INTEREST RATE MODEL

Preamble

The guidelines issued by RBI vide its Notification No. DNBS. 204 / CGM (ASR)-2009 dated 2nd January 2009 and RBI/DoR/2023-24/106 DoR.FIN.REC.No.45/03.10.119/2023-24 dated October 19, 2023 (including all updates and modifications to the same from time to time) as well as its guidelines on Fair Practices Code for NBFCs, as amended from time to time (any of these or all these regulations may henceforth be referred to “RBI Regulations”), directs all NBFCs to make available the rates of interest and the approach for gradation of risk on website of the companies.

The RBI Regulations also mandate all NBFCs to have an Interest Rate Model in place approved by the Board taking into account relevant factors such as, cost of funds, margin and risk premium, etc and determine the rate of interest to be charged for loans and advances.

In compliance with the regulations mentioned above, the company has put in place the internal guidelines, policies, procedures and a comprehensive interest rate policy.

Company background

Five Star Business Finance Limited is into providing small-ticket loans to small business owners and self-employed individuals for their business, housing and other needs. 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.

It is also pertinent to note that small-ticket size loans mean higher operating expenses; lending to such borrowers who are probably first-time borrowers to formal credit ecosystem would mean higher perceived credit risk and may result in higher credit cost. All these would need to be factored into the Interest Rate Model so that it can stand the test of time and would not necessitate frequent modifications.

Interest Rate Model

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 model used by Five-Star determines the lending rate as the sum of the following components:

1. Cost of funds charged by the lenders, including annualised impact of processing and other fees charged by the lenders, fund-raising cost, negative carry on investments, ALM mismatch cost, etc
2. Risk premium depending on customer risk category
3. Operational expenses
4. Credit cost
5. Expected profitability
6. Market Practices

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.

1. **<u>Cost of funds</u>**

1.a Borrowing Cost – Five Star borrows moneys from a multitude of financial institutions viz. banks, NBFCs, through issue of Non-Convertible Debentures, Commercial Paper, Securitisation transactions, etc. There are a number of factors evaluated by the lenders before arriving at the cost of funds that would be levied on the company viz. Company's rating, benchmark rates, spread over the benchmark rate, interest rate scenario, tenure of the facility, etc. The type of institution (banks, other NBFCs, mutual funds, Insurance Companies, Developmental Financial Institutions, etc) and the structure of the borrowing facility (Term loan, Cash Credit, Non-Convertible debentures, Securitization – PTC transactions, External Commercial Borrowing, etc) also have differential cost impact.

1.b Processing and Other fees – In addition to the borrowing rate, lenders also charge processing and other fees which would increase the cost of the transaction. In case of debt arrangers involved in the transaction, arranger fees would also have to be factored into the overall cost of the transaction. In a normal scenario, NBFCs would also have to plan for funding in advance so that they do not face any issue from a disbursal perspective. This would entail negative carry since the return on investments would be substantially lower than the cost that would need to be paid to the lenders. For PTC and NCD transactions, other parties such as Trustees, Rating Agencies are involved which would push up the cost. The negative carry on any cash collateral provided on the Securitization transactions also has a cost impact. All these would need to be factored into the pricing to be determined by the Company.

1.c ALM – Another aspect that would have to be evaluated is the tenure of the underlying borrowing facility vis-à-vis tenure of the lending undertaken by the Company. The Company lends long-term loans to its borrowers, and it may not be able to secure match-funding to fund its assets. In such a scenario, the Company exposes itself to interest rate risks from time to time, which needs to be factored into the loan pricing.

2. **<u>Credit Risk Premium</u>**

Based on risk gradation of the loan which is detailed subsequently under the Clause 7 on Risk-based Pricing, credit risk premium is computed on a case-to-case basis.

3. **<u>Operational Expenses</u>**

Operational expenses include personnel expenses, branch related fixed and variable costs, operations costs, sales and marketing expenses, technology expenses, collections and recovery expenses, depreciation etc.

4. **<u>Credit Cost</u>**

Credit costs include Expected Credit Loss provisions and write offs. While the eventual credit losses would always be negligible given the secured nature of loans, there is a necessity to build a strong provision base given the slightly vulnerable nature of our borrowers. Such borrowers would go through skews in their cashflows, which may lead to higher credit costs (ECL provisions) than normal, which needs to be factored into the loan pricing.

5. **<u>Expected Profitability (RoA)</u>**

Expected Profitability or Return on assets is the minimum return expected by the company on its assets. This would need to be tailored towards giving an appropriate return to the shareholders as well.

6. Market Practices

The Company shall also undertake a periodic analysis of the interest rates charged by the other market players. Views of the Asset Liability Management Committee (ALCO) on loan product pricing with respect to prevailing interest rates offered by peer NBFCs for similar products / services shall be considered before any revisions to loan pricing is undertaken. Given the customer profile, the Company provides only fixed rate loans, which is easy from the perspective of customer understanding and communication. This also means that the Company carries an interest rate risk at all points of time, and in a rising interest rate cycle, there would be an impact on the spreads. However, as stated above, this is a conscious call taken by the Board keeping the customer profile in consideration.

7. Risk-based Pricing approach[1]

Five Star has always been adopting very clear approach towards categorising the customers based on their risk rating. The final pricing would depend on various factors, which the Company believes would have an impact on the risk profile of the loan, which includes (but not limited to) the following:

a. Threshold credit bureau score for the main income earner **(AND)**

b. Purpose for which the loan has been granted

c. Loan Ticket Size

The Company may also introduce other parameters depending on the industry situation, environment, etc to profile the customers based on the level of risk.

8. Revision to Lending rates

The revision to Lending Rate would be decided periodically, depending upon market volatility and cost to company. The revisions to Lending rates shall only be prospective and further, as the Company provides only fixed-rate loans to its customers, no changes to the Lending rate would be applicable on loans already disbursed. Changes to Lending rates would be applicable only on incremental loans disbursed.

At the time of sanction, the customer would be communicated with the annualised rate of interest along with the Annual Percentage Rate (APR), computed in line with RBI Circular RBI/2024-25/18 DOR.STR.REC.13/13.03.00/2024-25 dated April 15, 2024. Any revision in the Lending Rate will be updated on the Company's website.

9. Fees & Charges

In addition to the interest rate, the Company also charges certain fees and other charges which is clearly documented in the Fair Practice Code (approved by the Board of Directors from time to time, at least on an annual basis). As already mentioned above, all these fees and charges (which are charged upfront) would be included in the computation of APR, which would enable the customer to do a meaningful comparison with the APR charged by other players in the market and take a considered decision.

The list of fees and charges are given below:

Sl No.	Charges for	Applicable Charges
1	Processing fee	2% on Sanction Loan amount plus GST, if applicable.
2	Legal & Inspection Charges	Upto Rs 2,000 per loan (inclusive of GST, if applicable).

[1] Amended vide Board approval dated September 20, 2025

3	Document Charges	Upto Rs 2,000 per loan (inclusive of GST, if applicable).
4	Document Storage related charges	Rs. 500 per loan (inclusive of GST, if applicable)
5	Cheque/ ECS / NACH Bounce charges	Rs 300 per return till March 31, 2023. Rs 500 per return from April 01, 2023 plus GST, if applicable.
6	Collection Pick up charges / Recovery Visit charges	Rs 100 per visit (inclusive of GST, if applicable).
7	Cash convenience charges – For any cash transaction made by the customer towards his loan account – Effective January 1, 2024	Rs. 100 per Transaction, Inclusive of GST, if applicable.
8	Penal Interest / Charges for delayed payment Penal Interest - Till 31 March 2024 or such other date stipulated by the regulator Penal Charges - From 1 April 2024 or such other date stipulated by the regulator	3% p.m (36% p.a) plus GST, if applicable on the delayed amount for delayed period. (To be charged at monthly intervals)
9	MOD registration expenses and other related expenses	Actuals to be borne by the customer plus GST, if applicable.
10	Encumbrance Certificate	Actuals to be borne by the customer plus GST, if applicable.
11	Stamp duty	Actuals to be borne by the customer plus GST, if applicable.
12	Insurance premium	Actuals to be borne by the customer plus GST, if applicable.
13	DD for Disbursement of Loan	Actual charge for DD issue plus GST, if applicable.
14	Legal/Other charges/pertaining to Collections / Recovery / Arbitration etc.	Actuals to be borne by the customer plus GST, if applicable.
15	Pre-closure charges	Within 12 months of disbursal, 1% on Outstanding loan amount plus GST, if applicable [2]In case of Variable rate loans, no pre-closure charges would be levied on the loan for any prepayment.

10.[3]Interest rate range

The Company would be operating in multiple products and the range of interest rates for Normal and Priority customers would differ based on the nature and risk profile of the product. The RoI range for each of the products is given below:

Type of loan	Indicative RoI range
Loan against property for Business & Other purposes	21.00% - 23.25%
Housing Loan	15.00% - 18.50%

The range of interest rate given above has been arrived at based on indicative parameters given below:

[2] Inserted vide Board approval dated September 20, 2025
[3] Amended vide Board approval dated September 20, 2025

	LAP	Housing Loans
Cost of funds (incl ALM, Negative carry on investments etc)	About 10%	About 9.5%
Risk Premium for Normal loans	About 1%	About 1%
Operational expenses	About 6%	About 2.5%
Credit Cost	About 1%	About 1%
Expected Profitability	About 5%	About 4%
Total indicative pricing for normal loans	**About 23%**	**About 18%**

Any permanent benefit accruing to the Company on the parameters given above shall be passed on to the borrowers from time to time in consonance with the decision of ALCO and the Board.

Few other points to be noted:

1. Loans with the Company staff as applicants / co-applicants shall get a discount from the final rate.
2. All rates mentioned are only indicative and are annualized. The final rate shall depend on the risk category of the loan, type and vintage of collateral, etc and would be decided at the time of sanction.
3. [4]Fixed rates sanctioned to customers are not likely to change during the tenor of the loan except if unforeseen or extraordinary changes in the money market conditions take place during the period of the agreement.
4. [5]Variable rate loans shall be linked to the PLR (Prime Lending Rate) shall move in line with the movements in the PLR.

The ALCO or the Board shall be the authority to decide on any revisions to pricing from time to time.

[4] Amended vide Board approval dated September 20, 2025
[5] Inserted vide Board approval dated September 20, 2025