paramount importance for the sustenance of a healthy performance.

Summing Up

ICRA's credit ratings are a symbolic representation of its opinion on the relative credit risk associated with the entity and the instruments being rated. ICRA arrives at this opinion by conducting a detailed evaluation of the entity's business and financial risks and uses this evaluation to project its future financial performance in various scenarios. While several parameters are used to assess an NBFC's business, management and financial risks, an NBFC with a strong business and stable financial performance would be viewed more favourably than one with comparable or better financial numbers but with a weaker business profile.

ANNEXURE

Summary of Rating Factors and an Example to Illustrate the Key Building Blocks of a Credit Rating

Category	Sub-category	Strong	Comfortable	Adequate	Moderate	Weak
Operating and business risk	Business risk profile					
	Management, lending process/policy and systems					
	Operating environment					
Financial risk	Profitability					
	Capitalisation					
	Asset quality					
		Superior	**Strong**	**Adequate**	**Stretched**	**Poor**
Liquidity indicator	Liquidity					
		Enhance		**Neutral**		**Hinder**
Does this factor enhance or hinder the credit profile?	Parent/Group support					

FINAL RATING	**AAA**	**AA+**	**AA**	**AA-**	**A+**	**A**	**A-**	**BBB+**	**BBB**	**BBB-**	**BB+**	**BB**	**BB-**	**B/C Category**

The above graphic is only for illustration purpose and does not represent a rating output from a formulaic model. The ratings assigned by ICRA are determined by the Rating Committees based on both quantitative and qualitative considerations.

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ICRA Limited was set up in 1991 by leading financial/investment institutions, commercial banks and financial services companies as an independent and professional investment Information and Credit Rating Agency.

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