INTEREST RATE MODEL

Preamble

Five Star Business Finance Limited is into providing Small Business Loans and Small Mortgage Loans to potential customers. The funds for such loans are borrowed from banks and other financial institutions for on-lending to potential borrowers. Given that these are customers who cannot be underwritten through the credit methodologies of banks and other financial institutions, these customers approach institutions like Five Star for their funding needs. Five Star has developed a niche underwriting methodology to evaluate the incomes of these customers and determine their creditworthiness.

Pricing on loans

An NBFC derives its incomes from the interest spread between the rate charged to its customers and the rate charged by its lenders. The operational and credit costs are deducted from this spread to arrive at the profitability of the NBFC.

The interest rate to be charged to potential borrowers depends on a multitude of factors listed below.

1. Cost of funds charged by the lenders
2. Risk premium depending on customer risk category
3. Operational expenses
4. Credit cost
5. Expected profitability

Each of these parameters shall be periodically monitored to arrive at the final interest rate to be charged to the borrower. The factors have been enumerated below.

Cost of funds

Five Star borrows moneys from a multitude of financial institutions viz. banks, NBFCs, through issue of Non-Convertible Debentures, Commercial Paper, Securitisation transactions, etc. While there are a number of factors evaluated by the lenders before arriving at the cost of funds that would be levied on the company, the primary parameter that differentiates the cost between different forms of funding is the underlying tenure of the facility sanctioned. Longer tenure facilities come at a higher cost compared to the shorter tenure facilities. In view of this, one of the important aspects of the Five Star Interest rate model must be the underlying tenure of the assets originated.

Risk premium

Five Star has a very clear approach towards categorising the customers based on their risk rating. The Company uses multiple parameters in categorising the customers into Low, Medium and High-risk categories, which has been clearly documented in the Credit policy and which is again reproduced below for reference.

The Risk profiling methodology of the customers is clearly documented under Clause 10 of the Credit policy.

Risk profiling of borrowers

Categorization of borrower should be done for each credit proposal. The various factors to be considered for risk profiling are DBR, Loan-to-Value ratio, High Mark / CIBIL Score, living style of customer and neighbourhood reference. The guidelines with respect to risk profiling are as follows:

- *Each parameter shall be classified as Low risk, Medium risk and High-risk basis the following:*

Parameters	***Low***	***Medium***	***High***
DBR	*<=45%*	*above 45% to 65%*	*> 65%*
LTV	*<=50%*	*Above 50% to 60%*	*> 60%*
Customer living style	*Good*	*Average*	*Poor*
Neighbourhood checks	*Good*	*Average*	*Poor*
Credit Bureau score	*>500*	*350 to 500*	*<350*

- *The final risk profile of borrower should be based on the majority risk categorization of above parameters. For eg:*
  a) If the borrower qualifies as low risk on a minimum of 3 parameters out of the 5, then the borrower will be categorized as a low risk borrower.
  b) If the borrower qualifies as low risk & medium risk on 2 parameters each and high risk on 1 parameter, then the borrower will be categorized as a medium risk borrower.

- *Proposals with Borrower's risk profile as High would not be encouraged.*

Based on the classification of the borrower into low, medium and high risk, the company has decided to keep the risk premium constant for the low and medium category borrowers while for the high-risk borrower, the risk premium will be higher by 1%.

Operational Expenses

Operational expenses include personnel expenses, administrative expenses, depreciation which are incurred on a monthly basis. In a steady state scenario, the operational expenses remain fairly stable.

Credit Cost

Credit costs include Expected Credit Loss provisions and write offs. In a state of stable portfolio performance, the ECL is also predictable and would remain fairly stable.

Profitability

The revenues net of all the expenses enumerated above would lead to the profitability of the company.

Interest rate model

From Five Star's perspective, the major points of consideration amongst the variables mentioned above are the Cost of funds and Risk premium since the other variables are expected to be constant across the various category of loans, irrespective of the risk categorisation of the borrower. Hence the Interest rate model aims at addressing these 2 variables to arrive at the pricing to the end customer.

Given the focus primarily on the cost of funds, which is dependent on the underlying tenure, and the fact that the Company refrains from doing high risk borrowers, it is proposed to adopt an Interest rate model, which will built on the underlying tenure of the assets originated. In case of high-risk borrowers being onboarded, an additional risk premium of 1% would be levied.

The ALCO or the Board shall be the authority to decide on the pricing to be charged for different tenures of assets.