CRISIL
An S&P Global Company

Criteria for rating hybrid instruments issued by NBFCs/HFCs

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Executive summary

Non-banking financial companies (NBFCs) and housing finance companies (HFCs) have been raising additional capital through perpetual debt instruments or upper Tier II bonds (referred to as hybrid instruments) since fiscal 2009.

The risk features of hybrid instruments are similar to those of upper Tier II bonds issued by banks under Basel II. However, these instruments carry added risks because they are restricted from debt servicing if the capital adequacy ratio (CAR) falls below the regulator-stipulated minimum. Also, in the event of losses or insufficient profits, NBFCs and HFCs are required to seek the approval of the Reserve Bank of India (RBI) and National Housing Bank (NHB), respectively, to service these instruments.

The rating of hybrid instruments starts with the assessment of the credit quality of the NBFC or HFC—through the corporate credit rating that is normally the same as the rating assigned to its senior bonds, bank loan facilities, or lower Tier II bonds. The hybrid instruments are then tested for additional risks to determine whether the rating should be the same as, or lower than, the corporate credit rating. Earlier, the extent of notch-down from the corporate credit rating used to be higher for NBFCs than for banks, given the potential risk that the regulatory approval for debt servicing may not be as easily forthcoming for NBFCs as for banks.

However, the extent of a notch-down for NBFCs was subsequently lowered or aligned closer to the framework used for bank hybrids because of the increasing systemic importance of NBFCs, measures to align their regulatory framework with those of banks, and recent instances of NBFCs receiving regulatory approval for servicing their hybrid instruments even in the event of losses.

CRISIL Ratings factors in the additional risks by evaluating the cushion in CAR that NBFCs and HFCs maintain over the regulator-specified minimum, their expected growth rates over the medium term, asset quality position, asset composition, and financial flexibility.

Scope

This criteria[1] document covers the rating methodology for hybrid instruments issued by NBFCs and HFCs.

Background and comparison with Basel II

The features of hybrid instruments that can be issued by NBFCs and HFCs are broadly similar to those of upper Tier II bonds issued by banks under Basel II, and are subordinated to depositors and general creditors as Table 1 indicates.

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[1] *Link to previous criteria:* https://www.crisil.com/content/dam/crisil/criteria_methodology/financials/archive/criteria-for-rating-hybrid-instruments-of-nbfcs-and-hfcs-dec2019.pdf

Table 1: Comparison on features of hybrid instruments

Key aspects	Banks (Basel II upper Tier II instruments)	NBFCs (perpetual debt instruments)	HFCs (upper Tier II bonds)
Maturity	Minimum maturity of 15 years	Perpetual	Similar to upper Tier II instruments for banks
Seniority of claims	Supersede those of investors in instruments eligible for Tier I capital, but subordinated to the claims of all other creditors	Claims of holders of these instruments will supersede those of equity shareholders, but subordinated to the claims of all other creditors	Similar to upper Tier II instruments for banks
Deferability	Servicing of these instruments to be deferred if CAR is below, or such payment results in CAR falling/remaining below, the regulatory minimum	Similar to upper Tier II Instruments for banks	Similar to upper Tier II instruments for banks
Capital treatment	Upper Tier II instruments and other Tier II capital should not exceed 100% of Tier I capital	Eligible for inclusion as Tier I capital—up to 15% of the Tier I capital. The quantum of hybrids in excess of this will be treated as Tier II capital within the eligible limits.	Similar to upper Tier II Instruments for banks
Regulatory requirements for dividend and/or interest payments[2]	CAR is to exceed the regulator-specified minimum	Similar to upper Tier II instruments for banks	Similar to upper Tier II instruments for banks
	In the event of losses, all debt servicing will need the RBI's approval	Similar to upper Tier II instruments for banks	In the event of losses, all debt servicing will need NHB's approval

Closer alignment of notch-down framework for bank hybrids

The criteria for upper Tier II instruments for banks stipulates a notch-down—by 0-3 notches—from the corporate credit rating, depending on factors such as current and expected Tier I and total CAR of the bank, the regulator-specified minimum, and ability to raise capital (refer to *CRISIL Ratings' criteria for hybrid capital instruments issued by banks under Basel II guidelines*).

While the hybrid instruments of NBFCs and HFCs have features similar to the upper Tier II instruments of banks, the notch-down framework differed till recently. That was because in the event of losses, regulatory approval could be accorded to NBFCs and HFCs on a selective basis for servicing these instruments, even if the CAR exceeded the regulatory requirement. Numerous developments in recent years, however, indicate a need for closer alignment of the notch-down framework for these companies to that of the upper Tier II instruments of banks:

[2] *The risk of non-payment of principal and interest on these instruments is linked to the CAR of NBFCs and HFCs falling below the regulatory minimum threshold. Payment on these instruments also requires regulatory approval in the event of a loss.*

1. NBFCs have grown considerably in size and scale, and have, therefore, gained importance in the financial system.
2. The regulator, the RBI, has also sought to increasingly align the regulatory framework for NBFCs with that of banks. Over the past few years, the RBI has introduced changes, such as the following, in the regulatory guidelines for NBFCs:
    - Minimum Tier I capital requirement for deposit-accepting NBFCs and systemically important non-deposit-accepting NBFC is 10%
    - Provisioning on standard assets should be done on the basis of asset category (as per the RBI's regulation) which might range 0.25-2.0%
    - CAR required for NBFCs and HFCs is 15%
    - Guidelines on liquidity risk management framework for NBFCs were introduced; the framework is closely aligned to the liquidity risk management framework in Basel III

The RBI has also allowed a leading NBFC that reported losses, but had maintained CAR above the regulator-specified minimum, to service its hybrid instruments. CRISIL Ratings, therefore, believes most NBFCs will get the regulator's approval to service their hybrid instruments even in the event of losses, subject to maintaining CAR above the regulatory requirement. The notch-down framework for hybrid instruments issued by NBFCs, therefore, is aligned closer to that used in rating bank hybrids.

Methodology for rating hybrid instruments of NBFCs and HFCs

Rating on lower Tier II instruments

CRISIL Ratings' approach on hybrid instruments to be issued by NBFCs and HFCs starts with an assessment of their credit quality—as indicated by their ability to meet obligations. Lower Tier II bonds (usually referred to as subordinate debt) issued by these companies have no restrictions on servicing instruments linked to their CAR or profitability, and therefore have no loss-absorption capacity. The rating on these instruments is, therefore, equated to the corporate credit rating of the NBFC or HFC.

The methodology for arriving at the corporate credit rating of NBFCs and HFCs is based on a comprehensive study of the risks involved in their business. This requires analysis of the capitalisation level, asset quality, earnings profile, market and liquidity positions, resource profile, and management quality *(refer to CRISIL Ratings' criteria for finance companies)*. Support of the parent or group is also factored in to arrive at the corporate credit rating: such support is assessed by evaluating the economic rationale and moral obligation of the parent to support the subsidiary *(refer to CRISIL Ratings' criteria for notching up standalone rating of companies based on parent support).*

Analysing risks associated with hybrid instruments of NBFCs and HFCs

The hybrid instruments are evaluated for inherent risks such as the following:

- **CAR falling below the regulator-specified minimum:** NBFCs and HFCs have to maintain CAR (15% for NBFCs and HFCs) as specified by the regulator. If CAR falls below the regulatory requirement, companies may not be allowed to service their hybrid instruments even if they have adequate resources to do so. As per CRISIL Ratings' criteria on recognition of default, an event resulting in non-servicing of hybrid instruments on a timely basis constitutes default.
- **Servicing instruments in the event of loss:** NBFCs and HFCs will need to get an approval from the RBI and NHB, respectively, to service their hybrid instruments in the event of losses, even though their CAR meets the regulatory requirement.

In recent years, the RBI has permitted several banks and a leading NBFC to service their regulatory capital instruments despite reporting losses. The approvals were granted where the CAR exceeded the regulatory requirement (9% for banks, and 15% for NBFCs and HFCs). It is, therefore, likely that the RBI/NHB will allow most NBFCs and HFCs to service these instruments even in the event of losses or inadequate profits, subject to maintaining CAR as stipulated.

Therefore, the primary risk in hybrid instruments is of non-payment if CAR falls below the regulatory requirement in the event of loss.

Framework for rating hybrid instruments of NBFCs and HFCs

CRISIL Ratings' approach to rate hybrid instruments begins with assessment of the corporate credit rating, or rating on the lower Tier II bonds and subordinate debt of the NBFC or HFC. This rating acts as the cap for the rating on hybrid instruments, as events forcing default on lower Tier II bonds will invariably affect the payment on hybrids. The rating will then be notched down or equated with the corporate credit rating depending on an assessment of the following:

- **The cushion in CAR above the regulator-specified minimum for the NBFC or HFC:** The expected cushion will be validated against any historical volatility in CAR, and factors such as growth plans and a possible erosion in capital due to deteriorating asset quality or very high losses. The proportion of Tier II capital maintained over a period of time will also be factored in.
- **Financial flexibility of the NBFC or HFC:** This will be driven by factors such as the extent of parental support, valuations, return on equity, current shareholding pattern, ability and willingness of the promoter to dilute its stake, and demonstrated access to capital markets. These factors help assess the ability to raise capital and improve the cushion in CAR over the regulatory requirement.

The rating of hybrid instruments for most NBFCs and HFCs will be a notch lower than the corporate credit rating. However, the rating may be equated with the corporate credit rating, or even be significantly lower (by up to three notches) in exceptional circumstances, depending on the capital buffer and financial flexibility.

Conclusion

CRISIL Ratings recognises the unique credit risks associated with the hybrid instruments issued by NBFCs and HFCs. The extent of notch-down in rating from the corporate credit rating will depend on the financial flexibility of these companies and the cushion in CAR above the regulatory requirement.

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