

Rating Methodology - Housing Finance Companies (HFCs)

[In supersession of “CARE’s Rating Methodology – Housing Finance Companies (HFCs)” issued in [September 2018](#)]

Background

Housing finance companies (HFCs) have grown in stature over the years and have gained systemic importance in the Indian financial landscape with growing share in housing credit vis-à-vis banks. 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 scheme (Pradhan Mantri Jan Aawas Yojna), increase in disposable income levels, changing age profile of the borrowers, easy availability of loans, nuclear families and urbanization, etc. 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 variety of other products including loan against property (LAP), real-estate construction finance, lease rental discounting (LRD) loans etc. HFCs are registered with the National Housing Bank (NHB) which also acts as the regulator for the sector. However, the regulatory oversight of HFCs is now being transferred to the Reserve Bank of India (RBI) which is formulating a revised framework. As per the RBI, HFCs will be treated as one of the categories of NBFCs. CARE Ratings will take cognizance of the revised regulatory framework for HFCs as and when RBI announces the same and build that up in its methodology appropriately.

Methodology

CARE’s rating methodology for HFCs is applied to companies registered as HFCs with the NHB/RBI. This methodology highlights the parameters considered by CARE for a standalone assessment of HFCs. The final rating also factors in any additional notching that is applicable for parent/promoter group linkages which is done as per CARE’s methodology of ‘Factoring Linkages in Ratings’. The key parameters considered for a standalone assessment of HFCs are depicted below.



The above parameters are elaborated in the sections below.

1. 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. While HFCs are required to comply with a minimum CAR stipulated by NHB (HFCs enjoy lower risk weight on certain categories of housing loans as compared to 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 a HFC to raise adequate equity capital from varied set of investors is viewed favourably. Similarly, demonstration of support to a HFC through equity infusion by a strong promoter group or parent company is also viewed favourably. For HFCs resorting to securitization of their assets, CARE Ratings 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.

CARE Ratings follows a consolidated approach when the group companies are engaged in similar business (lending) but operate through different entities due to different asset class and corresponding regulatory compliances to be followed. In such case, CARE Ratings considers the capital adequacy of the holding company at standalone level as per regulatory requirements. Further, overall gearing and Net NPA / Net worth ratios are

analysed to ascertain whether the entity has sufficient level of capitalization at the consolidated level.

2. Asset Quality

Asset Quality is one the most critical parameters while assessing HFCs. Asset quality is dependent on the portfolio mix of the HFC. 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 are exhibit greater credit risk and are priced higher vis-à-vis prime home loans. Apart from housing loans, HFCs also extend LAP and real-estate construction loans which exhibit different risk behavior. The HFCs assume credit risk and earn 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 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 primarily are dependent on wholesale funding, worsening of key parameter like Gross NPA level can quickly and severely impact access to funds which in turn can threaten the viability of the operations of a 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. HFCs can resort to the SARFAESI Act, 2002 to recover the loan by selling mortgage assets (housing/any other) easily as compared to traditional tools of recovery available to NBFCs.

The historical collection efficiency and the company's experience of loan losses and write-off/provisions are studied. 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. Further, such exposures are also viewed in relation to the company's net-worth so as 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 will 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.

Exposure to group entities, in the form of lending or investment, is examined to understand the loss potential of such assets. The same is subject to stress test in the same way as any other asset and the impact is evaluated on level of NPA and provisioning needs.

3. 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 total income. Each business area that contributes to the core earnings is assessed for risks as well as for its earnings prospects and growth rate. It is examined whether the interest yields are commensurate with the asset class 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 a 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 a 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 a 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 a HFC and the geographical spread of its operations. A geographically diversified loan book catering to varied borrower types would entail higher 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 and Cost to Income are looked at in order to understand its impact on the overall profitability of a 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. The overall impact of the above factors on the Return of Total Assets (RoTA) is studied to gain an understanding about profitability. Further, the Return on Networth (RoNW) is also looked at and is impacted by the extent of leverage of a HFC.

4. 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

assets liabilities maturity (ALM) profile, collection efficiency and proportion of liquid assets in relation to its total borrowings. The contractual liabilities like 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 overall tight liquidity scenario in the system.

CARE Ratings looks at the debt repayment obligations of a HFC over the next 12 months and the extent to which cash and liquid assets are available to cover for it. Further, the scheduled inflows from credit assets (adjusted for collection efficiency) over the next 12 months is compared with the 12 month debt obligations to arrive at a cover based on such asset inflows. For HFCs running a negative ALM mismatch in 1 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 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 a 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.

5. Resource Profile

Resource base of the HFC is analyzed in terms of cost and composition. Proportion of deposits/loans/bonds in funding mix is examined. Ability to diversify funding sources is a key factor in rating of HFCs. Generally, the entities having major 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. Ability of the company to raise additional resources at competitive rates is examined critically. Stability of sources for finance is also an important indicator of the resource raising ability of the HFC. Market reputation of the promoters/senior management of a HFC is also a key factor in its ability to access various funding sources at competitive rates. The managements' 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.

6. Management & Systems

The track record of the promoters, credentials of the CEO and the organizational 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 Ratings focuses on modern 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 cos/businesses is considered while assessing the management strength. Further, 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. The company's policy on liquidity risk and interest rate risk is examined. CARE Ratings examines track record of the company in complying with regulatory requirements of RBI.

7. Size, Vintage & Market Presence

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

Additional Considerations

▪ ***Peer Group Analysis***

CARE Ratings analyzes various financial and non-financial parameters of a 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. Further, CARE Ratings also keeps a track of bond yields and spreads of HFC debt instruments in order 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 a HFC and also 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 analyzing HFCs. The description of such ratios can be found in the '[Financial Sector – Ratios](#)' document on CARE Ratings' website www.careratings.com

Criteria for Rating of Subordinated Debt of HFCs

CARE Ratings generally does not differentiate between the rating of senior and subordinated debt of a 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 debts 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 FY2009 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 alters their risk profile vis-à-vis the senior debt issued by HFCs. Key features of such instruments are as below.

Maturity Period	Minimum Maturity of 15 years
Options	<ul style="list-style-type: none"> ▪ May have embedded ‘Call’ option subject to the instrument having ran for at least 10 years from date of issue ▪ Call option shall be exercised only with the prior approval of NHB. Key consideration for NHB would be HFC’s CRAR position at the time of exercise of the call option and after the exercise
Lock-in Clause	<p>HFCs may defer the payment of interest, if:</p> <ul style="list-style-type: none"> ▪ the HFC’s CRAR is below the minimum regulatory requirement prescribed by NHB; or ▪ the impact of such payment results in HFC’s CRAR falling below or remaining below the minimum regulatory requirement
Interest Payment	Interest payment requires prior approval of NHB when the impact of such payment may result in net loss or increase the net loss, provided the CRAR remains above the regulatory norm
Claim Seniority	Claims of the PDI investors shall be superior to the claims of equity shareholders and subordinated to the claims of all other creditors

Capital Treatment	Upper Tier II instruments along with other Tier II instruments should not exceed 100% of tier I capital.
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The ‘Lock-in’ clause introduces additional risk to the servicing of interest on upper tier II instruments by HFCs. Given the above features, 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 Capital Adequacy Ratio (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) following the invocation of the lock-in clause, would constitute an event of default as per CARE’s definition of default and as such, these instruments may exhibit a somewhat sharper migration of the rating compared with conventional debt instruments.

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