ICRA Nepal Rating Feature

ICRA Nepal's Credit Rating Methodology for Non-banking Finance Companies

RATING METHODOLOGY

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Non-banking finance companies (NBFCs) are institutions, which are engaged in limited banking activities and do not have a full-fledged banking licence. In the Nepalese context, companies that are involved in limited banking activities include investment companies, microfinance companies, lending intermediaries, etc, which have a licence from the regulator only for lending with specified conditions. This methodology also covers other institutions with limited banking activities. The NBFCs play an important role in the Nepalese financial market.

While the Nepal Rastra Bank (NRB) regulates both banks and NBFCs, there are some significant differences in the regulatory treatment. The NBFCs are given greater flexibility in operational matters and allowed to lend independent of priority sector targets and statutory reserve requirements. However, there are regulatory restrictions on the range of services that the NBFCs can offer and on their funding options. These include specific guidelines for NBFCs with activities in specific areas. Additionally, ICRA Nepal would follow the same process for the rating evaluation of any entity, which is not regulated by the Central Bank, undertaking a non-banking finance activity, as its risk profile could be similar to finance companies. However, ICRA Nepal would also look at the compliance of these entities with the Central Bank's regulations for finance companies.

Typically, NBFCs extend the following types of loans:

- Vehicle loans (for purchase of commercial vehicles, cars, tractors, two-wheelers, etc)
- Construction equipment loans
- Personal loans
- Loans against property
- Loans against shares
- Business loans

In rating an NBFC, ICRA Nepal evaluates the NBFC's business and financial risks, based on which it projects the level and stability of the NBFC's future financial performance in various likely scenarios. The ratings are determined on a 'going concern' basis rather than on a mere assessment of the assets and debt levels as on a particular date. The broad parameters for assessing the business and financial risks of an NBFC are presented below and discussed at some length in the following sections

1. **Business Risk**
   - o Business Mix
   - o Management, Systems and Governance Structure
   - o Franchise and Size
   - o Operating Environment

2. **Financial Risk**
    - o Profitability
    - o Liquidity
    - o Capital Adequacy
    - o Asset Quality

While several parameters are used to assess an NBFC's business and financial risks, the relative importance of each parameter 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 business cycles. Therefore, in this case, a higher weight would be given to the company's business risk profile rather than its financial performance. Further, an NBFC with a strong business profile and stable financial performance would be viewed more favourably than one with comparable or better financial numbers, but with a weaker business risk profile.

BUSINESS RISK

- **Business Mix**

ICRA Nepal evaluates an NBFC's business risk by thoroughly analysing, among other factors, the company's asset mix, customer mix, pace of growth, track record, and franchise. As some of these parameters are qualitative, ICRA Nepal tries to remove subjectivity in its analysis by capturing and assessing information on defined sub-parameters and by using these to make a comparison across various companies. This analysis also incorporates ICRA Nepal's assessment of the performance of various sectors through business cycles, its outlook on the economy, and its views on issues related to the operating environment.

The assessment of an NBFC's business mix involves evaluating its competitive position (ability to change the 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 diversification of its loan book.

As for the track record, this is evaluated in relation to completed business cycles. Thus, while a five- to six-year-old car finance company is considered to have a reasonable track record (the typical loan tenure being three to four years), a home finance company of the same vintage would be said to have an average track record (the typical loan tenure being 15 to 20 years). 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 that of another NBFC, which has a stable growth rate and has been growing within existing geographies with the same loan mix.

- **Management, Systems and Governance Structure**

Governance issues, quality of management, systems and policies, shareholder expectations and the strategy followed to manage these expectations along with the accounting quality are the building blocks for an NBFC's credit risk profile. 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.

The ownership structure could have a key influence on an NBFC's credit profile as a strong promoter and strategic fit with the parent can benefit an NBFC's earnings, 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, the shareholding pattern of the NBFC, the NBFC's operational synergies with its promoter, the level of involvement and commitment of the promoter in the NBFC, and the track record and willingness of the promoter in providing funding support.

All credit ratings 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 to understand the business objectives, plans and strategies, and views on past performance, besides the outlook on the industry. Some of the other points assessed are:

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

A careful evaluation of the risk management policies of the NBFC is conducted as it provides important guidance for evaluating the impact of events on the liquidity, profitability, and capitalisation of the company concerned. ICRA Nepal also evaluates the strategy and business plans of the NBFC along with the shareholders' expectations from the company. Although ICRA Nepal's ratings are for debt holders, meeting shareholders' expectations is important. Inability to do so could lead to a change in the company's strategy itself (to meet shareholders' expectations), which, in turn, could alter its credit profile.

ICRA Nepal believes that an appropriate governance structure is important to ensure that the powers given to the line managers are exercised in accordance with the established procedures and that they are in harmony with the broad policy guidelines and strategic objectives of the NBFC concerned. ICRA Nepal's evaluation of an NBFC's governance structure involves the evaluation of the structural aspects of the board and board-level committees, and the functioning of these committees. For instance, the internal auditors and audit committees are mutually supportive; it is essential for the audit committee to consider the work of the internal auditors to gain an understanding of the organisation's risk management processes and control systems, and of the areas that need strengthening.

Consistent and fair accounting policies are a pre-requisite for financial evaluation and peer group comparisons. The NBFCs are required to follow the accounting standards prescribed by the Institute of Chartered Accountants of Nepal. Further, the NRB has issued prudential norms specifying the accounting methods to be used for income recognition, provisioning for bad and doubtful advances, and valuation of investments. To evaluate the accounting quality, ICRA Nepal reviews the NBFC's accounting policies, notes to accounts, and auditor's comments in detail. Deviations from the Generally Accepted Accounting Principles (GAAP) are noted and the financial statements of the NBFC are adjusted to reflect the impact of such deviations.

- **Franchise and Size**

For an NBFC, its franchise strength determines its capacity to grow while it maintains reasonable risk-adjusted returns. It also determines the NBFC's ability to maintain the resilience of earnings, thereby facilitating the predictability of its future financial performance. It may be noted that an NBFC with a significant market share, and an NBFC, which is a niche player, can both have a defensible franchise[1], which could, in turn, benefit their individual credit profiles.

As for size, it is usually 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.

- **Operating Environment**

The operating environment has a significant bearing on an NBFC's credit rating as it can significantly impact its growth prospects and asset quality. In assessing the operating environment, ICRA Nepal 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.

The regulatory environment and changes therein could also impact the credit profile of NBFCs. Hence, all relevant regulatory framework is analysed. While a strong regulatory framework is a credit positive, frequent changes in regulations, which impact an NBFC's growth and profitability prospects, are viewed as credit negatives.

Intensity of competition has a significant bearing on an NBFC's credit profile as it can change the company's growth prospects, earnings and management strategy. ICRA Nepal's evaluation focuses on the current level of competition as well as the attractiveness of the segment for potential competition by evaluating the growth potential, entry barriers and risk-adjusted returns.

FINANCIAL RISK

- **Profitability**

An NBFC's ability to generate adequate returns is important from the perspective of shareholders as well as debt holders. The purpose of ICRA Nepal'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 changes in the operating and regulatory environment, the liquidity position and financial flexibility of the company, and its strategy. The NBFC's ability to complement its interest income with fee income is also assessed. A large fee income provides more diversification in the income stream, which, in turn, can improve the resilience of earnings, thereby improving an NBFC's risk profile. After assessing the income stream, ICRA Nepal evaluates the NBFC's operating efficiency (operating expenses in relation to total assets, and the

[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

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 indicators[2] are compared across peers. Importantly, a significantly high return on equity may not necessarily translate into a better credit rating, as the underlying risk could be very high as well and could therefore be more volatile or difficult to predict.

- **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 for an NBFC to manage its interest rate risk, as the same could impact its future profitability.

For assessing the liquidity profile, ICRA Nepal evaluates the liquidity policy of the NBFC, the maturity profile of its assets and liabilities, the resulting asset-liability maturity gaps, and the backup available to plug any gaps and meet future disbursement requirements. ICRA Nepal's evaluation also focuses on the diversity of the NBFC's funding sources and their quality (i.e. the availability of these sources in a stressful situation).

- **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 operating risk) is an important consideration for ratings. Riskiness of the product and portfolio granularity 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 riskiness of the product mix, as the following chart shows.

Risk Capital Requirement Matrix

		Expected credit losses and variability	
		Low	High
Portfolio Concentration	High	Moderate	High
	Low	Low	Moderately high

[2] *Profit after tax as a percentage of average total assets, and profit after tax as a percentage of average net worth*

ICRA Nepal starts with the adjusted capital (adjusted for deviations from GAAP) 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, a capital adequacy analysis is done for the individual business lines (including off-balance sheet portfolios) of the NBFC, and the aggregate capital required is compared with the actual capital available as well as the minimum capital the company is expected to maintain.

ICRA Nepal 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 the regulatory capital adequacy requirement is also evaluated.

- **Asset Quality**

The 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 of capital or provisions) to protect the debt holders from an unexpected deterioration in the 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 mix, risk appetite, availability of data to facilitate credit decision-making, and the track record of managing the loan book through lifecycles. The asset quality is also assessed for credit risk concentration, trend in viability of customers, trend in delinquencies (adjusted for the vintage of the book), gross NPA[3] percentage, net NPA percentage, and net NPAs in relation to net worth.

Diversification is an important consideration in the assessment of an NBFC's asset quality. It is generally evaluated in the context of loan mix, credit risk, portfolio granularity, geographical presence and borrower profile. High levels of diversification can shield an NBFC from a downturn in any segment. At the same time, diversification into riskier segments may not improve resilience and may therefore 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 factor, as is management depth and ability to adopt the skills and techniques needed to run different businesses.

As the asset quality indicators can vary, depending on the asset class, borrower profile, NPA recognition norms and the accounting policy for write-offs, comparing these indicators across NBFCs operating in different asset classes may not yield meaningful results. ICRA Nepal, therefore, compares the delinquency levels (at 0 days+, 30 days+, 60 days+, 90 days+) for the same asset class and borrower profile across players, after adjusting write-offs. When available, a static pool analysis is done as this gives a meaningful estimate of the losses at various stages of the loan cycle as well as of the overall lifetime losses and is free from the distortions caused by a high growth rate.

[3] *Non-performing assets*

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