



This methodology note stands superseded. Refer to ICRA's website www.icra.in to view the updated methodology note on the sector.

ICRA Rating Feature

Rating Methodology for Housing Finance Companies

This note replaces ICRA's earlier methodology note on the industry published in 2011.

Overview

Housing Finance Companies (HFCs) play an important role in the Indian financial market. They compete with banks in offering home loans and other related products. Apart from traditional home loans, other products offered by HFCs include, among others, loans against property, builder loans, and lease rental discounting. HFCs are regulated by the National Housing Bank (NHB) while banks are regulated by the Reserve Bank of India (RBI). There are some significant differences in the regulatory treatment of banks versus HFCs, with HFCs being given greater flexibility in matters relating to governance structure and operations, the freedom to lend independent of priority-sector targets, and lower statutory reserve requirements. However, at the same time, there are regulatory restrictions on services that HFCs can offer and their funding options. For instance, HFCs cannot mobilise savings or current deposits, while some HFCs can mobilize term deposits, subject to a maximum of five times their net worth.

Although HFCs primarily lend home loans, they also offer the following products:

- Loans against property (residential, commercial)
- Builder and project loans
- Lease rental discounting
- Other, including personal, loans

ICRA's Risk Analysis Framework for HFCs

In rating an HFC, ICRA evaluates the company's business and financial risks, and uses this evaluation to project the level and stability of its future financial performance in various likely scenarios. The ratings are determined on a "going concern" basis rather than on a mere assessment of the company's assets and debt levels as on a particular date. The broad parameters for assessing the business and financial risks of an HFC (as in the bullet list below) are discussed at length in the next two sections. This methodology note does not purport to be an exhaustive discussion on all the rating parameters involved in assigning credit ratings to HFCs, but presents a broad framework for the exercise.

1. Business Risk Profile

- Operating Environment
- Business Mix
- Ownership Structure, Management & Systems, Governance Structure

2. Financial Risk Profile

- Asset Quality

- Liquidity
- Profitability
- Capital Adequacy

While several parameters are used to assess an HFC's business and financial risks, the relative importance of each of these parameters can vary across companies, depending on its potential to change the overall risk profile of the company concerned. Further, an HFC with a relatively safer salaried home loan portfolio and stable financial performance would be viewed more favourably than another with comparable or better financial numbers, but with riskier assets.

1 BUSINESS RISK PROFILE

ICRA makes an assessment of an HFC's business risk by analysing, among other factors, the company's product mix, competitive position, operating environment, franchise, and management and systems. As many of these parameters are qualitative, ICRA tries to remove the subjectivity in its analysis by capturing and assessing information on defined sub-parameters, and using these to make a comparison across various companies. This analysis also incorporates ICRA's assessment of the performance of various sectors, its outlook on the economy and real estate demand, and its views on issues related to the operating environment.

1.1 Operating Environment

The operating environment has a significant bearing on an HFC's credit rating as it can impact its growth prospects and asset quality quite considerably. Further, regulatory changes could impact its earnings, regulatory capital requirements or competitive environment. In assessing the operating environment, ICRA looks at the overall economic conditions, the outlook on the real estate sector, trends in demand and price movements in real estate, and the regulatory environment.

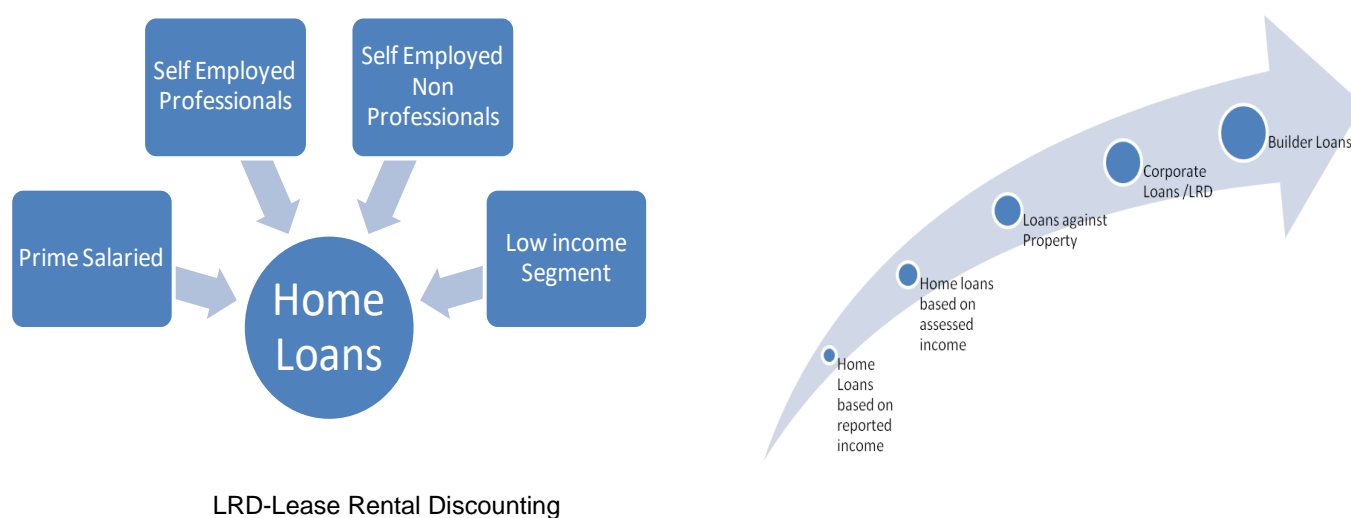
For an HFC, regulatory changes can significantly impact (either positively or negatively) credit losses. For instance, the establishment of the credit information bureau has helped lenders take informed credit decisions, while coverage under the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002, (SARFAESI) makes recovery of real estate backed loans more efficient. Thus, coverage of HFCs under SARFAESI is considered a credit positive. On the other hand, changes in regulations with respect to making a deferred tax liability (DTL) provision on special reserves created under Section 36(1) (viii) of the Income Tax Act, 1961, has pushed up the incremental tax expenses for HFCs. Similarly, nil prepayment penalties in the case of floating-rate loans to individual borrowers have encouraged balance transfers and reduced the profitability of HFCs.

1.2 Business Mix

1.2.1 Product Mix

The risk profile of an HFC is determined by the interplay of its borrower profile and its product profile. The borrower profiles that an HFC typically deals with are prime salaried segment, self-employed segment, and low-income segment. HFCs compete with banks in the housing finance space. Although some of the larger HFCs are able to compete with banks focused primarily on the salaried home loan segment, most other HFCs target special customer segments, such as self-employed and affordable housing to optimize yields and capitalize on the higher growth potential that the special customer segments offer. In addition to borrower profile, product mix is the other key determinant of the riskiness associated with an HFC. The following charts depict the various borrower segments catered for by HFCs and the various products offered across the risk spectrum.

Chart 1: Various Borrower, Product Segments served by HFCs



Intensity of competition has a significant bearing on the credit profile of an HFC, given that the prevailing or anticipated competitive intensity would influence the company's growth prospects, earnings and management strategy. If any leading market player initiates certain promotional schemes, they could impact the competitive position of the other players (e.g. teaser rate loans). Therefore, ICRA's evaluation focuses on the current level of competition as well as the attractiveness of the segment for potential competition by assessing several factors including growth potential, entry barriers and risk-adjusted returns.

1.2.2 Track Record

As for track record, this is evaluated in relation to completed business cycles. Therefore, while a five- to six-year-old car finance company is considered to have a reasonable track record (the typical loan tenure being three to four years), an HFC of the same vintage would be considered to have an average track record (the typical loan tenure being 15 to 20 years). Further, if an HFC is expanding into new products and geographies, its track record and management experience may not provide the same level of comfort as the same of another HFC with a stable growth rate and growing within existing geographies with the same loan mix.

1.2.3 Competitive Position

ICRA assesses an HFC's competitive position (ability to change lending norms and/or yields), reliance on outsourcing, pace of growth and responsiveness to market changes, track record, and management experience (in relation to growth plans and the lifecycle of the loans extended), besides the extent of diversification of its loan book.

1.3 Ownership Structure, Management and Systems

1.3.1 Ownership Structure

Ownership structure could have a key influence on an HFC's credit profile as a strong promoter and a strategic fit with the parent can benefit an HFC's earnings, liquidity and capitalisation, and hence its credit profile. In assessing an HFC's ownership structure, the parameters examined include, among others: the credit profile of the promoter/investor, shareholding pattern of the HFC, operational synergies of the HFC with its promoter/investor, level of involvement of promoter/investor in the HFC and their level of commitment, and track record of the promoter/investor in providing capital and debt fund support. The assessment also factors in shareholders' expectations and the strategy followed to manage these expectations. ICRA also evaluates the strategy and business plans of the HFC, along with the shareholders' expectations from the company. Although ICRA-assigned ratings are for debt holders, meeting shareholders' expectations is imperative as otherwise the HFC's strategy itself could undergo a change (to meet shareholders' expectations), which in turn could alter its credit profile.

1.3.2 Governance Structure

ICRA believes that an appropriate governance structure is important to ensure that the powers given to line managers at an HFC are exercised in accordance with the established procedures, and that these procedures are in harmony with the broad policy guidelines and strategic objectives of the HFC. ICRA's evaluation of an HFC's governance structure involves an assessment of the structural aspects of the Board and Board level committees, the functioning of the various Board committees, and the involvement of key shareholders in strategic decision making.

1.3.3 Management

The quality of the top management, extent of reliance on promoter/keyman for making strategic decisions, presence of second line of management, quality of auditors, systems and policies, shareholder expectations, the strategy followed to manage these expectations, and accounting quality are the key variables judged while measuring the management quality of an HFC. The importance of these factors is even higher for a new HFC, one with a shorter track record, or one with a changing business profile.

Although this part of the exercise is mostly subjective, the actual track record of the management is a supporting factor. Usually, a detailed discussion is held with the management of the issuer HFC to understand its business objectives, plans and strategies, and views on past performance, besides the outlook on the industry.

All credit ratings, including those in the HFC sector, necessarily incorporate the strengths/weaknesses arising from the HFC being a part of a "group". Some of the other factors assessed are:

- Experience and commitment of the promoter/management in the HFC's line of business.
- Attitude of the promoter/management to risk taking and containment.
- The HFC's risk management policies (credit risk and market risk).
- Strength of the other companies belonging to the same group as the HFC.
- The ability and willingness of the group to support the HFC concerned through measures such as capital infusion and liquidity support, if required.

1.3.4 Underwriting Process and Lending Norms

A careful evaluation of the risk management policies of the HFC provides important guidance for assessing the impact of stress events on the liquidity, profitability, and capitalisation of the company concerned. The process of risk profiling also involves evaluating the HFC's business sourcing practices (in-house vs. outsourced). ICRA compares the underwriting policies of the HFC with the best practices in the industry to make an assessment of the company's risk profile. Some of the key underwriting norms such as loan to value ratio, fixed obligation to income ratio, and proportion of portfolio at relatively higher residual tenures are also evaluated and compared across HFCs. For the assessed income segment, ICRA also goes through the credit appraisal process followed by the HFC concerned.

1.3.5 Controls and Risk Management Systems

ICRA compares the origination process, internal audit process, quality of the management information systems and collection mechanisms across HFCs.

1.3.6 Accounting Quality

Consistent and fair accounting policies are a prerequisite for financial evaluation and peer group comparisons. By virtue of being incorporated under the Companies Act, HFCs are required to follow the Accounting Standards prescribed by the Institute of Chartered Accountants of India. Further, the NHB has also issued prudential norms for HFCs specifying the accounting methods to be used for income recognition, provisioning for bad and doubtful advances, and valuation of investments. In evaluating an HFC's accounting quality, ICRA reviews the company's accounting policies, notes to the accounts, and auditors' comments in detail. Deviations from the Generally Accepted Accounting Practices are noted and the financial statements of the HFC are adjusted to reflect the impact of such deviations.

2 FINANCIAL RISK PROFILE

2.1 Asset Quality

Asset quality plays an important role in indicating the future financial performance of an HFC. The focus of asset quality evaluation is on lifetime losses, variability in losses under various scenarios, the impact of likely credit costs on profitability, and the cushions available (in the form of capital or provisions) to protect the debt holders from unexpected deterioration in asset quality.

In evaluating an HFC's asset quality, ICRA assesses the quality of the company's credit appraisal process and lending norms, the riskiness of its loan mix¹, its risk appetite², the availability of data to facilitate credit decision making, and its track record in managing its loan book through lifecycles. Assessment is also made of credit risk concentration, trend in delinquencies (adjusted for vintage of the book), Gross NPA[†] percentage, Net NPA percentage, and Net NPAs in relation to Net Worth.

Further, the extent of diversification is also an important indicator of an HFC's asset quality. In assessing diversification, the factors generally looked at include loan mix, credit risk, portfolio granularity, geographical diversification, and borrower profile. High levels of diversification can shield an HFC from the impact of downturn in any one segment. At the same time, diversification into riskier segments may not improve resilience and therefore may not translate into superior ratings. However, an HFC's ability to manage diversification, especially in new geographies, is a very important issue, just as management depth and the ability to adopt the skills and techniques needed to run different businesses are.

As asset quality indicators can vary depending on the accounting policy on write-offs, comparing these indicators across HFCs may not yield meaningful results. ICRA therefore makes a comparison of the delinquency levels (at 30 days+, 60 days+, 90 days+) for the same asset class and borrower profile across players after adjusting for write-offs. When available, static pool analysis is done as this gives a meaningful estimate of the losses at various stages in the loan cycle as well as of the overall lifetime losses, and is free from the distortions caused by a high growth rate.

2.2 Liquidity

Asset-liability mismatch is common in HFCs as the average tenure of assets (home loan tenure varying from 15 to 20 years) is longer than that of its liabilities. However the gaps vary depending on the funding mix and liquidity policy of the company.

In assessing an HFC's liquidity profile, ICRA evaluates the company's policy on liquidity, the maturity profile of its assets and liabilities, the asset-liability maturity gaps, and the backups available to plug such gaps. The evaluation also focuses on the diversity of the HFC's funding sources and their quality (i.e. availability of these sources in a stress situation). It is important for HFCs to maintain an adequate liquidity profile for the smooth functioning of its funding activity (fresh asset creation) and to honour its debt commitments in a timely manner. ICRA also analyses the gaps over the short term and the backup lines an HFC has to maintain disbursements over short term.

It is also important that an HFC manage its interest rate risk since the same could impact its interest spreads and future profitability. In most cases however, the interest rate risk is relatively low for HFCs, given that most loans are variable and linked to the prime lending rates (PLRs) of HFCs, which gives HFCs the flexibility to pass on increases in their cost of funds to borrowers.

¹ A company with focus on prime salaried customers, as opposed to self-employed customers with low reported income, would be less risky. Similarly, a company with a higher proportion of loans against property (LAP) would be riskier than one operating solely in the salaried home loan segment.

² The ideal loan mix the company intends to maintain.

[†] Non-Performing Assets

2.3 Capitalisation

An HFC's capital provides the second level of protection to debt holders (earnings being the first) and therefore its adequacy (in relation to the embedded credit, market, and operational risk) is an important consideration for ratings. Riskiness of the product and granularity of the portfolio are factors that have a significant bearing on the amount of capital required to provide the desired degree of protection to an HFC's debt holders. The requirement of risk capital varies with the concentration and the riskiness of the product mix, as the following chart shows.

Chart 2: Risk Capital Requirement Matrix

		Expected credit losses and variability	
		Low	High
Portfolio Concentration	High	Moderate	High
	Low	Low	Moderately high

Besides evaluating an HFC's ability to meet regulatory capital adequacy, ICRA also assess the adjusted capital of the HFC (in relation to managed portfolio) and considers the internal capital generation and possible support from a strong parent/group company while evaluating the adequacy of its risk capital for a particular rating category. Typically, capital adequacy analysis is done for the individual business lines (including off-balance sheet portfolios) of the HFC and the "aggregated capital required" compared with the actual capital available as well as with the minimum capital that the company is expected to maintain.

ICRA also evaluates the HFC's net worth in relation to total managed advances, as regulatory risk weights for certain loans are lower and regulatory requirements keep changing. A higher percentage of Net Worth is viewed more favourably; however this ratio needs to be assessed in relation to the riskiness of the product mix of the HFC.

2.4 Profitability

An HFC's ability to generate adequate returns is important from the perspective of both its shareholders and debt holders. The purpose of ICRA's evaluation here is to assess the level of future earnings and the quality of earnings of the HFC concerned, which is carried out by looking closely at the building blocks: interest spreads, fee income, operating expenses, and credit costs.

The evaluation of an HFC's profitability starts with the interest spreads (yields minus cost of funds) and the likely trajectory of the same in the light of the changes in the operating environment, and its asset and product mix strategy. The ability of the HFC to complement its interest income with fee income is also assessed. Fee income allows for some diversification, which in turn can improve the resilience of earnings, thereby improving the HFC's risk profile. After assessing the income stream, ICRA evaluates the HFC's operating efficiency (operating expenses in relation to total assets, and cost to income ratio) and compares the same with that of its peers. Finally, the credit costs are estimated on the basis of the company's asset

quality profile, and the profitability indicators³ compared across peers. Importantly, a high return on equity may not necessarily translate into a high credit rating, given that the underlying risk could be high or capitalisation could be weaker and being so it could be more volatile or difficult to predict.

2.5 Franchise and Size

For an HFC, its franchise strength determines its capacity to grow while maintaining reasonable risk-adjusted returns, and to maintain resilience of earnings, thereby facilitating predictability of its future financial performance. It may be noted that an HFC with a significant market share and another being a niche player can both have a defensible franchise⁴, which could in turn benefit its credit profile.

As for size, typically it is in relation to an HFC's loan mix; size has a bearing on the company's competitive position, diversity, credit risk concentration, stability of earnings, and financial flexibility.

Summing up

The credit ratings assigned by ICRA are a symbolic representation of its current opinion on the relative credit risk associated with the instruments rated. This opinion is arrived at following a detailed evaluation of the issuer's business and financial risks and on using such evaluation to project the level and stability of its future financial performance in various likely scenarios. While several parameters are used to assess an HFC's risk profile, the relative importance of each of these parameters (qualitative as well quantitative) can vary across companies, depending on its potential to change the overall risk profile of the company concerned.

³ Profit after Tax as a percentage of Average Total Assets, and Profit after Tax as a percentage of Average Net Worth.

⁴ The bigger company on the strength of its standing in the overall market and the smaller one on account of its unique offering or its strong relationship with the key participants in the credit chain of the target segment.

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