Journal of Advances and Scholarly Researches in Allied Education

Vol. IV, Issue VII, July-2012, ISSN 2230-7540

RISK ASSESSMENT FOR ASSET FINANCING NBFCS

Journal of Advances and Scholarly Researches in Allied Education
Vol. IV, Issue VII, July-2012, ISSN 2230-7540

Risk Assessment for Asset Financing NBFCs

Ashutosh Saxena

Research Scholar, Faculty of Commerce & Management, CMJ University, Shillong, Meghalaya

Abstract – Non-banking financial companies (NBFCs) form an integral part of the Indian financial system. The history of the NBFC Industry in India is a story of under-regulation followed by over-regulation. Policy makers have swung from one extreme position to another in their attempt to set controls and then restrain them so that they do not curb the growth of the industry. Most of NBFCs' are operating with high risk of lending and more often NBFCs' lend credit to Small and Medium size enterprises, which are categorized as high risk class of Assets. This paper aim is to Assess Risk for NBFCs' based on both qualitative and quantitative aspects of the client.

Keywords: - NBFC, Asset Financing, Risk, Credit Rating

---------------------------♦----------------------------

Non-Banking Finance Companies (NBFCs) accomplish various functions and provide a variety of financial services to individuals, businesses, and organizational customers. They play an extremely fundamental role in the economic growth of any country. Non-banking financial companies (NBFCs) form an integral part of the Indian financial system. The history of the NBFC Industry in India is a story of under-regulation followed by over-regulation. Policy makers have swung from one extreme position to another in their attempt to set controls and then restrain them so that they do not curb the growth of the industry. Non-banking financial companies (NBFCs) have seen considerable business model shift over last decade because of regulatory environment and market dynamics.

In the early 2000s, the NBFC sector in India was facing following problems:

1) High cost of funds

2) Slow industrial growth

3) Stiff competition with NBFCs as well as with banking sector

4) Small balance sheet size resulting in high cost of fund and low asset profile

5) Non performing assets

Majority of NBFCs were not able to face the pressure created on and were wiped out. However, since FY2001-2002, there has been significant improvement in the business model of existing NBFCs with improvement in overall business environment. NBFCs have been able to expand their resource profile by diversifying the funding avenues. Further a strict control on asset quality and overheads, coupled with use of innovative borrowing tools such as securitization has resulted in improved profitability of NBFCs. In today's scenario NBFCs (Non Banking Financial Companies) are facing a lot of competition from the banking sector nationalized as well as from the foreign banks. In liberalized economy, service differentiation has become insignificant and companies are trying to differentiate their offer by various augmentations in the service level.

The relatively lucrative spreads in the retail financing market will attracts both banking companies and NBFCs, thus intensifying competition and in turn bringing pressure on spreads. However, for the public sector banks to emerge as serious competition for the top-rated NBFCs, significant changes in the way they operate are a must. Otherwise, the public sector banks can only chip away at their market share in non-metro locations, not take it over entirely. Current commercial vehicle and construction equipment financing is quite crowded with lots of financing companies coming into this line. The list includes ICICI, HDFC Bank, Kotak Mahindra Finance, Cholamandalam Investment & Finance, Sundaram Finance, LGF, Tata Finance, Citi Corp, Sivagami Finance & Investments, Ashok Leyland Finance Limited, and Centurion Bank Limited being the active partners in this sector. Only smart financing option and service level are a positive influence.

The commercial vehicles financing segment is a large proportion of the financing market. For NBFCs, commercial vehicles financing account for a much larger proportion of their disbursements. After a few moribund years, activity in the commercial vehicle market has picked up. This is reflected in the growth in disbursements of NBFCs too.

The interpretation of the word 'risk' will determine the approach to risk management. The word 'risk' is interpreted in three distinct senses namely risk as hazard, risk as opportunity, and risk as uncertainty.

Risk as hazard is the most commonly used meaning of risk and it means likely financial losses arising from negative events such as control failures, bad publicity, and loss of reputation. Risk management in this context would mean eliminating possibilities of losses from such negative events by putting in place adequate control systems. Risk is as an opportunity means, taking risks, and earning adequate returns on them. This implies the trade-off between risk and return. Here risk management, becomes risk optimization meaning maximizing the upside potential and minimizing the downside. Here capacity and ability to manage risk is used to increase shareholders' value and achieve a competitive advantage.

Risk, as uncertainty is basically a statistical concept, which assumes a normal distribution for future outcomes. Here risk management means narrowing the difference between the expected outcomes and actual results. Banks need to manage the risk inherent in the entire portfolio as well as the risk in individual credits or transactions. The effective management of risk is a critical component of a comprehensive approach to risk management and essential to the long-term success of any banking organization. In simple words, risk is the possibility of losses associated with decrease in the credit quality of borrowers. In a bank, loss may stem from default due to inability or unwillingness of a customer to meet his commitments in relation to lending, trading, settlement and other financial transactions. A default reduces the present value of the loan and consequently the value of the bank’s business. Thus, it is imperative that banks have a robust risk management.

To aid the assessment process and to systematize the entire process, key for assessment has been developed in consultation with people well versed in this field. The key will not only quicken the assessment, but also standardizes it. The parameters in each risk category should be analyzed based on the key and must be given a score. The scores should be multiplied with the weights assigned, in proportion to the importance of the parameter, to arrive at an aggregate for each risk category.

Each risk category is measured separately and is also expressed as a percentage, which would help to measure the risk easily. After calculating the risks under each category, they must be summed up and the grand score will be on 1000. To get a single point indicator of the risks, it is divided by 10 and expressed as a score on 100. Based on the final score the company is given a rating by referring to the scoring guide of the model. As mentioned earlier, the grades used in the internal risk grading system should represent, without any ambiguity, the default risks associated with an exposure.

We can employ a numeric rating scale. Numeric scales developed are such that the lower the risk, the lower is the rating on the scale. The rating scale consists of 6 levels, of which levels 0 to 2 represents various grades of acceptable credit risk and levels 3 to 5 represents various grades of unacceptable credit risk associated with an exposure. The scale, starting from "0" (which would represent lowest level credit risk and highest level of safety) and ending at "5" (which would represent the highest level of credit risk and lowest level of safety), is deployed to standardize, benchmark, compare and monitor credit risk associated with the bank's loans and give indicative guidelines for risk management activities.

Conclude the risk calibration on the Risk Assessment Scale the amount of risk assessed and that now experienced in respect of these customers were found to be the identical. Customers with high scores and low risk have been prompt payers on the other hand; those with low scores and high risk were found to be defaulters with at least two dues against their names.

The following are the key findings based on the study:-

• The qualitative measures interest the bankers more than the quantitative measures.

• Liquidity risk or the inability of the prospect to meet the immediate liability is considered most significant of all kinds of risks.

• While credit or the willingness of the customer to repay falls in line next, the operational efficiency is rated third in vitality.

• Statement showing financial position rated as top quality information provider.

• Credit investigation and interview with customers are also known to provide reliable information.

REFERENCE:-

1. Chabra T.N. “Human Resource Management” 5th Edition, 2004.

2. Bolar, Malati, (1979) “Performance Appraisal” Vikas publishing house, New Delhi.

3. Acerbi, Carlo and Dirk Tasche, “On the coherence of expected shortfall,” Journal of Banking and Finance,2002.

4. Artzner, Philippe, Freddy Delbaen, Jean-Marc Eber, and David Heath, “Coherent Measures of Risk,”Mathematical Finance, 1999.

5. Basel Committee on Bank Supervision, “Credit Risk Modelling: Current Practices and

Applications,"Technical Report, Bank for International Settlements 1999.

6. Billingsley, Patrick, Probability, and Measure, third ed., New York: John Wiley & Sons, 1995.

7. Tripati P.C., Reddy P.N. "Principal of Management" Tata McGraw-Hill.