# Ratings Methodology – Non Banking Finance Institutions

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A subsidiary of CARE Ratings Limited, India

**Background**
NBFIs have grown in stature over the years and have gained systemic importance in the Mauritius financial landscape with growing share in credit vis-à-vis banks. NBFIs operate in wide variety of asset classes ranging from granular retail loans (e.g., personal loans, vehicle loans, small business loans, gold loans, microfinance loans, etc.) to large-ticket wholesale loans (e.g., lending to corporates, infrastructure, real-estate and structured credit). NBFIs operate under the regulatory ambit of the Bank of Mauritius (BOM) and the level of regulation and supervision for NBFIs is relatively moderate when compared to banks. However, the regulatory requirements for NBFIs have been increasing in the recent past to structurally strengthen the sector, especially towards liquidity risk management. NBFIs have carved a niche for themselves in the Mauritius financial sector through their differentiated business models, credit appraisal methods targeting the relatively un-banked borrower segments with niche domain expertise, providing last mile credit delivery and significant usage of technology for achieving better operational efficiency and risk management. CareEdge Africa (CRAF) assigns ratings to various debt instruments and bank facilities of NBFIs based on this methodology.

**Methodology**
CRAFs' rating methodology for NBFIs is applied to companies registered as NBFIs with the BOM. This methodology highlights the parameters considered by CRAF for a standalone assessment of NBFIs. The final rating also factors in any additional notching that is applicable for parent/promoter group linkages which is done as per CRAFs' methodology of 'Factoring Linkages in Ratings'. The key parameters considered for a standalone assessment of NBFIs are depicted below. **The above-mentioned parameters are elaborated in the sections below.**

1. **Business Mix and Growth Trend**

   NBFIs lend to various retail loan segments such as personal loans, gold loans, microfinance, consumer loans, vehicle finance, housing loans, small business loans and wholesale loan segments like corporate loans, infrastructure loans, real estate loans, structured credit, etc. The business mix through different loan products offered by the NBFI is the key determinant of the risk and returns for the entity in conjunction with the operating environment. The prevailing economic scenario for the asset classes being financed has significant impact on the growth potential and asset quality of the NBFI.

   In case of retail NBFIs in particular, products offered are assessed on key parameters such as loan tenor, ticket size, yields and loan to value. Each parameter is seen in relation to the relevant asset class. For example, riskier asset classes like unsecured MSME loans tend to have higher yields.

   The proportion of unsecured loans in the outstanding advances is also considered along with the borrower segments and geographical diversification of the portfolio. Higher proportion of unsecured funding to the borrowers with marginal credit profile increases the vulnerability of the NBFI to change in business cycles. A higher geographical diversification is often viewed favorably as it limits the exposure to event-based risks in specific geographies, particularly in asset classes such as microfinance loans. In case of wholesale NBFIs, the sectors financed and major exposures are seen.

CRAF also looks at the trend in disbursements made by the NBFI in light of the economic scenario for the asset classes in which it operates. Inability to scale up operations may impact the future sustainability of the NBFI. The growth rate of disbursements also indicates the level of seasoning of the portfolio.

**2. Capital and Leverage**

The level of capital determines the ability of the NBFI to absorb losses arising out of its business activities and provides cushion to its lenders against such losses. Capital Adequacy Ratio (CAR) is a measure of the degree to which the company's capital is available to absorb unexpected loss; high CAR also indicates the ability of the company to undertake additional business.

While NBFIs are required to comply with a minimum CAR stipulated by BOM, CRAF looks at the management's approach towards maintaining a cushion over regulatory CAR in light of the asset-class mix of its lending portfolio along with the corresponding trend in delinquencies and portfolio concentration. Sensitivity analysis on the CAR of the NBFI is also carried out if required for various scenarios like increase in credit cost which may affect the CAR. A higher Tier I CAR is viewed favorably as it reflects the core capital of the NBFI.

CRAF also looks at the debt equity ratio of the NBFI as a leverage measure. NBFI's leverage is a function of its business mix, asset-class-wise growth potential, delinquency trends and portfolio concentration among other factors. While relatively higher leverage is acceptable for granular and stable asset classes like retail home loans, a lower leverage may be warranted for portfolios which are either more concentrated (e.g., Corporate or builder loans) or the ones which exhibit higher risk of delinquencies like Micro Finance loans, unsecured SME loans, etc. CRAF looks at leverage in light of these underlying factors along with any synergies derived from parentage or group linkages. In case of significant exposure to group entities, adjusted standalone leverage is calculated by reducing the amount of such exposure from the tangible networth of the entity.

Demonstrated ability of an NBFI to raise adequate equity capital from varied set of investors is viewed favourably. Similarly, demonstration of support to an NBFI through equity infusion by a strong promoter group or parent company is also viewed favourably. For NBFIs resorting to securitization of their assets, CRAF assesses leverage, asset quality and profitability on the basis of assets under management (AUM) by treating such off-balance sheet assets as on-balance sheet.

CRAF follows a consolidated approach when the group companies are engaged in similar business (lending) but operate through different entities due to different asset class and corresponding regulatory compliances to be followed. In such case, CRAF considers the capital adequacy of the holding company at standalone level as per regulatory requirements. Furthermore, overall gearing and Net NPA / Net worth ratios are analyzed to ascertain whether the entity has sufficient level of capitalization at the consolidated level.

3. **Asset Quality**

Asset quality is one the most critical parameters while assessing NBFIs. Asset quality is dependent on the asset class in which an NBFI operates. The business of NBFIs is to assume credit risk and earn a profit after factoring in the expected level of credit costs. Such credit costs depend on the nature of the asset class and are built into the pricing of loans in that segment. NBFIs strive to keep the credit costs in check within expected levels through efficient risk management, collection and recovery framework. Credit costs are primarily impacted by level of delinquencies observed in the loan portfolio. Worsening of the delinquencies in the loan portfolio not only suppresses profitability through higher credit costs, but also puts pressure on capital cushion available to absorb losses and can lead to restricted access to funds from the market resulting in subdued growth prospects. Given that NBFIs primarily are dependent on wholesale funding, worsening of key parameter like Gross NPA level can quickly and severely impact access to funds which in turn can threaten the viability of the operations of an NBFI.

The overall asset quality of NBFIs is assessed by evaluating the asset-class-wise exposures and Days Past Due (DPD) bucketing of the outstanding advances. In case of wholesale assets, large vulnerable exposures are evaluated since the same can impact capital position in case of stress. In case of retail loan book (vehicle, housing, SME, etc.), the empirical trend in delinquencies exhibited for the entity is examined for each retail asset-class and the same is also compared with the industry peers.

The historical collection efficiency and the company's experience of loan losses and write-off/provisions are studied. The portfolio diversification and exposure to vulnerable sectors is evaluated to assess the level of vulnerable assets. In case of high-ticket size loans like corporate or real estate loans, the top exposures are seen. The proportion of such wholesale loans in the overall portfolio is considered. Furthermore, such exposures are also viewed in relation to the company's net worth so as to assess the extent of concentration and vulnerability to any of the large exposures turning delinquent. The asset quality of individual product classes is viewed in tandem with the seasoning of the loan book. NBFIs with short track record would have seen limited seasoning of its portfolio so as to make any meaningful assessment of its steady state asset quality. NBFIs which report an aggressive growth rate of loan book year-on-year also have a large part of their loan book remaining unseasoned and hence assessment of its steady state asset quality becomes difficult. The gross NPA is looked at on a lagged basis to negate the effect of growth on the asset quality parameters.

Exposure to group entities, in the form of lending or investment, is examined to understand the loss potential of such assets. The same is subject to stress test in the same way as any other asset and the impact is evaluated on level of NPA and provisioning needs.

**4. Profitability**

CRAF analyses the composition of income of the company by segregating it into fee-based and fund-based activities. Core earnings are also identified by excluding non-recurring income from the total income. Each business area that contributes to the core earnings is assessed for risks as well as for its earnings prospects and growth rate. It is examined whether the interest yields are commensurate with the asset class and nature of operations.

Profitable operations are essential for NBFIs to operate as a going concern and generate internal capital which can be deployed for future growth. Historical trend in declaring dividend and the dividend policy is studied as this would determine the extent of profits retained and available for plough back in the business. Profitability is gauged through trend in return on total assets (ROTA) and return on net worth (RONW). The contributing factors to NBFI's profitability are assessed to study the overall impact. The ROTA chain (both on balance sheet and adjusted for off-book portfolio) is analysed through interest spread, net interest margin, other income, operating expenses and credit costs.

Interest spread and Net interest margin are determined by average yield earned on assets and average cost of funds raised by an NBFI. While interest rates charged on loans is a function of the asset class and NBFI's competitive positioning, interest expense is driven by the liability profile and borrowing mix of a NBFI. Apart from interest income, many NBFIs also have a fee income component which adds to the total income and is intended to cover up for operating expenses.

Operating expenses (opex) are dependent upon the nature of operations and business model deployed by a NBFI. Retail lending is generally more opex intensive as it involves setting up branches and deploying manpower for various functions like origination, underwriting and collections. On the contrary, opex is relatively low for wholesale lending operations. Within retail lending also, some products require higher opex vis-à-vis others. The trend in the Pre-Provisioning Operating Profit earned by the NBFI is observed. Ratios, such as, Operating Expenses/Average Total Assets and Cost to Income (net of Interest expenses) are looked at in order to understand its impact on the overall profitability of a NBFI.

Finally, the credit cost is driven by provisioning and write-offs made by the NBFI and is dependent on the asset quality of the underlying portfolio. The overall impact of the above factors on the RoTA is studied to gain an understanding about profitability. Furthermore, the RoNW is also looked at and is impacted by the extent of leverage of an NBFI.

**5. Liquidity**

Lack of liquidity can lead an NBFI towards failure, while, strong liquidity can help even an otherwise weak company to remain adequately funded during difficult times. CRAF evaluates the internal and external sources of funds to meet the company's requirements. The liquidity risk is evaluated by examining the stated liquidity policy, the assets liabilities maturity (ALM) profile, collection efficiency, deposit renewal rates (based on empirical evidence) and proportion of liquid assets in relation to its total borrowings. The contractual liabilities like commercial papers, short-term loans are not assumed to be rolled over. The short-term external funding sources in the form of unutilized lines of credit available from banks, etc., along with direct and other investments if any are important sources of reserve liquidity. While considering unutilized bank lines as back up, the availability of such lines is also assessed in a scenario of change in sentiments towards the sector or the promoters or due to overall tight liquidity scenario in the system.

CRAF looks at the debt repayment obligations of NBFI over the next 12 months and the extent to which cash and liquid assets are available to cover it. Further, the scheduled inflows from credit assets (adjusted for collection efficiency) over the next 12 months are compared with the 12-month debt obligations to arrive at a cover based on such asset inflows. For NBFIs running a negative ALM mismatch in 1-year bucket, such cover will tend to be below 100%, thereby increasing the refinancing risk. A stress test on the inflows is also done to evaluate the impact on liquidity in case the contracted inflows are lower than expected.

In case there are significant inflows considered from group entities, the possibility of rescheduling of such inflows and the liquidity profile of the borrower is evaluated considering that the lender may require the continue to support the group entity. This may result in the cash flow being delayed, impacting the ALM profile of the NBFI.

From liquidity perspective, NBFIs adopting a liability maturity profile which is consistent with the asset maturity are viewed favourably. Any negative mismatch without proper backup is viewed as a risk. In case of entities belonging to large groups, demonstrated support from group will be considered as backup.

In case of presence of any acceleration clauses embedded in borrowing agreements with lenders/investors which are linked to downgrade in external credit ratings, the ALM profile of an NBFI can be severely distressed in case of such rating downgrades. CRAF, in its assessment of liquidity, does not take into account the presence of such rating-linked acceleration clauses. However, NBFIs have witnessed severe liquidity mismatches in such events which have translated into sharp deterioration in their liquidity profile upon trigger of such clauses. In such cases, the ratings will see a much sharper migration than otherwise.

**6. Resource Profile**

Resource base of the NBFI is analysed in terms of cost and composition. Proportion of deposits/ loans/ bonds in funding mix is examined along with the investor type CRAF also looks at the trend of raising resources through securitisation. The ability to diversify funding sources is a key factor in rating of NBFIs. Generally, the entities having major funding from different segments of the capital markets and overseas markets are considered having better diversification of resources. Average as well as incremental cost of funds are examined in the context of prevailing interest rate regime. The ability of the company to raise additional resources at competitive rates is considered. Stability of sources of finance and trend in funding mix is also an important indicator of the resource raising ability of the NBFI. The managements' strategy for funding is examined in light of its appropriateness with its growth strategy, the assets class, maintaining buffer / head room for raising capital in the form of securitisation, tier II capital, etc. The funding mix should be prudent to the nature of assets.

**7. Management & Systems**

The track record of the promoters, experience of the management team and the organizational structure of the company are considered. If the shareholding of the company is fragmented without a clear majority, it would entail further analysis on commitment of the individual shareholders to support the company.

The company's strategic objectives and initiatives in the context of resources available, its ability to identify opportunities and track record in managing stress situations are taken as indicators of managerial competence. Market reputation of the promoters of an NBFI is also a key factor in its ability to access various funding sources at competitive rates. Adequacy of the information systems used by the management is evaluated. CRAF focuses on modern practices and systems, level of technology deployed, capabilities of senior management and personnel policies. In case of shared resources by group companies, the strength and quality of group cos/businesses is considered while assessing the management strength. Furthermore, the proven capabilities of the NBFI in its asset class and peer group is also examined.

The management's stance (both stated and exhibited) on risk and risk management framework is considered. Credit risk management is evaluated by assessing the appraisal, monitoring and recovery systems and prudential lending norms of the company. The company's policy on liquidity risk and interest rate risk is considered. CRAF looks at the track record of the company in complying with regulatory requirements of BOM.

**8. Size, Vintage & Market Presence**

Size is reflected through the level of capital and level of total assets of a NBFI. Large size would generally be associated with long operating track record, significant market presence, demonstrated ability to raise resource from varied source and asset quality and profitability performance established over time through the cycles. Management's strategy for profitable growth and their ability to navigate through difficult business environment is better assessed for an NBFI which has a long track record of operations and has grown to a relatively large size. While large size by itself is not a direct determinant of ratings, it does provide an indication of the competitive strength and financial flexibility of a NBFI. Large NBFIs can have a diversified portfolio or could be a sizeable player in a single asset class. In either case, the ability to compete and generate risk-adjusted returns over time is better gauged for NBFIs which have a long track record.

CRAF looks at the market position of the NBFI in individual asset classes and an understanding about its competitive position is developed. Market presence is gauged through the extent of its branch network and geographical spread of operations.

Track record of an NBFI in a given asset class is viewed in order to assess the experience of the company in operating in a given asset class and its ability to perform steadily through various asset cycles. Portfolio seasoning is critical for assessing the asset quality and profitability parameters on a steady state basis. NBFIs with low vintage or very rapid growth in loan book lack adequate portfolio seasoning and may not reflect steady state asset quality and profitability parameters. Hence, vintage is an important parameter which is considered while assessing critical parameters like asset quality and profitability.

**Additional Considerations**

- **Peer Group Analysis**

CRAF analyzes various financial and non-financial parameters of an NBFI under the overall framework mentioned above. The quantitative factors are evaluated based on the absolute level of numbers and ratios as well as their volatility and trends exhibited over time. CRAF also compares the company's performance on each of the above-discussed parameters with its peers. Detailed inter-firm analysis is done to determine the relative strengths and weaknesses of the company in its present operating environment and its prospects.

- **Market-based Indicators**

CRAF tracks market-based indicators like market capitalization and price/book value for equity-listed NBFIs and compares the same with other listed NBFIs to gain a sense of relative valuation as viewed by equity market. Furthermore, CRAF also keeps a track of bond yields and spreads of NBFI debt instruments in order to gain an understanding of the markets view about its risk perception. Reasons for sharp changes in yields vis-à-vis similarly rated peers are examined. CRAF tracks these market indicators so as to understand the market's perception of the value and risk of a NBFI and also to assess the ability of the NBFI to raise resources (equity & debt) at competitive rates to support its business model.

CRAF looks at various financial ratios while analyzing NBFIs. The description of such ratios can be found in the 'Financial Ratios – Financial Sector' document on CRAFs' website.

**Criteria for Rating of Subordinated Debt of NBFIs**

CRAF generally does not differentiate between the rating of senior and subordinated debt of a NBFI. This is on account of the inherent features of the subordinated debt as highlighted below.

- A subordinated debt instrument functions exactly similar to a senior debt instrument in a going concern scenario, i.e., servicing of the same (principal as well as interest) is purely cash-flow driven. The servicing of this instrument is not dependent on presence of profits or maintenance of any minimum capital adequacy parameter by the borrowing entity (unlike the case with other instruments like Upper Tier II or Innovative Perpetual debt issues by the banks).
- Similar to other senior debt instruments, e.g., Non-Convertible Debentures (NCDs), there are no regulatory restrictions with respect to servicing of a subordinated debt instrument in a going concern scenario. These instruments are in nature of medium to long-term instruments and are required to be issued for a minimum five-year tenor to qualify for capital adequacy computation.
- The instrument derives its "subordinated" nature only in the event of liquidation of the issuer, wherein it would rank lower to the claims of other senior creditors. This would affect the loss given default (LGD). However, it would not lead to any difference in the probability of default (PD) between Senior and Subordinated instruments.

The seniority of claim of a Senior Debt over Subordinated Debt comes into picture only in case of a liquidation scenario and on a going concern basis the repayments for both types of debt instruments happens simultaneously and is a matter of liquidity risk. For highly rated NBFIs and HFCs, the liquidity risk is typically minimal. Therefore, the long-term probability of default for Senior and Subordinated debts of a company are similar and the same should reflect in their long-term ratings. However, CRAF may choose to differentiate between senior and subordinated debt on a case-to-case basis on the basis of credit strength, liquidity profile and any issuer-specific circumstances that may prevail.

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**About:**

CareEdge is a knowledge-based analytical group that aims to provide superior insights based on technology, data analytics and CARE Ratings (Africa) Private Limited (CRAF) is the first credit rating agency to be licensed by the Financial Services Commission of Mauritius in May 2015. It is also recognized by Bank of Mauritius as External Credit Assessment Institution (ECAI) from May 2016. CRAF is also licensed by Capital Markets Authority of Kenya to operate as a Credit Rating Agency in Kenya. CRAF intends to expand across other geographies in Africa with Mauritius as its hub of operations. With an equitable position in the Mauritius capital market, CARE Ratings (Africa) Private Limited provides a wide array of credit rating services that help corporates to raise capital and enable investors to make informed decisions backed by knowledge and assessment provided by the company.

CRAF's shareholders are CARE Ratings Limited, African Development Bank, MCB Equity Fund and SBM (NFC) Holdings Limited.

CRAF gets its technical support in the areas such as rating systems and procedures, methodologies, etc. from CARE Ratings Limited on an ongoing basis. CARE Ratings Limited, with an established track record of rating companies over almost three decades, follows a robust and transparent rating process that leverages its domain and analytical expertise backed by the methodologies congruent with the international best practices.

CRAF's Rating Committee consist of full-time members comprising of Senior Rating officials from CARE Ratings Limited and a panel of experienced professionals from Mauritius and African Development Bank.

CRAF has had a pivotal role to play in developing bank debt and capital market instruments including MMIs, corporate bonds and structured credit.