

Rating Methodology - Housing Finance Companies (HFCs)

CARE's ratings are an opinion on the relative ability and willingness of an issuer to make timely payments on the specific debt obligations over the life of the instrument. CARE has developed a comprehensive methodology for credit rating of debt instruments issued by HFCs.

Overview

Housing is a significant engine for growth and development of the economy. Housing and housing finance activities in India have witnessed tremendous growth over the years. Some of the factors that have led to this growth are-tax concessions to borrowers, increase in disposable income levels, changing age profile of the borrowers, easy availability of loans, nuclear families and urbanization, etc. The proportion of Mortgages to the Gross Domestic Product(GDP) ratio for India is much lower than that for developed countries. As per 11th Five Year Plan(2007-012) the total number of houses that would be required cumulatively in the plan period is slated at 45 million units (7 million backlog plus 38 million additional units) which will require an investment of around Rs.10 trillion between 2007-2012, i.e. Rs.2 trillion per year. Some of the factors considered in CARE's analysis for rating HFCs are described below:

QUANTITATIVE FACTORS

The starting point of analysis is a detailed review of key measures of financial performance and stability:

a) Capital Adequacy

Capital Adequacy Ratio (CAR) is a measure of the degree to which the company's capital is available to absorb possible losses. High CAR indicates the ability of the company to undertake additional business. Debt equity ratio is also examined as a measure of gearing. CARE

examines the conformity of the company to the regulatory guidelines on capital adequacy norms and further examines the capital adequacy on the basis of expected erosion of capital arising as a result of factors such as:

- ❖ Additional provisioning for NPAs
- ❖ Possible losses from other weak assets

CARE also examines the trends and pattern of growth in the last three years in both Tier I & Tier II capital. Ability of the HFC to raise additional capital commensurate with the projected growth in assets is critically evaluated.

b) Asset Quality

Asset Quality review begins with the examination of the company's credit risk management framework. Sound credit appraisal system & rigorous post sanction follow up mitigate credit risk. CARE studies robustness of the HFC's credit appraisal process by examining the quantitative and qualitative parameters used in selecting the borrower. Loan portfolio is examined in terms of LTV(Loan to Value) ratios, IIRs (Installment to Income ratios), age profile of the borrowers, tenure of the loans and class of the borrowers like salaried, self employed etc. CARE also considers diversification of the portfolio into project financing, builder loans, reverse mortgages etc. The historical collection efficiency and the company's experience of loan losses and write-offs/provisions are studied. The proportion of assets classified into standard, substandard, doubtful or loss and the track record of recoveries of the company is examined closely.

c) Resources

Resource base of the company is analysed in terms of cost and composition. Various option is available to HFCs to raise resources include borrowings from banks/Financial institutions, market borrowings, refinance from NHB etc. Average as well as incremental cost of funds is examined in the context of prevailing interest rate regime. Ability of the company to raise additional resources at competitive rates is examined critically. Ability of the promoters to bring in funds and access to equity/debt markets in India or abroad are also taken into account.

d) Liquidity

Lack of liquidity can lead an HFC towards failure, while, strong liquidity can help even an otherwise weak company to remain adequately funded during difficult times. CARE evaluates the internal and external sources of funds to meet the company's requirements. Generally, HFCs in India finance their loan advances that have longer maturity with borrowings of lower maturity. The liquidity risk is evaluated by examining the assets liability maturity (ALM) profile, collection efficiency and proportion of liquid assets to total assets. CARE also evaluates the steps taken by HFCs such as securitization of mortgages to manage their ALM profile. Short term external funding sources in the form of unutilized lines of credit available from banks etc. along with other investments if any are important sources of reserve liquidity.

e) Earnings Quality

Profitable operations are essential for HFC to operate as an going concern. Each business area that contributes to the core earnings is assessed for risks as well as for its earning prospects and growth rate. Yield on business assets and investments are viewed in conjunction with cost of funds to arrive at the spreads earned by the company. Interest cover is also a useful indicator of the extent of cover over the interest paid by the company. Operating efficiency is examined in terms of expense ratios. Quality of company's earnings is also influenced by the level of in interest rate and foreign exchange rate risks that the company is exposed to. Finally, the overall profitability is examined in terms of, return on capital employed, return on assets and return on shareholders funds.

Evaluation of quantitative factors is done, not only of the absolute numbers and ratios ,but their volatility and trends as well. The attempt is to determine core measures of performance. CARE also compares the company's performance on each of the above parameters, with its peers. Detailed inter-company analysis is done to determine the relative strengths and weaknesses of the company in its present operating environment and its prospects.

Qualitative Factors

Some of the qualitative factors that are deemed critical in the rating process are:

a) Ownership

Ownership pattern and track record of the promoters/group companies is examined. Strong promoters are more likely to provide support to the company in times of crisis.

b) Management quality

The composition of the Board, credentials of the CEO and the organisational structure of the company are considered. 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. Adequacy of the information systems used by the management is evaluated. CARE focuses on modern practices and systems, degree of computerisation, capabilities of senior management, personnel policies and extent of delegation of powers.

c) Risk Management

The management stance on risk and risk management frame work is examined. Credit risk management is evaluated by examining the appraisal, monitoring and recovery systems and prudential ending norms of the company. The company's policy and exposure to interest rate and foreign currency risk is examined. Interest rate risk arises due to differing maturity of assets and liabilities and mismatch between the floating and fixed rate assets and liabilities.

Pre-payments of fixed rate housing loans tend to rise when interest rates decline and increase the interest rate risk of HFCs. Foreign currency risk arises due to difference in currency denomination of assets and liabilities. The derivatives and other risk management products used in the past and implication of these deals are also analysed.

d) Compliance with statutory requirements

CARE examines track record of the company in complying with regulatory requirements of NHB.

e) Accounting Quality

Rating relies heavily on audited data. Policies for income recognition, provisioning and valuation of investments are examined. Suitable adjustments to reported figures are made for consistency of evaluation and meaningful interpretation.

f) Size and Market Presence

The fund base and branch network of the company may have a bearing on the company's competitive position. While both large and small companies have successfully co-existed in India, in the rapidly changing competitive environment, the niche strategy of smaller companies against the scale advantages of larger players/banks would be carefully examined to understand the business model of each company.

All relevant quantitative and qualitative factors are considered together, as relative weakness in one area of the company's performance may be more than adequately compensated for by strengths elsewhere. However, the weightage assigned to factors are different for short term ratings and long term ratings. The intention of long term ratings is to look over a business cycle and not adjust ratings frequently for what appear to be short term performance aberrations. The quality of the management and the competitiveness of the company are of greater importance in long term rating decisions.

The rating process is ultimately a search for the fundamentals and the probabilities for change in the fundamentals. The assessment of management quality, the company's operating environment and its role in the nation's financial system is used to interpret current data and to forecast how well the company is positioned for the future. The final rating decision is made by the Rating Committee after a thorough deliberation on the rating report on the company.

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CARE's ratings are opinions on credit quality and are not recommendations to sanction, renew, disburse or recall the concerned bank facilities or to buy, sell or hold any security. CARE has based its ratings/outlooks on information obtained from sources believed by it to be accurate and reliable.

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