ICRA Lanka's
Credit Rating Methodology for
Housing Finance Banks/Companies

Specialized Housing Finance Banks (HFB) play an important role in the Sri Lankan financial market. They compete with commercial banks in offering home loans and other related products. Apart from traditional home loans, other products offered by HFBs are Loans against Property, Builder Loans and others. HFBs are also regulated by the Central Bank of Sri Lanka. They are classified as licensed specialized banks for regulation by the Central banks. The banking regulations/directions differ from those applicable to licensed commercial banks.

Though HFB's main area of operations is home loans, HFB may also offer the following products

- Loans against Property(Residential, Commercial)
- Builder/Project Loans
- Other Personal Loans

In rating an HFB, ICRA Lanka evaluates the bank'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 being based on mere assessment of the bank's assets and debt levels as on a particular date. The broad parameters for assessing the business and financial risks of an HFB (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 the credit rating of HFBs, but presents a broad framework for the exercise.

- **Business Risk**
  - Operating Environment
  - Product Mix and Competitive Position
  - Franchise and Size, competitive position
  - Ownership Structure
  - Management, Systems and Strategy, Governance structure
- **Financial Risk**
  - Asset Quality
  - Liquidity
  - Profitability
  - Capital Adequacy

While several parameters are used to assess an HFB's business and financial risks, the relative importance of each of these parameters can vary across banks/companies depending on its potential to change the overall risk profile of the bank/company concerned. Further, an HFB 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.

BUSINESS RISK

ICRA Lanka makes an assessment of an HFB'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 Lanka 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 Banks. This analysis also incorporates ICRA Lanka'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.

- **Operating Environment**

The operating environment has a significant bearing on an HFB's credit rating as it can impact its growth prospects and asset quality quite considerably. In assessing the operating environment, ICRA Lanka looks at the overall economic conditions, outlook on real estate sector, trends in demand and price movements in real estate, and the regulatory environment. For an HFB, regulatory changes can also significantly impact (either positively or negatively) credit losses. .

- **Product Mix and Competitive Position**

Intensity of competition has a significant bearing on the credit profile of an HFB, 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. ICRA Lanka'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. ICRA Lanka analyses the product and customer mix of the company and the ability of the company to manage the product lines it is in.

- **Franchise and Size**

For an HFB, 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 HFB with a significant market share and another being a niche player can both have a defensible franchise, which could in turn benefit its credit profile. As for size, typically it is in relation to an HFB's loan mix; size has a bearing on the bank's competitive position, diversity, credit risk concentration, stability of earnings, and financial flexibility.

- **Ownership Structure**

Ownership structure could have a key influence on an HFB's credit profile as a strong promoter and a strategic fit with the parent can benefit an HFB's earnings, liquidity and capitalization, and hence its credit profile. In assessing an HFB's ownership structure, the parameters examined include, among others, the credit profile of the promoter, shareholding pattern of the HFB, operational synergies of the HFB with its promoter, level of involvement of promoter in the HFB and their level of commitment, and track record of the promoter in providing capital and debt fund support.

- **Governance Structure**

ICRA Lanka believes that an appropriate Governance structure is important to ensure that the powers given to line managers at an HFB 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 HFB. ICRA Lanka's evaluation of an HFB's Governance structure involves an assessment of the structural aspects of the Board and Board level committees, and of the functioning of the various Board committees

Management, Systems and Strategy

Quality of management, systems and policies, shareholder expectations and the strategy followed to manage these expectations, and the accounting quality are the foundation stones on which an HFB's credit risk profile is built. The importance of these factors is even higher for a new HFB, one with a shorter track record, or one with a changing business profile.

In evaluating an HFB's management, systems and strategy, ICRA Lanka assesses the company'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.

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

All credit ratings, including those in the HFB sector, necessarily incorporate an assessment of the quality of the issuer's management as well as the strengths/weaknesses arising from the HFB being a part of a "group". This part of the exercise is mostly subjective, although the actual track record of the management is a supporting factor. Usually, a detailed discussion is held with the management of the issuer HFB to understand its business objectives, plans and strategies, and their views on past performance, besides the outlook on the industry. Some of the other factors assessed are:

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

A careful evaluation of the risk management policies of the HFB provides important guidance for assessing the impact of stress events on the liquidity, profitability, and capitalisation of the bank concerned. ICRA Lanka compares the underwriting policies of the HFB with the best practices in the industry to make an assessment of the bank's risk profile. The process of risk profiling also involves evaluating the HFB's business sourcing practices, besides its recovery and monitoring systems.

ICRA Lanka also evaluates the strategy and business plans of the HFB, along with the shareholders' expectations from the company. Although ICRA Lanka -assigned ratings are for debt holders, meeting shareholders' expectations is imperative as otherwise the company's strategy itself could undergo a change (to meet shareholders' expectations), which in turn could alter its credit profile.

FINANCIAL RISK

- **Asset Quality**

Asset quality plays an important role in indicating the future financial performance of an HFB. 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 HFB's asset quality, ICRA Lanka assesses the quality of the company's credit appraisal process and lending norms, the riskiness of its loan mix (a company with focus on prime salaried customers vis-a-vis self-employed with low reported income would be less riskier), its risk appetite (the ideal loan mix the company intends to maintain), 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 HFBs 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 HFB 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 HFB'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 HFBs may not yield meaningful results. ICRA Lanka therefore makes a comparison of the delinquency levels (at 30days+, 60days+, 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.

Liquidity

Asset Liability mismatch is common in HFBs as the average tenor of assets (home loan tenor varying from 15-20 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 HFB's liquidity profile, ICRA Lanka 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

HFB's funding sources and their quality (i.e. availability of these sources in a stress situation). It is important for HFBs 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.

It is also important that an HFB manage its interest rate risk since the same could impact its interest spreads and future profitability.

- **Capital Adequacy**

An HFB'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 HFB'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 1: Risk Capital Requirement Matrix

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

Besides evaluating an HFB's ability to meet regulatory capital adequacy, ICRA Lanka also assess the adjusted capital of the HFB (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 portfolio's) of the HFB 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 Lanka also evaluates the HFB'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 HFB.

- **Accounting Quality**

Consistent and fair accounting policies are a prerequisite for financial evaluation and peer group comparisons. HFBs are required to follow the Accounting Standards prescribed by the Institute of Chartered Accountants of Sri Lanka. Further, the Central Bank of Sri Lanka has also issued prudential norms for HFBs specifying the accounting methods to be used for income recognition, provisioning for bad and doubtful advances, and valuation of investments. In evaluating an HFB's accounting quality, ICRA Lanka 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 HFB are adjusted to reflect the impact of such deviations.

- **Profitability**

An HFB's ability to generate adequate returns is important from the perspective of both its shareholders and debt holders. The purpose of ICRA Lanka's evaluation here is to assess the level of future earnings and the quality of earnings of the HFB 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 HFB's profitability starts with the interest spreads (yields minus cost of funds) and the likely trajectory of the same in light of the changes in the operating environment, and its strategy. The ability of the HFB 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 HFB's risk profile. After assessing the income stream, ICRA Lanka evaluates the HFB'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 indicators 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 capitalization could be weaker and being so it could be more volatile or difficult to predict.

Summing up

The credit ratings assigned by ICRA Lanka 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 HFB'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.