Rating Methodology - Housing Finance Companies (HFCs)

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Background

Housing finance companies (HFCs) have grown in stature over the years and have gained systemic importance in the Indian financial landscape. 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, interest subvention schemes, increase in disposable income levels, changing age profile of the borrowers, easy availability of loans, nuclear families, urbanisation, etc. CARE Ratings Limited (CARE Ratings) assigns ratings to various debt instruments and bank facilities of HFCs based on this methodology.

Apart from retail housing loans, HFCs also provide a variety of other products including loan against property (LAP), real-estate construction finance, lease rental discounting (LRD) loans, etc. With effect from August 09, 2019, the regulatory powers, including registration of HFCs, stands transferred to Reserve Bank of India (RBI) from National Housing Bank (NHB) and HFCs are to be treated as one of the categories of non-banking finance companies (NBFCs). Accordingly, NHB continues to carry out supervision of HFCs and HFCs continue to submit various returns to NHB. Furthermore, grievance redressal mechanism regarding HFCs also continues to rest with the NHB.

Methodology

CARERatings' methodology for HFCs is applied to companies registered as HFCs with the NHB/RBI. This methodology highlights the parameters considered by CARE Ratings for a standalone assessment of HFCs. The final rating also factors in any additional notching that is applicable for the parent/promoter group linkages which is done as per CARE Ratings' methodology of 'Factoring Linkages Parent Sub JV Group' which is available on our website www.careedge.in. The key parameters considered for a standalone assessment of HFCs are depicted below.

The above parameters are elaborated in the sections below.

1. **Business mix**

HFCs are primarily engaged in extending housing loans. In addition, HFCs can extend various other loans including LAP, lending to builders for construction of dwelling units, LRD, loan against Shares (LAS), etc. This provides flexibility to NBFC-HFC and aids in profitability.

CARE Ratings' analyses the business mix of HFCs based on broad categories such as retail & wholesale and housing & non-housing. HFCs with larger share of retail portfolio are better placed due to benefits arising from granularity and risk diversification while HFCs with exposure to wholesale portfolio are exposed to concentration risk. Furthermore, housing loans which cater to salaried segment exhibits better asset quality as compared with the non-salaried/self-employed segment. Portfolio mix in terms of various categories/ sub-segments are analyzed in detail as these factors have linkage to yield, asset quality, profitability, etc. Furthermore, HFCs operating in limited geographies have geographical concentration risk which exposes them to political and other state-related crises.

2. **Capital and Leverage**

Level of capital determines the ability of the HFC 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. CARE Ratings adjusts the net worth for investments in subsidiaries and other non-core activities while assessing the adequacy of an HFC's risk capital. While HFCs are required to comply with a minimum CAR stipulated by RBI (HFCs enjoy lower risk weight on certain categories of housing loans as compared with other NBFCs), CARE Ratings looks at the management's approach towards maintaining a cushion over regulatory CAR in light of the portfolio mix (HL vs. Non-HL, retail vs. large-ticket wholesale, etc.) along with the corresponding trend in delinquencies and portfolio concentration. CARE Ratings also looks at the debt equity ratio of the HFC as a leverage measure. HFC's leverage is a function of its business mix, growth potential, delinquency trends, and portfolio concentration among other factors. While relatively higher leverage is acceptable for granular and stable products like prime retail home loans, a lower leverage may be warranted for portfolios which are either more concentrated (e.g., corporate or builder loans, high-ticket LAP) or the ones which exhibit relatively higher risk of delinquencies. CARE Ratings looks at leverage in light of these underlying factors along with any synergies derived from parentage or group linkages. Demonstrated ability of an HFC to raise adequate equity capital from varied set of investors is viewed favourably. Similarly, demonstration of support to an HFC through equity infusion by a strong promoter group or parent company is also viewed favourably. For HFCs resorting to direct assignment/securitisation of their assets, CARE Ratings also 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.

3. **Asset quality**

Asset quality is one the most critical parameters while assessing HFCs. Asset quality is dependent on the portfolio mix of the HFC. In view of high competition from banking sector in prime housing/salaried segment and to improve profitability, HFCs also focus on various other borrower segments. Apart from traditional home loans to salaried individuals, HFCs also lend to self-employed individuals and individuals belonging to mid-income/low-income groups. Such loans exhibit greater credit risk and are priced higher vis-à-vis prime housing loans. Apart from housing loans, HFCs also extend LAP and real-estate construction loans

which exhibit different risk behaviour. The HFC assumes credit risk and earns a profit after factoring in the expected level of credit costs in each of its products and builds that up into the pricing of loans in that segment. HFCs strive to keep the credit costs in check within the 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 HFCs are primarily dependent on wholesale funding, worsening of key parameter like gross non-performing assets (NPA) level can quickly and severely impact access to funds which in turn can threaten the viability of the operations of an HFC.

The overall asset quality of HFCs is assessed by evaluating the product-segment-wise exposures. In case of wholesale loans, large vulnerable exposures are examined critically since the same can impact capital position in case of stress. In case of retail loan book, the empirical trend in delinquencies exhibited for the entity is examined for each retail product segment and the same is also compared with the industry peers wherever segment-wise data are available. HFCs can resort to the SARFAESI Act, 2002 to recover the loan by selling mortgage assets (housing/any other).

The historical collection efficiency and the company's experience of loan losses and write-off/provisions are studied. Also, the proportion of restructured portfolio and loan book under moratorium is assessed and its impact on the asset quality is also examined thoroughly. 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 analysed. The proportion of such wholesale loans in the overall portfolio is examined. Furthermore, such exposures are also viewed in relation to the company's net-worth 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. HFCs 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. HFCs which report an aggressive growth rate of loan book year-on-year also have a large part of their loan book remaining unseasoned as the tenor of the home loans is typically higher (more than 10 years) and hence assessment of its steady-state asset quality becomes difficult. In such cases, CARE Ratings analyses the NPA levels on a lagged basis, which adjusts the growth of the loan book.

Exposure to group entities, in the form of lending or investment, is examined to understand the loss potential of such assets.

4. Profitability

CARE Ratings 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. It is examined whether the interest yields are commensurate with the sub-segments and nature of operations.

Profitable operations are essential for HFCs 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 and return on net-worth. The contributing factors to HFC's profitability are assessed to study the overall impact. The major ones include 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 HFC. While interest rates charged on loans is a function of the product segment and HFC's competitive positioning, interest expense is driven by the liability profile and borrowing mix of an HFC. Apart from interest income, many HFCs also have a fee income component which adds to the total income and is intended to cover up for operating expenses.

Operating expenses are dependent upon the business model deployed by an HFC and the geographical spread of its operations. A geographically-diversified loan book catering to varied borrower types would entail higher operating expenses (opex) as it involves setting up branches and deploying manpower for various functions like origination, underwriting and collections. The ratios Operating Expenses/Average Total Assets are looked at in order to understand its impact on the overall profitability of an HFC.

Finally, the credit cost is driven by provisioning and write-offs made by the HFC and is dependent on the asset quality of the underlying portfolio/segment to which HFC caters. The overall impact of the above factors on the Return of Total Assets (RoTA) is studied to gain an understanding about profitability. Furthermore, the Return on Networth (RoNW) is also looked at and is impacted by the extent of leverage of an HFC.

5. 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 Ratings 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 asset liability maturity (ALM) profile, collection efficiency and the proportion of liquid assets in relation to its total borrowings. The contractual liabilities such as 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 the overall tight liquidity scenario in the system. In addition to the above factors, the ability of the HFC to raise funds in short notice and in a challenging environment are considered favourably.

CARE Ratings looks at the debt repayment obligations of an HFC for all the time buckets and specifically over the next 12 months and assesses the extent to which cash and liquid assets are available to cover for it. Furthermore, the scheduled inflows from credit assets (adjusted for collection efficiency) for all the time buckets and specifically over the next 12 months is compared with the respective time buckets' debt obligations to arrive at a cover based on such asset inflows. For HFCs, running a negative ALM mismatch in one-year bucket, such cover will tend to be below 100%, thereby increasing the refinancing risk.
From liquidity perspective, HFCs 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 the 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 HFC can be severely distressed in case of such rating downgrades. CARE Ratings, in its assessment of liquidity, does not take into account the presence of such rating-linked acceleration clauses. However, HFCs 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 HFC is analysed in terms of cost and composition. The proportion of deposits/loans/bonds in funding mix is examined. The ability to diversify funding sources is a key factor in the rating of HFCs. Generally, the entities having 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 is examined in the context of prevailing interest rate regime. The ability of the company to raise additional resources at competitive rates is examined critically. Stability of sources of finance is also an important indicator of the resource-raising ability of the HFC. Market reputation of the promoters/parent of an HFC is also a key factor in its ability to access various funding sources at competitive rates. The management's 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 management team and the organizational structure of the company are considered. Industry experience of board of directors of a company from the point of view of strategic decision making is also taken into consideration. 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.

Adequacy of the information systems used by the management is evaluated. CARE Ratings focuses on 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 companies/businesses is considered while assessing the management strength. Furthermore, the proven capabilities of the HFC in its asset class and peer group is also examined.

The management's stance on risk and risk management framework is examined. Credit risk management is evaluated by examining the appraisal, monitoring and recovery systems and prudential lending norms of the company. CARE Ratings also analyses the sourcing mix in terms of own sourcing/direct selling agents (DSAs) and the trend thereon. The companies who have their own sourcing and collection teams tend to have a better control on their loan origination and quality of customers. The company's policy on gearing levels, liquidity risk and interest rate risk are examined. CARE Ratings examines track record of the company in complying with regulatory requirements of RBI/NHB.

8. Size, Vintage & Market presence

Size is reflected through the level of capital and level of total assets of an HFC. Large size would generally be associated with long operating track record, significant market presence, demonstrated ability to raise resource from varied sources, and asset quality and profitability performance established over time through the cycles. Management's strategy for profitable growth and its ability to navigate through difficult business environment is better assessed for an HFC 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 the ratings, it does provide an indication of the competitive strength and financial flexibility of an HFC. The ability to compete and generate risk-adjusted returns over time is better gauged for HFCs which have a long track record.

CARE Ratings looks at the relative market position of the HFC in individual asset classes (majorly housing loans, real estate loans & LAP) 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 HFC is viewed in order to assess the experience of the company 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 especially for housing loans which are of longer tenure relative to other NBFC asset classes. HFCs 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 such as asset quality and profitability.

Additional Considerations

- **Peer group analysis**

  CARE Ratings analyses various financial and non-financial parameters of an HFC 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. CARE Ratings 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**

  CARE Ratings tracks market-based indicators like market capitalization and price/book value for equity-listed HFCs and compares the same with other listed HFCs to gain a sense of relative valuation as viewed by equity market. Sharp changes in prices are tracked, and CARE Ratings tries to form an understanding of the underlying trend. Furthermore, CARE Ratings also keeps a track of bond yields and spreads of HFC 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. CARE Ratings tracks these market indicators so as to understand the market's perception of the value and risk of an HFC and to assess the ability of the HFC to raise resources (equity & debt) at competitive rates to support its business model.

CARE Ratings looks at various financial ratios while analysing HFCs. The description of such ratios can be found in the 'Financial Sector – Ratios' document on CARE Ratings' website www.careedge.in

Criteria for rating of Subordinated Debt of HFCs

CARE Ratings generally does not differentiate between the rating of senior and subordinated debt of an HFC. 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 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 NBFCs and HFCs, the liquidity risk is typically minimal. Therefore, the long-term probability of default for Senior and Subordinated debt of a company are similar and the same should reflect in their long-term ratings. However, CARE Ratings 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.

Criteria for Rating of Upper Tier II Debt of HFCs

NHB allowed HFCs to issue Upper Tier II instruments in FY09 in order to augment their capital base. The feature of such instruments is similar to the feature of upper tier II instruments issued by bank. Such instruments have some unique features which alter their risk profile vis-à-vis the senior debt issued by HFCs.

Such instruments are rated at least one notch lower than the rating of senior debt in view of their increased sensitivity to the HFC's CAR, capital-raising ability and profitability during the long tenure of the instruments. Any delay in payment of interest/principal (as the case may be) would constitute an event of default as per CARE Ratings' definition of default, and as such, these instruments may exhibit a somewhat sharper migration of the rating compared with conventional debt instruments.

Analysis of environmental, social and governance risk factors:

Over the past few years, environmental, social and governance (ESG) risks have started gaining importance across the globe and are increasingly influencing investment decisions. The companies might have to incur operational or capital costs towards mitigating these risks. CARE Ratings analyses the impact of ESG risks on the credit profile of an entity by assessing the expected impact of these costs on the future earnings/revenue/cash flows of entities. As the appreciation of ESG risks increase, the company's ability to raise capital might be affected as higher scrutiny from the investors in terms of ESG compliance will increase, especially for the players who raise funds from overseas markets.

The considerations with respect to ESG aspects are an integral part of assessing credit risk and get addressed under various parameters wherever relevant. For example, the environmental risk is factored in credit risk assessment of polluting sectors wherein the expected cost to be incurred towards mitigants in the form of pollution control certifications, effluent treatment measures, etc., and the impact of those on future cash flows is evaluated. The social risk would play out prominently in a labour/manpower intensive services industry like banks and financial services or hospitality, where social issues like employee policies or customer relationships are important factors. Similarly, governance parameters like transparency, adherence to applicable regulations, public disclosures and costs towards these objectives form part of the credit risk analysis. The importance of each risk might vary from sector-to-sector.

As compared to the environmental and social risk, which arises from external factors, governance risk is based on the internal factors. Governance refers to how effectively an entity is controlled and run in a way, thereby safeguarding the interests of all the stakeholders.

Accounting quality

A review of accounting quality and adherence to prudential accounting norms are examined for measuring the entity's performance. The impact of the auditors' qualifications and comments are quantified to the extent possible and analytical adjustments are made to the accounts, if material. The rating team interacts with the auditors to understand their comfort level with the accounting policies, systems and controls within the entity and its assessment of the management of the entity. Also, a change of accounting policy in a particular year which results in improved reported performance is analysed more closely. However, CARE Ratings does not conduct an audit of the financial statements of an entity and relies upon the judgement and financial prudence of the auditors.

[For previous version please refer 'Rating Methodology – Housing Finance Companies' issued in December 2020**]**

CARE Ratings Limited
Corporate Office: 4th Floor, Godrej Coliseum, Somaiya Hospital Road, Off Eastern Express Highway, Sion (East), Mumbai - 400 022
Phone : +91 - 22 - 6754 3456 I CIN: L67190MH1993PLC071691

Connect :

Locations: Ahmedabad I Andheri-Mumbai I Bengaluru I Chennai I Coimbatore I Hyderabad I Kolkata I New Delhi I Pune

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