Rating Methodology - Housing Finance Companies

[Issued in March 2025]

Background

Housing finance companies (HFCs) have grown in stature over the years and have gained systemic importance in the Indian financial landscape. With effect from August 09, 2019, regulatory powers, including registration of HFCs, stands transferred to Reserve Bank of India (RBI) from National Housing Bank (NHB), where both NHB and HFCs are to be treated as one of the categories of non-banking finance companies (NBFCs). Given the rising systemic importance, HFCs are also governed by scale-based regulatory framework with a view to strengthen their governance standards, capital requirements, and provisioning norms.

Methodology

CARE Ratings Limited's (CareEdge Ratings') methodology for HFCs is applied to companies registered as HFCs with the NHB/RBI. This methodology highlights the parameters considered by CareEdge Ratings for a standalone assessment of HFCs. The rating also factors in additional notching that is applicable for the parent/promoter group linkages which is done per CareEdge Ratings' criteria on Notching by Factoring Linkages available on our website www.careratings.com. The key parameters considered for a standalone assessment of HFCs are depicted below.

- Business Mix
- Capital & Leverage
- Asset Quality
- Profitability
- Liquidity
- Resource Profile
- Management & Systems
- Size, Vintage & Market Presence

The above parameters are elaborated in the following sections.

1. **Business mix**

   HFCs are primarily engaged in extending housing loans. In addition, HFCs can extend other loans, including loan against property (LAP), lending to builders for construction of dwelling units, lease rental discounting (LRD), and loan against shares (LAS), among others. This provides flexibility to HFC and supports its profitability.

CareEdge Ratings analyses the business mix of HFCs based on broad categories such as retail vs wholesale and housing vs non-housing. HFCs with larger share of retail portfolio are better placed due to benefits arising from granularity and risk diversification while HFCs with higher exposure to wholesale portfolio are exposed to concentration risk. Housing loans, which cater to salaried segment exhibits relatively better asset quality compared to the non-salaried/self-employed segment. Portfolio mix in terms of categories/ sub-segments are analysed in detail, as these factors have linkage to yield, asset quality, and profitability, among others.

2. Capital and leverage

Level of capital determines HFC's ability 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 company's ability to undertake additional business. CareEdge 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, CareEdge 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.) and the corresponding trend in delinquencies and portfolio concentration.
CareEdge Ratings also looks at the debt to 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 such as prime retail home loans, a lower leverage may be warranted for portfolios which are either more concentrated (corporate or builder loans, high-ticket LAP) or the ones which exhibit relatively higher risk of delinquencies. CareEdge Ratings looks at leverage in conjunction with these underlying factors and synergies derived from the parentage or group linkages. Demonstrated ability of an HFC to raise adequate equity capital from varied set of investors by a strong promoter group or parent company is viewed favourably. If the shareholding of the company is fragmented without a clear majority, it would entail further analysis on commitment of individual shareholders to support the company.

For HFCs resorting to direct assignment/securitisation of their assets, CareEdge 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 depends 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 lend to self-employed individuals and individuals belonging to mid-income/low-income groups. Such loans exhibit greater credit risk and are priced higher against 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 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 delinquencies in the loan portfolio not only suppresses profitability through higher credit costs, but also puts pressure on capital cushion available to absorb losses. This can lead to restricted access to funds from the market, resulting in subdued growth prospects. Given that HFCs primarily depend on wholesale funding, worsening of key parameter such as gross non-performing assets (GNPA)/ gross stage 3 (GS3) levels can quickly and severely impact access to funds which in turn can threaten the viability of an HFC operations.

HFC's overall asset quality is assessed by evaluating the product-segment-wise exposures and days-past-due (DPD) bucketing of the outstanding advances. 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 to the industry peers wherever segment-wise data is 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. 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. Top exposure are analysed in case of high-ticket size loans such as corporate or real estate loans. The proportion of such wholesale loans in the overall portfolio is examined. 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, limiting 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 (over 10 years) and hence assessment of its steady-state asset quality becomes difficult. In such cases, CareEdge Ratings analyses the non-performing assets (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, and the credit profile of such group entities is also examined to understand the loss potential of such assets.

4. Profitability

CareEdge Ratings analyses the composition of the company's income 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 the HFCs to operate as a going concern and for the generation of 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 (RoTA) and return on net worth (RoNW). 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 is determined by average yield earned on assets and average cost of funds raised by an HFC. While interest rate 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 counterbalance the operating expenses.

Operating expenses depend on 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 functions such as origination, underwriting, and collections. The ratio of operating expenses to average total assets is looked at 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 depends on the asset quality of the underlying portfolio/segment to which HFC caters. Overall impact of the above factors on the RoTA is studied to ascertain the profitability. For HFCs with sizeable off-book portfolio, the profitability metrics are calculated and assessed in relation to managed assets. 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 an otherwise weak company to remain afloat in difficult times. CareEdge 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. CareEdge Ratings also evaluates key assumptions underlying the ALM profile.
The short-term external funding sources in the form of unutilised lines of credit available from banks, among others, and direct and other investments, if any, are important sources of reserve liquidity. While considering unutilised bank lines as back-up, the availability of such lines is also assessed in a scenario of change in sentiments towards the sector or promoters or due to the overall tight liquidity scenario in the system. In addition to above factors, HFC's ability to raise funds at short notice and in a challenging environment are considered favourably.

CareEdge 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 the cover in the form of cash and liquid assets is available. The inflows from credit assets (adjusted for collection efficiency) for time buckets and specifically over the next 12 months is compared to 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 could result in the coverage to be below 100%, 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 is considered as a credit positive.
CareEdge Ratings also examines the presence of any acceleration clauses embedded in borrowing agreements with lenders/investors which are linked to downgrade in external credit ratings, where the ALM

profile of an HFC can be severely distressed in case of such rating downgrades. CareEdge Ratings, in its assessment of liquidity, does not consider 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, ratings will see a much sharper migration than otherwise.

6. Resource profile

CareEdge Ratings evaluates a company's resources raising ability both from equity and debt standpoint. Given the capital-intensive characteristics of lending businesses, a company's capacity to secure recurring growth capital and track record of the investors is critical.

Resource base of the HFC is analysed in terms of cost and composition. An HFC's ability to diversify resource profile in terms of geographies and lenders/ investors mix is viewed favourably. Average and incremental cost of funds is examined in the context of prevailing interest rate regime. The company's ability 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 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, and Tier-II capital, among others.

7. Management and systems

The promoters' track record, experience of the management team and the organisational structure are considered. Industry experience of board of directors of a company from the point of view of strategic decision making is also 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. CareEdge Ratings focuses on practices and systems, extent of technology deployment, capabilities of senior management, and personnel policies. In case of shared resources by the group companies, the strength and quality of group companies/businesses is considered while assessing the management strength. 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. CareEdge 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. CareEdge Ratings examines track record of the company in complying with regulatory requirements.

8. Size, vintage, and 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 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 having a long track record.

CareEdge Ratings looks at the relative market position of the HFC in individual asset classes (majorly housing loans, real estate loans, and 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 to assess the experience of the company and its ability to perform steadily through 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 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**

  CareEdge Ratings analyses 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 and their volatility and trends exhibited over time. CareEdge 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**

  CareEdge Ratings tracks market-based indicators such as market capitalisation 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 CareEdge Ratings tries to form an understanding of the underlying trend. CareEdge Ratings also keeps a track of bond yields and spreads of HFC debt instruments to gain an understanding of the markets' view about its risk perception. Reasons for sharp changes in yields against similarly rated peers are examined. CareEdge 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.

CareEdge Ratings assesses the financial ratios while analysing HFCs. The description of such ratios can be found in the 'Financial Sector – Ratios' document on CareEdge Ratings' website www.careratings.com.

Criteria for rating of Subordinated Debt of HFCs

CareEdge Ratings generally does not differentiate between the rating of senior and subordinated debt of an HFC. This is considering 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, servicing of the same (principal and interest) is purely cash-flow driven. The servicing of this instrument does not depend on presence of profits or maintenance of minimum capital adequacy parameter by the borrowing entity.

- Similar to other senior debt instruments, such as, 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 liquidation of the issuer, where 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. On a going concern basis, repayments for both types of debt instruments happen 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, CareEdge Ratings may choose to differentiate between senior and subordinated debt on a case-to-case basis depending on credit strength, liquidity profile, and issuer-specific circumstances that may prevail.

Criteria for rating of perpetual debt instruments of NBFCs - HFCs

Owing to the scale-based regulation for NBFCs, there was harmonisation in definition of capital (Tier-I and Tier-II) for NBFCs and HFCs, enabling inclusion of perpetual debt instrument as a part of Tier-I/Tier-II capital. Perpetual debt instruments have some unique features which alter their risk profile against the senior debt issued by HFCs. Key features of such instruments are as below.

Maturity Period	Perpetual maturity
Options	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 RBI. Key consideration for RBI would be HFC's CRAR position at the time of exercise of the call option and after the exercise.
Lock-in clause	HFCs may defer the payment of interest, if: the HFC's CRAR is below the minimum regulatory requirement prescribed by RBI; 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 RBI 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	PDI shall be eligible to be treated as Tier-I capital upto 15% of the total Tier-I capital. The amount of PDI over and above 15% threshold shall qualify as Tier-II capital.

The 'Lock-in' clause introduces additional risk to the servicing of interest on perpetual debt instruments by HFCs. Given above features, such instruments are generally notched down by at least one notch than the rating of senior debt in view of their increased sensitivity to the HFC's CAR, capital-raising ability, and profitability in the long tenure of instruments. Any delay in the payment of interest/principal (as the case may be) following the invocation of the lock-in clause would constitute an event of default per CareEdge Ratings' definition of default and as such, these instruments might exhibit a somewhat sharper migration of the rating compared to conventional debt instruments.

Analysis of environmental, social, and governance risk factors:

Over 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. CareEdge 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.

Environmental risk:

Environmental risk is a critical factor in assessing credit risk, especially for sectors having a significant environmental impact. In these cases, the potential costs associated with environmental mitigation measures, such as pollution control certifications and effluent treatment processes, are considered. These costs can affect the future cash flows of the business and are therefore factored into the overall credit risk analysis. The impact of environmental risks on a company's financial health is an important element in determining its creditworthiness.

Social risk:

Social risk plays a prominent role in labour- or service-intensive industries, such as banking, financial services, and hospitality. In these sectors, factors including employee policies, workplace conditions, and customer relationships are critical components of the credit risk assessment. Social considerations include how a company manages its workforce, its corporate social responsibility practices, and its interactions with the community. Issues related to social risks can have a significant impact on a company's reputation and financial stability, influencing its credit risk profile.

Governance risk:

Governance risk refers to the internal factors related to how a company is managed and controlled, which directly impacts the safeguarding of stakeholders' interests. Key governance parameters include transparency, adherence to applicable regulations, public disclosures, and the costs associated with maintaining strong governance structures. Companies with strong governance practices are generally considered to have lower credit risks, as they are better equipped to handle regulatory challenges and protect investor interests. The governance framework is a vital aspect of credit risk assessment, ensuring long-term sustainability and compliance.

As compared to the environmental and social risks, 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, safeguarding the interests of all 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 entity's management. A change of accounting policy in a particular year which results in improved/adverse reported performance is analysed more closely. However, CareEdge Ratings does not conduct an audit of the financial statements of an entity and relies upon the judgement and financial prudence of auditors.

[For previous version please refer 'Rating Methodology – Housing Finance Companies' issued in January 2023]

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 Noida I Pune

About:

CareEdge is a knowledge-based analytical group offering services in Credit Ratings, Analytics, Consulting and Sustainability. Established in 1993, the parent company CARE Ratings Ltd (CareEdge Ratings) is India's second-largest rating agency, with a credible track record of rating companies across diverse sectors and holding leadership positions in high-growth sectors such as BFSI and Infra. The wholly-owned subsidiaries of CareEdge Ratings are (I) CARE Analytics & Advisory Private Ltd (previously known as CARE Risk Solutions Pvt Ltd), (II) CARE ESG Ratings Ltd, (previously known as CARE Advisory Research and Training Ltd) and (III) CareEdge Global IFSC Ltd. CareEdge Ratings' other international subsidiary entities include CARE Ratings (Africa) Private Ltd in Mauritius, CARE Ratings South Africa (Pty) Ltd, and CARE Ratings Nepal Ltd. For more information: www.careedge.in.