FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms IIFL Finance at 'B+'; Removes Rating Watch Negative; Outlook Stable

Mon 04 Nov, 2024 - 3:22 AM ET

Fitch Ratings - Singapore - 04 Nov 2024: Fitch Ratings has affirmed India-based IIFL Finance Limited's Long-Term Issuer Default Rating (IDR) and medium-term note programme rating at 'B+', and removed the ratings from Rating Watch Negative. The Outlook on the IDR is Stable.

This follows the company's announcement that the Reserve Bank of India had lifted regulatory restrictions on IIFL Finance's gold-backed lending business in late September 2024, and the receipt of information indicating a gradual return of funding to support new disbursements in gold-backed loans and other products.

KEY RATING DRIVERS

Gradual Business Stabilisation: The affirmation and Stable Outlook reflect our expectation that IIFL Finance's franchise will gradually stabilise now that the regulatory ban on new gold-backed lending has been lifted. Funding towards the gold-backed lending entity remains tentative, which could continue to restrain growth in the product. Nonetheless, funding volume for the housing finance and microfinance subsidiaries has been more resilient, which should support the credit profile of the consolidated group, even if it does not quickly regain its past scale and scope.

Lifted Sanctions, Improved Compliance: The removal of the regulatory embargo suggests that IIFL Finance has adequately addressed the Reserve Bank of India's concerns on its gold-backed lending practices. Risk and compliance standards are therefore likely to have improved. The company has also introduced new risk and compliance personnel, which may further strengthen controls and oversight.

Nonetheless, we believe corporate risk culture takes time to develop and overall risk and compliance standards may not yet be commensurate with that of the highest-rated local peers rated by Fitch.

Moderate Asset Quality Pressure: We expect ongoing weakness in the SME and microfinance sectors to exert further pressure on the group's asset quality. Higher impairments in the two segments led to an uptick in the reported gross non-performing asset ratio, to 2.4% in the second quarter of the financial year ending March 2025 (FY25) (FY24: 2.3%).

Ongoing Impairment Risk: IIFL Finance's moderate reported non-performing assets ratio partly reflects its practice of disposing of problem loans through bad debt sales. Nonetheless, the group retains exposure to the credit risk, as the sales are on deferred payment terms, with receivables linked to underlying recoveries and reported as investment assets. The problem asset ratio, including such receivables, remains elevated and poses impairment risk. The company incurred a INR5.9 billion provision on some problem-asset receivables in 2QFY25, equivalent to 1.3% of ending on-book loans.

Profitability Hinges on Loan Stabilisation: Profitability should gradually recover if lending volume strengthens. Pre-tax profit remained positive in 1HFY25, at around 1.0% of average assets on an annualised basis, despite a quarterly net loss in 2QFY25 on depressed lending volume and large problem-asset provisions. Sustained profitability in the housing finance and microfinance subsidiaries should underpin group profitability if the gold-backed lending business does not recover meaningfully.

Capitalisation Supports Loss Absorption: IIFL Finance's improved capitalisation amid a declining loan portfolio underpins its capacity to absorb unexpected losses. This helps to offset the impairment risk from weakening microfinance and SME asset quality as well as legacy problem assets.

The standalone Tier 1 regulatory capital ratio of 20.1% remained meaningfully above the 10% regulatory minimum, while moderate debt/equity of 2.9x at end-2QFY25 represented acceptable asset coverage of liabilities. Nonetheless, capital buffers could reduce if the company expands aggressively to recapture its diminished loan portfolio.

Funding Remains Confidence Sensitive: Funding volumes remain below pre-regulatory ban levels, despite some improvement in key business lines, particularly the housing finance and microfinance subsidiaries. Ambitious growth ahead of funding volumes would pressure the liquidity buffer, as seen by the 2QFY25 decline in liquid assets as the company deployed funds to new lending.

Adequately Match Asset-Liability Maturities: IIFL Finance's positive asset-liability maturity position supports its ability to meet upcoming debt maturities and provides some surplus for new lending. We expect IIFL Finance to manage its liquidity position carefully as it ramps up loan disbursals.

RATING SENSITIVITIES

Factors that Could, Individually or Collectively, Lead to Negative Rating Action/Downgrade

-- Further significant regulatory or operational events that weaken market confidence in the company

-- Prolonged pressure on the liquidity buffer as the company resumes gold-back lending, such that available liquid assets continue to fall short of three months' upcoming debt repayments without a clear path to improvement

-- Sustained weakened funding access, such that loans-under-management continue to decline over the next one to two years

-- Persistent earnings pressure, such that Fitch projects pre-tax profit/average assets to remain below 1.5% (FY23: 4.3%) for a sustained period

-- Excessive growth, particularly towards riskier loan profiles, or a significant deterioration in problem loan exposures

Factors that Could, Individually or Collectively, Lead to Positive Rating Action/Upgrade

Positive action is unlikely in the near-term in light of the recent regulatory findings. In the longer term, positive action may be possible with the following:

-- Significant progress in resolving the problem asset portfolio and tightened management of loan delinquencies, such that Fitch expects the problem asset portfolio to remain below 5% of gross loans and other credit exposures

-- A liquidity buffer consistently in excess of three months' upcoming debt repayments, and projected liquidity inflows remaining sufficient to cover 12 months' upcoming debt maturities under Fitch's stress scenario

-- Fitch expecting the four-year average pre-tax profit/average assets to remain above 2%, with debt/tangible equity to remain below 6x

DEBT AND OTHER INSTRUMENT RATINGS: KEY RATING DRIVERS

The US-dollar senior secured medium-term note programme is rated at the same level as IIFL Finance's Long-Term Foreign-Currency IDR, in line with Fitch's rating criteria. The debt of Indian non-bank financial institutions (NBFIs) is usually secured and we believe non-payment of the senior secured debt would best reflect the entity's uncured failure. NBFIs can issue unsecured debt in the offshore market, but such debt is likely to form a small part of total funding and cannot be viewed as the NBFIs' primary financial obligations. There is no longer any debt outstanding under the programme.

DEBT AND OTHER INSTRUMENT RATINGS: RATING SENSITIVITIES

Any change in the Long-Term Foreign-Currency IDR would lead to a corresponding change in the medium-term note programme rating.

ADJUSTMENTS

The sector risk operating environment score has been assigned above the implied score due to the following adjustment reasons: economic performance (positive), size and structure of economy (positive).

The business profile score has been assigned below the implied score due to the following adjustment reason: business model (negative).

The asset quality score has been assigned below the implied score due to the following adjustment reason: non-loan exposures (negative).

The funding, liquidity and coverage score has been assigned above the implied score due to the following adjustment reason: funding flexibility (positive).

Report of Issuer's Appeal

The issuer appealed the decision of the original rating committee. In accordance with Fitch's policies, the issuer's request was reviewed by an appeal review panel, which determined that an appeal committee was warranted due to the availability of new information.

Relative to the original rating committee, the appeal committee updated Fitch's assessment of the following key rating drivers: business profile outlook to stable, from negative, and funding, liquidity and coverage outlook to stable, from negative. The updates were of sufficient magnitude to affect the rating outcome.

The outcome of the appeal committee, as detailed within this rating action commentary, was different to the original rating committee outcome.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG CONSIDERATIONS

IIFL Finance has an ESG Relevance Score of '4' for Customer Welfare - Fair Messaging, Privacy & Data Security, due to the recent history of regulatory findings on the company's customer-related practices in gold loans, which may pose lingering reputation risk for IIFL Finance. This factor has a negative impact on the credit profile and is relevant to the rating in conjunction with other factors.

IIFL Finance has an ESG Relevance Score of '4' for Management Strategy, as we believe the company's operations and franchise remain sensitive to management's ability to maintain sound implementation of internal controls and return the business to adequate profitability now that sanctions have been lifted. This factor has a negative impact on the credit profile and is relevant to the rating in conjunction with other factors.

IIFL Finance has an ESG Relevance Score of '4' for Governance Structure, which is revised down from '5', as the lifting of regulatory restrictions imply that the incidences of non-compliance have been adequately addressed, and as such, the factor is no longer a key rating driver. Nonetheless, as the recent regulatory actions imply a record of gaps in the oversight structure and management of compliance risks that may continue to pose reputational risks for the company, the factor is scored at '4'. This factor has a negative impact on the credit profile and is relevant to the rating in conjunction with other factors.

The highest level of ESG credit relevance is a score of '3', unless otherwise disclosed in this section. A score of '3' means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. Fitch's ESG Relevance Scores are not inputs in the rating process; they are an observation on the relevance and materiality of ESG factors in the rating decision. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/topics/esg/products#esg-relevance-scores

RATING ACTIONS

ENTITY / DEBT	RATING			PRIOR
IIFL Finance Limited	LT IDR	B+ Rating Outlook Stable	Affirmed	B+ Rating Watch Negative
senior secured	LT	B+	Affirmed	B+ Rating Watch Negative

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

Country-Specific Treatment of Recovery Ratings Criteria (pub. 04 Mar 2023)

Non-Bank Financial Institutions Rating Criteria (pub. 18 Jan 2024) (including rating assumption sensitivity)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

IIFL Finance Limited	EU Endorsed, UK Endorsed

UNSOLICITED ISSUERS

IIFL Finance Limited (Unsolicited)	
With Rated Entity or Related Third Party Participation	Yes
With Access to Internal Documents	Yes
With Access to Management	Yes

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IIFL Finance Limited	-	Standalone Credit Profile	Unsolicited
IIFL Finance Limited USD 1billion MTN Programme	-	Long Term Rating	Unsolicited
IIFL Finance Limited	-	Long Term Issuer Default Rating	Unsolicited

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