UN-HABITAT

Housing Finance Mechanisms In India

UNITED NATIONS HUMAN SETTLEMENTS PROGRAMME

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Housing Finance Mechanisms in India

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FOREWORD

At the dawn of this new urban era, UN-HABITAT research shows that by 2030, two-thirds of humanity will be living in towns and cities. We thus live at a time of unprecedented, rapid, irreversible urbanisation. The cities growing fastest are those of the developing world.

And the fastest growing neighbourhoods are the slums. Indeed, the global number of slum dwellers is now at or close to the 1 billion mark. Excessive levels of urbanization in relation to the economic growth have resulted in high levels of urban poverty and rapid expansion of unplanned urban settlements and slums, which are characterized by a lack of basic infrastructure and services, overcrowding and substandard housing conditions.

Yet housing and the services that should be provided with it are one of the most basic human needs. It is enshrined in various international instruments, including the *Habitat Agenda*. And reducing the number of slum dwellers around the world is a cornerstone of the *Millennium Development Goals* set to fight poverty around the world.

So if we fail to achieve the Goals in towns and cities, we will simply fail to achieve them at all.

It was with this crisis in mind that the United Nations General Assembly decided in its resolution of 26 February 2002 to transform United Nations Commission on Human Settlements into a fully pledged programme. The General Assembly in its resolution called on UN-HABITAT to take "urgent steps to ensure a better mobilization of financial resources at all levels, to enhance the implementation of the *Habitat Agenda*, particularly in developing countries." It also stressed "the commitments of member states to promote broad access to appropriate housing financing, increasing the supply of affordable housing and creating an enabling environment for sustainable development that will attract investment".

The *Habitat Agenda* recognizes that housing finance systems do not always respond adequately to the different needs of large segments of the population, particularly the vulnerable and disadvantaged groups living in poverty and low income people. It calls UN-HABITAT to assist member states to improve the effectiveness, efficiency and accessibility of the existing housing finance systems and to create and devise innovative housing finance mechanisms and instruments and to promote equal and affordable access to housing finance for all people.

In our quest to reach as many people as possible, a cornerstone of our agency's new Medium-term Strategic and Institutional Plan is partnerships. We have no choice but to catalyze new partnerships between government and the private sector. This is the only way to finance housing and infrastructure at the required scale – the scale needed to stabilize the rate

of slum formation, and subsequently reduce and ultimately reverse the number of people living in life-threatening slum conditions.

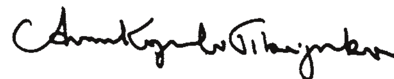
It is clear that in the coming 20 years, conventional sources of funds will simply be unavailable for investment at the scale required to meet the projected demand for housing and urban infrastructure.

Many countries around the world continue to face deficits in public budgets and weak financial sectors. Local governments have started to seek finance in national and global markets, but this is only in its initial phase. New mortgage providers have emerged, including commercial financial institutions and mortgage companies. But only middle and upper income households have access to such finance, while the poor are generally excluded. Although social housing is becoming less important in Europe and in countries with economies in transition, the need to provide shelter that is affordable to low income households still exists, including in developing countries.

This is why the exchange of information and knowledge on human settlements finance systems is so important. It is why it receives increased recognition in facilitating the development of human settlements finance systems and in turning knowledge into action for developing practical human settlements finance methods and systems for these pressing problems.

Our *Human Settlements Finance Systems* series documents the state, evolution and trends of human settlements finance in member states, and examines the factors and forces which drive the development of human settlements finance systems and the roles of different institutions and actors in shaping the systems and trends, and reviews human settlements finance systems. It presents an interesting review of policies, instruments, processes and practices. It examines the strengths and weakness of these systems and practices, their relations to the housing sector and the broad economic and social sectors, and lessons learned from practices.

Indeed, the country review studies we present are a valuable resource for member states because it is a body of work that also shows how human settlements finance systems and models can be applied to local use and thus provide a wider range of options for human settlements finance. The series also serves as guidebooks for policy makers, practitioners and researchers who have to grapple daily with human settlements finance systems, policies and strategies.



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All conversions of Indian rupees (INR) to US dollars (USD) are based on the prevailing 'Reference Rate' issued by the Reserve Bank of India.

The financial year is from April 1 to March 31. All references to years refer to the financial year.

ABBREVIATIONS

BSE	Bombay Stock Exchange Limited
CBOs	Community-Based Organisations
CAGR	Compounded Annual Growth Rate
CIBIL	Credit Information Bureau (India) Limited
DSAs	Direct Selling Agents
EIA	Environment Impact Assessment
EWS	Economically Weaker Sections
FCCB	Foreign Currency Convertible Bond
FSI	Floor Space Index
GDP	Gross Domestic Product
HDFC	Housing Development Finance Corporation Limited
HUDCO	Housing and Urban Development Corporation Limited
IAY	Indira Awas Yojana
IFC	International Finance Corporation, Washington D.C.
KfW	Kreditanstalt fuer Wiederaufbau
LIG	Low Income Groups
LTV	Loan-to-Value Ratio
MIBOR	Mumbai Inter-Bank Offered Rate
MoEF	Ministry of Environment and Forests
NCAER	National Council of Applied Economic Research
NGOs	Non-Governmental Organisations
NHB	National Housing Bank
NSE	National Stock Exchange of India Limited
NSSO	National Sample Survey Organisation
RBI	Reserve Bank of India
SARFAESI	Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest
SLR	Statutory Liquidity Ratio
ULCRA	Urban Land (Ceiling and Regulation) Act, 1976
UN	United Nations
VAMBAY	Valmiki Ambedkar Awas Yojana

CHAPTER 1: OVERVIEW OF HOUSING IN INDIA

India is home to over 1.1 billion people. With about one in every sixth person in the world living in India, housing perforce assumes significant importance. Successive Indian governments have regarded housing as a primary need of the people. The need to provide affordable housing has been the reason behind State interventions in the sector. Housing policies, however, tended to be framed by the government from a social rather than economic perspective. Despite explicit recognition of the need for housing, dedicated programmes have only benefited from low public spending. Housing and subsidies have largely synonymous with each other, hence a tendency to view housing finance from the angle of the government's cash budget, rather than as a developmental activity with tremendous spin-offs to the economy.

A significant trigger of change in housing policies in India occurred pursuant to the Global Shelter Strategy adopted by the United Nations (UN) in November 1988. This set of resolutions encouraged individual countries to establish comprehensive, multi-faceted housing programmes to provide shelter for all. The Global Shelter Strategy's main aim was to ensure social, economic and environmental sustainability while simultaneously upgrading living conditions. A defining feature of the Strategy was that it sought to involve national governments, private bodies as well as non-governmental organisations in formulating housing programmes. This provided the Indian government with the impetus to draft its first National Housing Policy, which was tabled in Parliament in 1992 and adopted in August 1994. Subsequently, with a national agenda of 'shelter for all', a new Housing and Habitat Policy was adopted in 1998. This proved to be a watershed, as the government recognised that it should withdraw from direct participation in the housing and related finance sector and instead take on the role of facilitator, thereby creating an enabling environment to encourage private sector capital. (*For further details on the Housing and Habitat Policy, refer to Appendix I.*)

In 2000, UN member countries adopted eight Millennium Development Goals, which range from eradication of poverty to developing a global partnership for development. With regard to housing, though, it was the seventh goal that would prove to be important. Goal 7 called for *"ensuring environmental stability"* and assigned UN-HABITAT the responsibility of assisting States to monitor and gradually attain the "*Cities Without Slums*" target, popularly known as Target 11. This target calls on member States cumulatively to achieve *"a significant improvement in the lives of at least 100 million slum dwellers by 2020"*. For India, this will prove to be daunting: in 2001, India's estimated slum population was 61.8 million (Ministry of Urban Employment, 2005).

The Role of Housing

Macroeconomic stability and the housing sector are inextricably linked. It is estimated that for every Indian rupee (INR) invested in housing, INR 0.78 is added to the country's GDP gross domestic product of the country. The housing sector has strong backward and forward linkages to over 250 ancillary industries. After agriculture, the housing and real estate industry is the second largest employment generator in India. It is estimated that the construction sector provides direct employment to 16 per cent of the country's workforce, which is growing at a rate of seven per cent per annum. The housing sector alone accounts for 58 per cent of workers in the construction sector. However, nearly 55 per cent of these workers are in the unskilled category *(ibid)*.

In India, residential housing accounts for almost 80 per cent of the real estate market in terms of volumes and has been growing at 30 to 35 per cent annually (CRISIL, 2006).

Table 1.1: Trends in Population Rise and Urbanisation in India

Year	Total Population (million)	Urban Population (million)	% share of Urban Population
1901	238	26	11%
1911	252	26	10%
1921	251	28	11%
1931	279	33	12%
1941	319	44	14%
1951	361	62	17%
1961	439	79	18%
1971	548	109	20%
1981	683	159	23%
1991	844	217	26%
2001	1,027	285	28%

Source: Census 2001

Trends in Urban Population

Since population and demographic changes largely determine housing needs, it is important to look at various trends and emerging patterns, particularly in terms of urbanisation. India's overall population rose rapidly after independence, but only in the recent decade has shown signs of stabilising. Accompanying this rapid rise in population was another one in urbanisation. The share of the urban population increased from 20 per cent in the 1950s to over 30 per cent currently.

India's Housing Shortage

Official and up-to-date statistics on the shortage of housing units in the entire country are not readily available. According to the National Buildings Organisation (NBO), the factors behind the housing shortage include (a) an excess of households over available houses, including homeless households, (b) congestion, i.e., the number of married couples requiring a separate room, (c) replacement or upgrading of unserviceable houses and (d) obsolescence/replacement of old houses. The last official (NBO) estimate of the housing shortage, put it at a total 19.4 million units, comprising 6.6 million units in urban and 12.8 million units in rural areas. On top of this, over 90 per cent of this shortage hits the poor and low-income category (Ministry of Urban Affairs, 1998). However, being based on the 1991 Census figures, these numbers are outdated. The unofficial estimate of the housing shortage is currently pegged at over 40 million dwelling units.

Despite the absence of reliable statistical information, a growing population and sustained urbanisation have kept the available housing stock under increasing pressure. As per the Planning Commission estimates, the total urban housing requirement during the 10th five- year plan (2002-2007), was 22.44 million dwelling units in urban areas. This comprises two components: an urban housing backlog of 8.89 million dwelling units (early 2002 estimate), and an addition of 13.55 million new dwelling units.

The 2001 Census showed that housing completions (defined as the absolute increase in housing stock during a particular period) stood at around five units per 1,000 inhabitants every year in India. Housing completions in urban areas remained steady at around seven per 1,000 during the past three decades or so. This, however, is lower than the minimum threshold of 8 to 10 housing units per 1000 as

Table 1.2: Addition of Census Houses per 1,000 Pop

	1971-81	1981-91	1991-01
Urban			
Added Census Houses (million)	11.55	16.55	19.53
Added Households (million)	10.00	11.64	12.95
Annual Housing Completions/1,000 population	7.23	7.61	6.83
Rural			
Added Census Houses (million)	19.25	29.02	34.56
Added Households (million)	15.50	19.16	25.61
Annual Housing Completions/1,000 population	3.66	4.62	4.65
Total			
Added Census Houses (million)	26.53	45.58	54.08
Added Households (million)	25.50	30.80	38.56
Annual Housing Completions/1,000 population	3.87	5.39	5.26

Source: Census 2001, NHB Trend and Progress Report, 2004

recommended by the United Nations for developing countries (NHB Trend and Progress Report, 2004).

In terms of distribution of households according to rooms occupied, the 2001 Census showed that 39 per cent of households lived in a single room, 30 per cent in two rooms, 14 per cent in three rooms and 17 per cent in more than three rooms. The median number of rooms has been two over the last four decades, during which the number of households living in a single room has declined, both in rural and urban areas.

Housing Conditions in India

Housing conditions are a key indicator of socio-economic development. India's National Sample Survey Organisation (NSSO) uses three classes, known as *katcha, semi-pucca and pucca,* to differentiate between the types of homes in India. A *katcha* house is built with non-durable materials like unburnt bricks, mud, thatch, leaves and bamboo. A *pucca* house is one built with permanent materials like oven-burnt bricks, concrete, stone blocks, cement, iron or other metal sheets and timber. A *semi-pucca* house is built with both *katcha* and *pucca* materials.

Table 1.3: Percentage Distribution of Households with Dwelling Units by Type of Structure (%)

Area Type	Pucca	Semi-Pucca	Katcha
Rural	36	43	21
Urban (incl. slum and squatter areas)	77	20	3

Source: NSSO, 2004

Table 1.4: Distribution of Housing by Exclusive Amenities (%)

Amenities	1981	1991	2001
Urban			
Safe drinking water	74.10	81.60	90.60
Toilet facilities	57.40	63.60	73.70
Electricity connections	61.60	75.90	87.60
Rural			
Safe drinking water	26.30	55.90	80.50
Toilet facilities	-	8.80	21.90
Electricity Connections	14.30	31.10	43.50
All-India			
Safe drinking water	37.90	62.70	83.30
Toilet facilities	-	23.50	36.40
Electricity connections	25.70	43.00	55.80

Source: NHB Trend & Progress Report, 2004, Census 2001

Table 1.1 demonstrates that the majority of households in India live in either *pucca* or *semi-pucca* homes. This situation has improved gradually over the years, though. In 2002, 36 per cent of those in rural areas lived in *pucca* homes as opposed to 32 per cent in 1993. In urban areas, the percentage of *pucca* homes increased to 77 per cent in 2002 from 74 per cent in 1993 (NSSO, 2004).

Further, statistics show that exclusive amenities available in homes are also improving. However, there still exists a wide disparity between amenities available in rural and urban areas, as well as those available to various income groups. Table 1.2 shows the change over the last three decades.

Further, the 2001 Census data on home conditions were recorded on a scale of 'good', 'livable' or 'dilapidated' based on the perception of the respondent. Of the total 192 million households surveyed, 96 million responded as living in houses which they considered as 'good', 85 million households responded as 'livable' and the remaining 11 million responded as living in dilapidated conditions.

Housing by Tenure Status

There is a preference amongst the majority of Indian households to own a home rather than opt for renting. In rural areas, availability of land is not as critical an issue as upgrading and improvement of the housing conditions, along with civic amenities and other basic infrastructure facilities. Thus over a 40-year period, the predominance of home ownership in rural areas has remained unchanged.

In urban areas, the trend has distinctly changed as more people have gradually begun to opt for ownership as against rental housing. The reasons are two-fold: first, rent-control laws in urban areas have discouraged new rent-based units from coming into the market. Secondly, an increase in available housing finance options over the years has enabled more people to buy a home.

Table 1.5: Tenure Status in Urban and Rural Areas (%)

	1961	1971	1981	1991	2001
Rural					
Owned	93.6	93.8	93.0	94.5	95.4
Rented	6.4	6.2	7.0	5.5	4.6
Urban					
Owned	46.2	47.1	53.5	65.9	71.5
Rented	53.8	52.9	46.5	34.1	28.5

Source: NHB Trend & Progress Report, 2004, Census 2001

Since 2001, the household sector has shown a preference for saving in the form of physical rather than financial assets. This could partly be attributed to a 'soft' or lower interest rate regime in the recent period (RBI, 2005). While physical assets also include livestock, jewellery and farm implements, amongst other items, housing is the most significant. Most people investing in a house are first-time homebuyers and genuine users of the home. The predominance of physical over financial assets is also due to the fact that availability of housing finance has improved in the recent period, and therefore has made housing more affordable.

Table 1.6: Household Savings as a percentage of GDP

	2001	2002	2003	2004	2005
Household Savings	**21.2**	**22.0**	**23.0**	**23.5**	**22.0**
Financial	10.2	10.8	10.3	11.5	10.3
Physical	11.0	11.2	12.7	12.0	11.7

Source: Economic Survey 2005-06

CHAPTER 2: THE NATURE AND SCOPE OF THE HOUSING PROBLEM

The Indian economy is undergoing a paradigm shift as it experiences a transition from a rural to an urban society. With an average gross domestic product (GDP) growth of over seven per cent over the last five years, the driver of growth is predominantly stemming from the services sector which now accounts for over 50 per cent of GDP. Changing demographics, a rising urban population, higher disposable incomes and fiscal incentives are encouraging more people to buy homes. However, an archaic legal framework and lack of mortgage penetration, especially in the lower income strata, continue to challenge efforts to alleviate the housing problem in India.

Based on the 2001 Census, for a total population of 1.03 billion, the number of Census-recorded houses stood at 249 million, of which 177 million (71 per cent) were in rural areas, while 72 million (29 per cent) were in urban areas.

In 2002, the average number of household members was 5.15 in rural areas and 4.47 in urban areas (NSSO, 2004). In line with international trends as well as with the decline of the joint family system and the rise of the nuclear family, it is expected that the average household size will continue to decline in India. Coupled with the fact that more individuals continue to migrate to cities in search of better livelihoods, smaller households suggest that there will be additional pressure on the availability of affordable housing.

Some of the key challenges and issues that stand in the way of a much-needed increase in the affordable housing stock are detailed below.

Rapid Urbanisation

Housing needs are strongly influenced by population growth and demographic changes. While in the recent period total population growth has been slowing down, the urban population continues to grow rapidly. The urban population has increased from 20 per cent in 1971 to almost 34 per cent currently (SSKI, 2006). Urbanisation is particularly concentrated in conurbations or 'mega' cities (i.e., those with a population in excess of one million). These mega cities account for almost 40 per cent of India's total urban population, and according to the 2001 Census, there are 35 of them. Polarisation of growth towards mega cities turns housing provision into a greater challenge in these areas, as the housing stock is unable to keep pace with demand (Nallathiga, 2005). This is exacerbated by continuing in-migration to urban areas. As a result, there has been a disproportionate rise of slums. For instance in Mumbai, almost 60 per cent of the total population live in slums.

Restrictive Laws

One of the major issues constricting the addition of homes is a string of archaic laws governing the Indian housing and real estate sector. Of the over 100 laws governing various aspects of real estate, many date back to the 19th century. The more significant include the Indian Contracts Act 1872, the Transfer of Property Act 1882 and the Registration Act 1908. Despite the plethora of laws, the legal framework requires a complete overhaul to make it more relevant to today's requirements.

These laws often lead to protracted litigation and create artificial scarcity of land, thereby raising prices. In India, land is a matter for individual States, as opposed to the central ('Union') government[1]. Thus, while central government may make amendments and issue guidelines, implementation remains optional for State governments. With 28 States and seven 'Union territories' (areas directly managed by the Union government), support for reforms has varied considerably from State to State.

Urban Land (Ceiling and Regulation) Act 1976 (ULCRA)

This legislation fixed a ceiling on the amount of land that a person can hold in a city. For the purposes of the act, a 'person' was defined as an individual, a family, firm, company or association. The ceiling ranged from 500 to 2,000 sq. metres and any excess land was to be surrendered to the State. The objective was to prevent concentration of urban land in the hands of a few and to bring about an equal distribution of land for the 'common good'. However, the act failed to achieve these objectives and has had many adverse side effects. In all, an estimated 19,200 hectares were procured and much land was locked up in litigation.

The act also led to corruption as landowners sought exemptions from government officials. It had two additional perverse side-effects: it prevented large tracts of available land from entering the market, and land usage after acquisition was often inefficient. Land collected for redistribution remained in government hands for a long time. Using Mumbai as an example, of the 1,300 hectares of land acquired under the 1976 act, it is estimated that the State only used about five per cent in over 20 years (World Bank, 2005). The end result was an artificial scarcity of land while limited supply pushed up land prices to unaffordable levels.

In 1999, the central government repealed the act and was duly followed by some States. However, major States such as Maharashtra and West Bengal have yet to repeal it.

Rent Control

Rent control initially was introduced as a temporary measure to prevent landlords from exploiting tenants after World War II. However, these rent control acts virtually became a permanent feature. Thus tenants occupying properties since 1947 continue to pay rents as fixed at that time, regardless of price increases or inflation. Rent legislation tends to be tenant-biased and subsequent court decisions have ruled that such property rights are inheritable, making the tenant the *de facto* owner. Further, in India, and in contrast to other countries, it is for the owner of the property to pay municipal taxes, rather than the occupier. These rules have combined to lead to a rapid reduction of rental housing and a withdrawal of existing housing stock from the rental market. Since the onus of maintenance of the building is on the landlord, the number of dilapidated buildings has increased. Litigation between landlords and tenants is not uncommon. Another outcome has been the stagnation of municipal tax revenue, since it is based on the rent payable. Rent control has been identified as the "*single most important reason for the proliferation of slums in India by creating a serious shortage of affordable housing for low-income families*" (Planning Commission, 2002).

In 1992, the central government proposed a new Model Rent Control legislation. However, many States are still to implement this. Cities such as Mumbai are ample testimony to what Swedish economist Assar Lindbeck once said: *"In many cases rent control appears to be the most efficient technique presently known to destroy a city — except for bombing."*

[1]India is a federation of States with two tiers of government: central and State. Under the Indian Constitution, the division of powers between the union government (centre) and the States falls in three lists: the Union List, the State List and the Concurrent List. Land falls under the purview of the States. Thus, the central government can guide States on land issues, but cannot adopt any specific law.

Planning and Development Control Regulations

Planning in Indian cities tends to be limited. Few State governments have laid out anything like a Town Planning Act. In its absence, the planning function is disseminated across various State departments with little co-ordination if any. Such departments also lack the resources or training to carry out proper planning, leading to delays and corruption for approvals.

Further, most of the current building laws in cities were made with the expectation of a smaller population. With increasing urbanisation, cities have experienced an influx from rural areas. To counter this problem, municipal authorities have imposed restrictive controls on the type of development that can occur within city limits. Such instances include restrictive zoning laws and low Floor Space Indices (FSI). For instance, in Mumbai, the amount of FSI permissible varies from 1.0 to 1.33 in 90 per cent of the city area. This is in stark contrast with other major cities in the world, where the FSI typically ranges between 0.5 and 15.0.

Such laws have led to India's artificial land scarcity, pushing up prices and making homeownership unaffordable for the poor. Potential remedies are threefold. A professional town planning committee would help ensure structured development, while higher FSIs could add to the housing stock in a given area. Improving infrastructure and connectivity to the city would also allow more homes to be built on the outskirts, enabling proper expansion.

Agricultural Land

At present, most Indian States restrict conversion of agricultural land to commercial use. In Delhi for instance, historical village land situated within city limits cannot be converted to develop urban settlements. Such laws prevent both urban expansion and additions to the housing stock. On top of this, no single person may by law hold more than 15-25 acres of agricultural land (Planning Commission, 2002). Lifting the controls on such land holdings would do much to boost the availability of stock.

High Transaction Costs

Another issue that constricts any additions to the official housing stock is the high transaction costs that go with home registration. At present, every home is subject to stamp duty at the time of registration. Stamp duty rates vary wildly across States though: some cap the total amount of duty to be paid, but others levy as much as 15 per cent of the value of the property. In contrast, most of the developed world charges stamp duty of one to two per cent. In some cases, high stamp duty leads to massive understatements of the proceeds of a sale. This places a large number of homes in the grey market, which prevents the formation of a genuine property market.

While India's National Housing and Habitat policies have called for rationalisation of stamp duties across all States, this has not happened so far. For the States, stamp duty is the second largest revenue earner after excise duties, whence a reluctance to reduce rates. On the other hand, lower stamp duties, would ensure better compliance and plug existing loopholes. Currently, if there is no registration, a transfer is not deemed to have taken place and capital gains tax can be avoided. This results in losses to the exchequer on various counts: understatement of sale proceeds, non-registration, non-payment of stamp duty and capital gains tax evasion. Moreover, a number of sales are not handled through legal agents, providing an opportunity to evade the transaction costs related to stamp duty, registration and property taxes.

Lack of Clear Land Titles

Establishing homeownership in India is difficult due to a lack of clear land titles. In India, it is not for States to certify housing titles or land property, and ownership is established only by a sequence of earlier transfers (Planning Commission, 2002). Such tenuous titles to land have led to next-to-no transparency in property transactions as well as widespread disputes and litigation. In effect, the very foundations of the real estate market are distorted. A panel working on the 10th five-year plan recommended computerisation of land records by the year 2005, but in many States this has not been implemented.

A Fragmented Market

The Indian housing market is highly fragmented, with the unorganised (i.e., informal) sector accounting for over 70 per cent of the units constructed. The unorganised (i.e., informal) sector of the housing market is characterised by local small builders and contractors. The organised (i.e., formal) sector accounting for the balance (30 per cent) comprises larger developers as well as government and other parastatal entities involved in housing and construction. Typically, organised developers tended to be niche players concentrating on a particular geographic location rather than having a pan-India presence. It is only recently that a few large, corporate developers have attempted to make their presence felt at an all-India level.

Tedious Approval Processes

Obtaining approvals for builders is an extremely tedious process as there is no single-window clearance facility. It is estimated that in Mumbai, a developer needs 57 approvals from various authorities. These tedious processes often result in unnecessary time overruns and delays. Since September 2005, prior environmental clearance from the Ministry of Environment and Forests (MoEF) is mandatory before any construction work or land development is started. This includes even residential housing projects in excess of IRN 500 million (USD 11.11 million). The MoEF is a central ministry and it is a tedious and unnecessary process to have to obtain central ministry approval although land is a State issue and each State has its own pollution control board. According to a study by Ernst & Young, the total time taken for clearances is approximately 120 days from the date of application, if an environment impact assessment (EIA) is not required. Where an EIA is required, approvals are estimated to take 254 to 450 working days (E&Y, 2005).

Lack of Data

Lack of reliable data remains a strong drawback for the Indian housing sector. For instance, in the USA, the figures for housing starts focus on privately owned housing units and include the number of building permits granted, and they are released on a monthly basis. Housing starts is a primary indicator of economic momentum; as such it causes fluctuations in financial markets,acting as a reliable pointer of home sales and spending patterns in general. Housing starts data is also used to predict the residential investment portion of gross domestic product. In India, no such data is available. Neither is there any reliable data on home sales and purchases, or on fluctuations in property prices.

Recognising the need for reliable and unbiased information on the performance of the residential property market, and specifically in terms of pricing and fluctuations, in 2005 the Ministry of Finance advised the National Housing Bank to develop a real estate price index. Accordingly, a group was constituted to develop 'Real Estate Price Indices for the Residential Housing Segment' (RESIDEX). The working group is expected to submit its final recommendations shortly.

Another problem in India is that there is no frequently available official data on outstanding mortgages, disbursements or the market shares of all housing finance institutions. In their own data banks include loans granted to housing finance companies who in turn on-lend to borrowers, which results in some double counting. Moreover, banks are only required to disclose total retail loan portfolios as part of segmental reporting, and are not mandated to disclose the composition of these portfolios. Therefore, most analysis can only be based on estimates.

Low Mortgage Penetration

Despite the frenetic pace of growth in housing finance over the past five years in India, mortgage penetration as a percentage of GDP remains low, at four per cent. This is extremely low indeed compared with countries such as the USA and the UK, where the combined value of mortgages passes 60 per cent of GDP. Even when compared with other Asian countries, India's performance is weak. On the flip side, this means that there are considerable growth opportunities in housing finance. This is further

corroborated by the fact that despite the recent, impressive rate of growth in the housing finance sector, financing through the organised/formal sector continues to account for only 25 per cent of total capital expenditure in housing in India (ICRA, 2003).

Table 2.1: A Cross-Country Comparison of Mortgages to GDP Ratios

Country	Mortgages to GDP Ratio (%)
India	4
China	11
Korea	14
Malaysia	22
Hong Kong	50
Germany	52
USA	64
UK	72

Source: European Mortgage Federation, HDFC, 2006

CHAPTER 3: THE EVOLUTION OF HOUSING FINANCE IN INDIA

Housing has been classified as a basic need in India and successive governments have highlighted its priority status. For all this emphasis, housing policies largely remained statements of intent rather than a matter of hands-on implementation. Earlier Indian governments tended to view housing from a social rather than an economic perspective, and the policies of the time reflected this. Today, the situation has changed. Participants like commercial banks and housing finance companies have made efforts to develop the mortgage market and improve the availability and affordability of housing.

The early development of housing finance in India came as an upshot of government housing policies. A clear perspective on the evolution of housing policies in India appears in the successive Five-Year Plans, which reflected a centrally planned mode of development. Development activities in India have been structured on the basis of Five-Year Plans since 1951.

Housing in the Five-Year Plans

India's 1st Five-Year Plan (1951-56) introduced housing in the national policy framework. Affordability was emphasised as the key issue, and government support through subsidies and loans was deemed necessary. A separate Ministry of Works and Housing was established and the National Buildings Organisation (NBO) was created. This plan in fact became the benchmark for subsequent Five-Year Plans over the next two decades.

The 2nd Plan (1956-61) strengthened the schemes laid out in its predecessor through expanded coverage. However, there was a policy shift as the central government decided to provide assistance to State governments to develop low-income housing, instead of directly providing loans to low-income groups. This gave rise to State Housing Boards that are still in existence today.

The 3rd Five-Year Plan (1961-66), followed by a triennial plan (1966-69), together placed emphasis on planned development and land acquisition, particularly for urban areas. Although both plans continued the schemes of those before them, they added a focus on the need to target low-income groups. State Housing Boards' resources were increased and they were expected to address the housing shortfall in their respective States.

Despite these efforts, by the 4th Five-Year Plan (1969-74) the government was faced with the dual problem of a rapidly growing population and a slow-growing housing stock. For the first time, the government decided to encourage private and co-operative housing schemes by providing financial assistance. However, the bulk of practical action remained within the public sector. The government also recognised the need to provide housing finance to low-income groups and accordingly set up the Housing and Urban Development Corporation (HUDCO) in 1970. HUDCO's mandate was to provide such groups with loans below peak interest rates and with longer repayment periods. At the same time, HUDCO also sought to finance urban development activities to help decongest cities. HUDCO actively bought bonds floated by various State Housing Boards and sought to provide other forms of financial assistance to them as well, effectively acting, in the main, as a wholesale lending arm for housing finance.

It was during the 5th Plan (1974-79) that the Urban Land (Ceiling and Regulation) Act (ULCRA) was adopted. ULCRA sought to prevent concentration of land holdings in urban areas and to make more land available for equitable disbursal. However, the legislation failed to achieve its goals and the repercussions are still being felt today. Coincidently, India's first retail housing finance company, known as the Housing Development Finance Corporation (HDFC) was set up at that time (in 1977). HDFC sought to provide financial assistance to individuals, groups and co-operative societies, as well as to companies for staff housing.

In a move to cope with increasing urbanisation, the thrust of the 6th Plan (1980-85) was on providing more housing in small and medium-size towns. Efforts were made towards improving living conditions in the slums while emphasising the need for more support to private groups. During this period, other housing finance companies also entered the market.

India had to wait until the 7th Plan (1985-90), however, for a radical change in government policies. As Garg puts it, the plan *"emphasised the need for radical reorientation of all policies relating to housing and argued that the major responsibility of house construction would have to be left to the private sector, [and] in particular, the household sector. [Further,] the government should be involved in housing not so much to build but to promote housing activity"* (Garg, 1998).

This was also when several reforms took place at home and abroad. In 1988 the UN General Assembly adopted the Global Shelter Strategy, which India endorsed . This gave the country the impetus it needed to draft its first National Housing Policy. Another major reform, also in 1988, was the founding of the National Housing Bank. NHB's mission was to promote and regulate housing finance companies and to mobilise additional resources for housing. A Building Materials and Technology Promotion Council was also established. During this period, several housing finance companies were promoted, but commercial banks still shied away from lending to this type of institution.

India's 8th Five-Year Plan (1992-97) built on the foundations of its predecessor, again acknowledging that housing-related activities belonged in the private sphere, while recognising that there was room for State intervention to provide housing to low-income groups. Those were the years when Parliament endorsed India's first National Housing Policy (1994). Importantly, the plan recognised that urbanisation was inevitable, and therefore concentrated resources on upgrading urban centres. The 8th Plan also recommended reforms of both a financial and a legal nature to allow the mortgage market to develop further. Special emphasis was on government incentives to enhance the flow of credit to the housing sector through housing finance institutions.

More recently, both the 9th (1997-2002) and 10th (2003-2007) Plans recommended further reforms to enable the government to play its role as facilitator and encourage development of the mortgage market. Particular emphasis was laid on market-friendly reforms in both taxation and infrastructure in a bid to increase capital spending in housing. Both Plans stressed the need to repeal old legislation, and in 1999 the central

Table 3.1: Capital Expenditure on Housing under Five-Year Plans (IRN billion)

Plan Period	Public Investment	Private Investment	Total Investment
1st (1951-56)	2.50	9.00	11.50
2nd (1956-61)	3.00	10.00	13.00
3rd (1961-66)	4.25	11.25	15.50
4th (1969-74)	6.25	21.75	28.00
5th (1974-79)	7.96	36.40	44.36
6th (1980-85)	14.91	180.00	194.91
7th (1985-90)	24.58	290.00	314.58
8th (1992-97)	315.00	660.00	975.00
9th (1997-02)	520.00	990.00	1,510.00
10th(2003-07)*	4,150.00	3,113.00	7,263.00

Source: NHB Trend & Progress Report, 2003
**Estimated figures as per Plan documents.*

government finally abrogated ULCRA. The government also adopted a revised National Housing Policy in 1998 and prepared another draft in 2005. The 9th and 10th Five-Year Plans also saw aggressive entry of commercial banks into housing finance.

Planned Investment

Proposed total investment in housing has soared from IRN 11.5 billion under the 1st Plan to IRN 7.26 trillion (USD 0.15 trillion) in the 10th Plan. However, the proportion of housing in the total capital expenditure under the plans has declined due to the shift in the government's emphasis from provider to facilitator (Garg, 1998).

The Development of the Formal Housing Finance System

Formal housing finance in India first came with the setting up of HUDCO in 1971. HUDCO sought mainly to cater to low-income groups, but at the same time provided technical and financial assistance to State Housing Boards, urban development institutions and the co-operative sector (Garg, 1998).

Private sector involvement in retail housing finance did not begin until the Housing Development Finance Corporation Limited (HDFC) was established in 1977. HDFC provides housing finance to individuals, co-operative societies and the corporate sector. HDFC's initial share capital included subscriptions from HH the Aga Khan and the International Finance Corporation (IFC).

Around the mid- and late 1980s a few housing finance companies were set up either as private limited companies (e.g., Dewan Housing Finance Limited) or as joint ventures with State governments (e.g., Gujarat Rural Housing Finance Corporation) or bank-sponsored housing finance companies (e.g., Can Fin Homes, SBI Home Finance, PNB Housing Finance). At that time, even State-owned insurance companies like the Life Insurance Corporation and the General Insurance Corporation of India set up their own housing finance arms.

With the recognition of the need to develop a network of specialised housing finance companies, also came the need for a dedicated supervisory agency specialising in the promotion and financial functions of housing finance, which until then had been in the purview of the Reserve Bank of India. As an outcome of the recommendations of the High Level Group on housing set up by the Union government (under the chairmanship of Dr. C. Rangarajan, then Deputy Governor of the Reserve Bank of India) with the National Commission on Urbanisation, in July 1988 the National Housing Bank (NHB) was established under an act of Parliament (NHB Act 1987). The National Housing Bank is the principal agency for the promotion and support (including financial) of housing finance institutions. The 1987 act empowers the National Housing Bank to issue directives to housing finance institutions in order to ensure sound business growth. NHB can also grant loans and advances or provide financial assistance to registered banks and housing finance institutions, or to any such authority established by or under any central, State or provincial act and engaged in slum improvement. Finally, NHB can devise schemes for the mobilisation of resources and extension of credit for housing.

The Role of Banks in Housing Finance

The Reserve Bank of India's initial efforts to encourage commercial banks to grant housing loans came in the form of 'directed' credit. This included mandating banks to lend to housing finance intermediaries at the banks' respective prime lending rates minus 150 basis points; commercial banks also has to allocate to housing finance 1.5 per cent of the previous year's incremental deposits. Over time and in a bid to move away from directed credit, the Reserve Bank removed the below-prime lending obligation in 1998, but the allocation for housing finance was increased to three per cent of incremental deposits.

Banks' housing-related lending takes three distinct forms: (1) direct lending, with banks extending housing loans; (2) indirect lending, where banks lend to approved housing finance companies or State housing boards which on-lend the monies; and (3), investments in securities backed by the mortgages issued by

housing finance companies (mortgage-backed securities or MBSs).

Domestic registered banks and foreign banks are required to extend a minimum of 40 per cent and 32 per cent respectively of their net bank credit to the priority sector, with sub-targets for various subsectors. Priority sector lending includes agriculture, small-scale manufacturing, small businesses, the retail trade, State-sponsored organisations for designated castes/tribes, and education. It took until 1990 for the Reserve Bank of India to add housing finance to its list of priority sectors (World Bank, 2004). For a direct housing loan to qualify as 'priority sector', it must not exceed IRN 1.5 million (USD 33,333) irrespective of whether the house is in a rural, semi-urban or urban area. As regards indirect housing finance, individual loans should not exceed IRN 500,000 (USD 11,111) to qualify as 'priority sector' lending.

It was not until the late 1990s that banks became involved in housing finance in any serious way. Against the combined backdrop of lower interest rates, industrial slow-down, sluggish credit off-take and ample liquidity, commercial banks recognised that if they were to maintain profit margins, they needed to shift their focus away from the wholesale segment and instead build retail portfolios. In the event, ower interest rates combined with rising disposable incomes, relatively stable property prices and fiscal incentives to make housing loans an attractive business. Moreover, in India this business has traditionally been characterised by a low proportion of non-performing assets, and the vast demand for housing loans further convinced almost all the major commercial banks to become involved.

India's Changing Housing Finance Market

Aggressive entry by commercial banks from the late 1990s onward changed a housing loan market that had so far been dominated by specialist finance companies. With increased competition this turned from a sellers' to a buyers' market, where the customer is provided with choice and bargaining power and is in a position to demand quality service.

The initial phase of banks' serious entry into housing finance could almost be termed as *'irrational competition'* in a drive to gain market share as quickly as possible. Some commercial banks devised extremely aggressive marketing campaigns to ramp up the size of their housing portfolios. This included intensive advertising, waiving of processing and administration fees, gift offers and other incentives, combined with on-the-spot loan approvals without sufficient documentary evidence, loan-to-value ratios in excess of 100 per cent and no prepayment charges on fixed rate loans. This was supplemented by cut-throat competition on the pricing front, with each new participant trying to undercut the other.

Fortunately, in the recent period, the market has seen some rationalisation and stability. Several banks came to realise that sheer undercutting in terms of pricing would ultimately affect profitability. As banks also found out, imprudent lending practices led to an increase in defaults as well as frauds. On top of this, constant cautionary warnings by the Reserve Bank of India of potential problems arising out of overheating in the sector and the need closely to monitor developments have helped to bring some semblance of order in the market. This led some banks to withdraw from housing credit, especially the public sector banks.

Today, the housing finance market has evolved into an oligopolistic structure (SSKI, 2006) with three dominant providers – HDFC, the largest housing finance company; ICICI Bank, the largest private sector bank; and State Bank of India, the largest bank in the country, which is also a public sector bank. Though there is no official data on market shares, SSKI India Research estimates that in 2005, the three leading housing credit providers accounted for approximately 75 per cent of the market. Only a few foreign banks are involved and they tend to focus on 'high net worth' individuals.

As regards housing finance companies, some of the smaller have been bought out by the larger ones, some bank-sponsored ones have been merged with their parent arm, while others have wound up business altogether. Barring three or four, most housing finance companies tend to be small, local, niche providers.

CHAPTER 4: TRENDS AND CHARACTERISTICS OF THE INDIAN HOUSING FINANCE MARKET

Housing finance in India has seen rapid growth on account of various factors such as increased urbanisation, favourable demographics, rising disposable incomes for a large section of the population, government tax incentives, larger supplies of better quality constructions, lower interest rates and relatively stable property prices.

Another significant change has taken place – in the mind-set of the Indian consumer. Until recently, the typical Indian was debt-averse, with borrowing often viewed as a social stigma. Borrowing from the formal sector was only used as a last resort. In India, the monies spent on housing were mostly from own savings, sale of assets, borrowings from relatives, friends or the ubiquitous moneylender. It has only been in the recent period that the mind-set has changed, with more individuals open to a credit culture and consumerism. This has best been seen in the rapid growth in housing loans, credit cards, auto finance and personal loans.

Increased Urbanisation

As the Indian economy's dependence on agriculture keeps decreasing, stronger economic growth has also opened up many new avenues for employment, especially in urban areas. Growing urbanisation and occupational shifts from agricultural to manufacturing and services-related jobs have been well correlated with changing attitudes towards consumption and retail finance (SSKI, 2006). As a result, India continues to undergo a transformation with rapid migration to the urban areas. India's urban population is expected to increase rapidly while the rural population experiences slower and eventually negative growth. An expanding urban population keeps the housing stock under pressure and creates demand for housing finance.

Favourable Socio-Economic and Demographic Factors

The socio-economic break-up of the Indian population can be seen as a pyramid, with a substantial low-income segment of the population at the base (incomes below USD 975 per annum), a growing middle class (incomes between USD 975 and 4,675 per annum) and a small, affluent/rich class (incomes above USD 4,675 per annum) at the top. This structure is expected to change towards a 'diamond' shape by 2010, as the middle-income group becomes larger with a substantial segment of the lower income group expected to move up to the middle income segment.

Table 4.1: Urban/Rural Population Rate of Change (%)

Year	Urban	Rural
2000-05	2.81	0.82
2005-10	2.73	0.43
2010-15	2.70	0.12
2015-20	2.74	(-) 0.09
2020-25	2.52	(-) 0.22
2025-30	2.25	(-) 0.40

Source: Draft National Urban Housing & Habitat Policy (2005), Census 2001

India is one of the youngest nations in the world with an average age of 28.4 years. Being more economically secure with a dynamic job market and strong growth, the new urban population is likely to resort to housing credit earlier in life. This is reflected in the fall in the age of an average home loan borrower from about 45 years to a 30-35 year range today.

The 'working population', defined as being between 15 and 64 year old, is expected to increase from 62.5 per cent in 2002 to over 70 per cent in 2030 (NCAER, 2005). The target age group for retail, and for that matter housing, finance is between the ages of 25 to 59 years and is expected to grow at a CAGR of 2.1 per cent over 2002-2011, compared with an overall population growth of 1.5 per cent over the same period (SSKI, 2006).

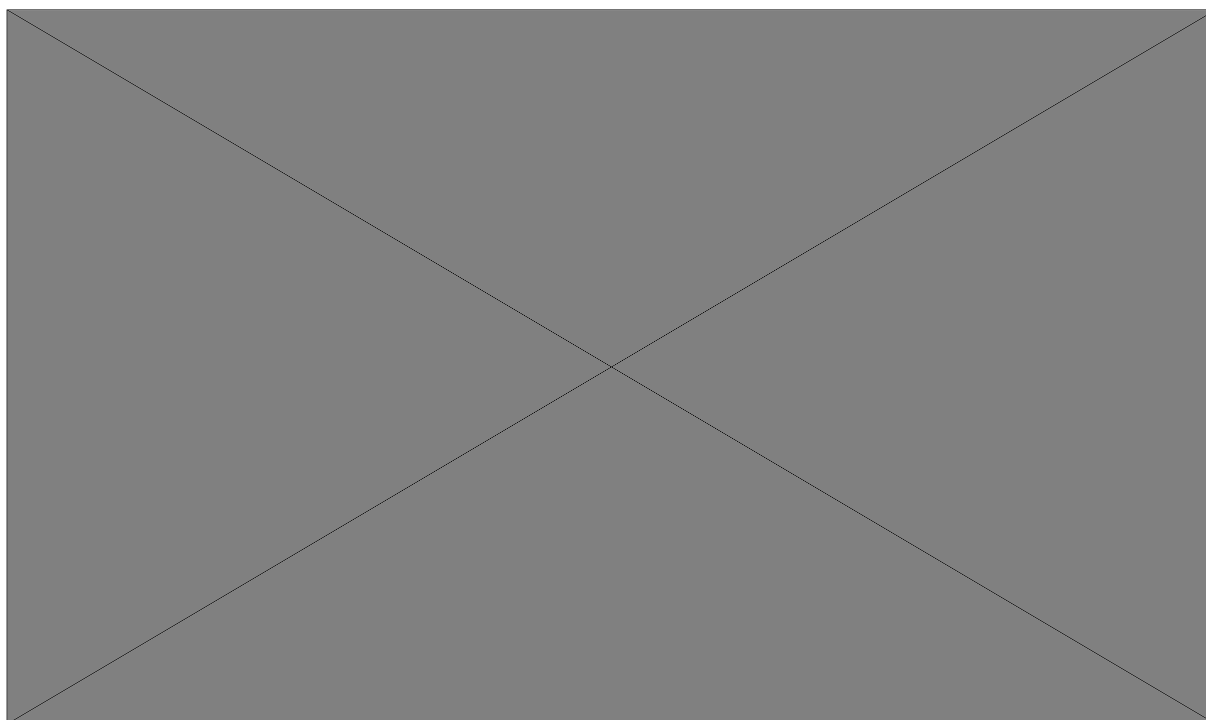
Enhanced Affordability

Housing today has hardly ever been at more affordable levels in Indian history. Estimates show that affordability (i.e., the ratio of the price of a residential property to the annual income of the borrower) has improved significantly. For instance, for a typical Mumbai suburb in 1995, it took about 22 times a borrower's total annual income to purchase a house, while in 2006 this ratio dropped to only five times (HDFC, 2006). Such enhanced affordability can also be attributed to the rapid rise in household earnings over the past decade. According to CRISIL, a credit-rating body, the average household income in urban areas has grown at a compounded 10 per cent in nominal terms over the last decade (CRISIL, 2006).

Interest Rates

Throughout the 1980s, interest rates were stable in India, predominantly as a result of a closed economy. By 1991 economic liberalisation resulted in volatility in interest rates. The 1996-1997 period was characterised by an acute liquidity crunch in the economy, with interest rates on housing loans peaking at 17 to

Affordability of Housing



18 per cent per annum. Until 1999 only fixed rates were available on home loans.

By the year 2000, commercial banks were actively offering home loans, and preferably with adjustable rates for a better fit with their liability structures. As market preference shifted to floating rate loans, most housing finance companies soon felt compelled to follow suit. However, adjustable rate housing loans are linked to an internal benchmark based on the cost of funds of each bank or housing finance company.

From 2000 to 2005, the interest rate cycle in India was on a downward trend with the cost of a 15-year home loan reaching an all-time low of 7.5 per cent. A low cost of credit gave a fillip to housing loans as the lower the interest rate, the higher the loan amount that a borrower can take for a given monthly payment.

In a decreasing interest rate cycle most borrowers began opting for floating rates. These are a function of the bank/housing finance company's prime lending rate. Most high-cost fixed rate loans were re-priced through conversion to floating for a nominal fee. First-time borrowers in particular focus excessively on initial monthly mortgage costs and have little understanding of the interest rate risks associated with various mortgage products (Miles, 2004). Therefore, it became important to explain the risks associated with floating rate loans to customers.

Most lenders offer customers an option to convert from fixed to floating rates (though most lenders do not allow the reverse option; the typical fee charged for converting a fixed to a floating rate would be 0.5 per cent of the outstanding principal of the loan amount.) Moreover, as the risks involved with floating rate loans became more evident to them, customers were offered combination loans of part fixed, part floating rates in a bid to hedge the interest rate risk.

Towards the end of 2005, India saw a gradual inching up of interest rates. Despite this, close to 85 per cent of housing credit customers still prefer floating rates as they are currently lower than fixed rates.

Loan Structures

Due to increased competition, loan maturities have lengthened to a maximum of 15 to 20 years for floating rate loans. This has proved to be beneficial to borrowers as it reduced the amount of the monthly instalments and thereby enabled larger loan sizes. However, the average maturity of most loans at origination is approximately 13 years. Some public sector banks today prefer to offer loans of up to 10 years in order to prevent any mismatch on their balance sheets, as most housing loans offered by banks are funded from current and savings accounts.

In a competitive environment, customisation of loan products is essential and most providers offer flexible repayment options in a bid to cater to individual needs. These, for instance, include various repayment options such as 'step-up repayment facilities' where the repayment schedule is linked to a customer's expected rise in income and repayment is accelerated in due proportion. Alternatively, under a 'flexible loan instalment plan' the repayment schedule is segmented, with an initial higher instalment followed by a lower instalment for the remainder of the term. Another formula, the 'balloon repayment facility', provides for repayment to be made on redemption of a financial investment, such as an insurance policy or bond, which is assigned as security for the loan.

Another outcome of increased competition was an increase in loan-to-value ratios (LTVs). In a bid to capture market share early on, some banks offered LTVs as high as 90 to 95 percent. A few banks went over the top with LTVs over 100 percent. Fortunately, the regulators were quick to step in to stop imprudent lending practices. Soon enough the few banks involved found that they had to curb any further housing credits, as non-performing assets began to build up.

For an experienced lender like HDFC, competition did not alter its approach to credit risk. HDFC typically has been conservative as regards credit appraisals. While HDFC's maximum LTV is 85 percent, on a portfolio basis it is in a 65 to 68 per cent range and the income to instalment ratio is between 35 and 40 percent.

Tax Benefits

In order to help boost home ownership, the government has offered tax incentives to individuals who opted for home loans. Interest payments on a housing loan up to INR 150,000 per annum (USD 3,333) and annual repayments up to INR 100,000 (USD 2,222) are eligible for deduction from a borrower's gross income. These tax benefits have considerably reduced the effective rates of interest on loans, to the extent that it is more beneficial to borrow from a bank or housing finance company than to use one's own funds. For instance, a borrower opting for an INR two million (USD 44,444), 15-year loan at 9.5 per cent per annum will effectively be paying an interest rate of 5.68 per cent per annum (HDFC, 2006).

While various tax committees have declared in favour of removing a host of current exemptions and deductions in the Income Tax Act, it is unlikely that the government will eliminate those on housing loans, in recognition of the fact that fiscal incentives have boosted home ownership.

Loan Products

Financial firms lend to individuals, members of co-operative societies and companies for the construction or purchase of residential housing in India. With competition currently the norm, products are designed to be as flexible as possible in order to satisfy borrowers' diverse needs Many financial firms have devised various innovative products to meet this purpose, offering flexible repayment facilities, or add-on benefits such as insurance or credit card facilities, on top of a housing loan.

Individual Loans

The most common form of credit is the 'plain vanilla' home loan to acquire or construct residential accommodation. The principal eligibility criterion is the borrower's repayment capacity. Loans are generally repaid in equal monthly instalments over a period of five to 20 years. Some lenders place a ceiling on loan amounts of either INR 10 million (USD 222,222) or 85 per cent of the cost of the property, whichever is lower; other lenders place no such constraints on loan amounts, but are driven solely by the repayment capacity of the borrower. The security for the loan generally takes the form of an equitable mortgage of the property and/or such other collateral security as may be necessary. Maturities vary according to the purpose of a loan, but most are for a maximum 15 to 20 years, or until the retirement age of the borrower, whichever is earlier.

A borrower can choose between a pure fixed rate of interest, a fixed rate with a money market condition clause (wherein interest rates would change only in

Table 4.2: Effective Rates on Home Loans

	2006	2002	2000
Loan amount	2,000,000	2,000,000	2,000,000
Nominal Interest Rate(%)	9.50%	10.75%	13.25%
Max deduction for interest allowed Deduction on principal	150,000 100,000	150,000 20,000	75,000 20,000
Tenor (years)	15	15	15
Total amount paid per year	250,620	269,028	313,500
Interest component	190,000	215,000	265,000
Principal repaid	100,000	54,028	48,500
Tax amount saved	76,500	51,250	30,325
Effective interest paid on home loan	113,500	163,750	234,675
Effective interest on home loan	5.68%	8.19%	11.73%

case of extreme fluctuations in money market conditions), a variable rate or a combination of fixed and floating rates. Banks (as opposed to financial firms) generally offer only floating rate loans.

Other types of home loans include home improvement for internal and external repairs and other structural improvements of the house. Home extension loans are for additions/extensions in the form of an additional room, floor and any other extension to the house. Home equity loans are advances against the value and security of a customer's existing property for purposes such as education or medical costs or other approved expenditures.

Loans related to non-residential premises are provided to professionals such as doctors, chartered accountants or other such professionals to facilitate the purchase, construction or renovation of occupational premises. Short-term bridging loans facilitate the transition between purchase of a new house and sale of the old one. Land loans are granted for acquisition of land prior to construction of a residential unit.

Most financial firms in India also offer loans to non-resident Indians and individuals of Indian origin for the purchase or construction of dwelling units anywhere in India.

Corporate Loans

Financial firms lend to corporate bodies for the construction or purchase of new residential housing for the use of their employees anywhere in India. Loans to business enterprises for non-residential premises are also readily available. Some financial firms provide loans against rent receivables.

In recent years, the demand for business loans has primarily been driven from the information technology and business process outsourcing sectors, which generally prefer to take premises on lease. Some financial bodies grant loans to the owners of these properties based on lease rental discounting.

Loans to approved corporates for the purchase or construction of staff accommodation and office premises are also available in India, as they are to housing boards and co-operative housing societies.

Developer Loans

The larger housing finance institutions offer loans to approved developers for the construction of housing projects that are secured on rent receivables from their tenants.

Developer loans are typically for maturities of one to two years. Financial firms generally require security by way of mortgage over the property, including personal guarantees in respect of the amounts due under the loan.

Marketing and Distribution

A new development in the Indian housing finance arena over the past five years has been the introduction of aggressive marketing. Until then, word of mouth and recommendations were the most effective means of reaching out to new customers. In a rush to establish a brand name, some financial firms even hired superstars as brand ambassadors, thereby spending large amounts of money on promoting loan products. In the recent period, however, the market has settled with more mature marketing strategies. Today, lenders resort to the electronic and print media and mobile telephony to lure new customers and announce promotional offerings. Other current marketing strategies include financial firms and developers co-hosting property exhibitions, or financial firms entering into special tie-ups with developers.

With this evolution came a strong realisation that housing loans are different from other types of consumer loans. For most customers, a house is possibly their largest asset while ironically, a housing loan represents their largest liability. Secondly, customers opting for a home loan typically do not look only for funding – they require loan counselling to identify a suitable property, determine the loan amount that they are eligible for and also need technical advice to check the condition of building and whether the builder has requisite approvals in place. In addition, a borrower also requires legal advice to ensure that all documents are in order. This calls for expertise, which some professionals have developed over time, giving them an upper hand in terms of customer service from the outset.

The mode of distribution of housing loans has also undergone a sea change in India. Earlier on, maintaining offices close to potential borrowers was seen as the best way of increasing the number of 'walk-in' customers. Housing finance companies typically maintain smaller branch networks than commercial banks. Large networks are not an all-round advantage, though, because a customer looking for a housing loan is different from someone coming to a bank for routine functions. The frontline staff skills of a bank and housing finance company typically differ: bank staff handles a wide array of functions, as compared with a single one at a housing finance company. Many (particularly public sector) banks, on entering the housing credit market, were not very customer-centered. However, with increased competition, most banks today have become better tuned to customer needs.

With competition in full swing and each new participant keen on greater market share, this has become a buyers' market, as mentioned before, with the customer shopping around for the best offer and in a position to negotiate terms and conditions. In an effort to reach out to more customers, the typical sales strategy has turned to a 'feet-on-the-street' approach: it is for banks and housing finance companies to go to the customer, rather than the reverse. This has led to the rise of a new distribution arm - the Direct Selling Agents (DSAs), whose presence was earlier seen predominantly in credit card and personal loan sales. DSAs typically service 'high net worth' individuals who want doorstep service.

Initially, several institutions handed over the reins to DSAs to ramp up their housing loan business. Understandably, a DSA's objective is to obtain his/her commission. A number of DSAs neither had the requisite skills nor training to sell housing loans. In India, DSAs were not required to undergo any formal training and were not regulated by any body. As a result, loans would occasionally be granted to customers who were not creditworthy, and intermediaries became a frequent source of dysfunctional communication. Nonetheless, DSAs today remain the strongest sales force for banks and housing finance companies. Some housing finance institutions only use DSAs as 'sourcing agents' while the credit, legal and technical appraisals take place entirely in-house but at least one meeting with the customer is mandatory.

Another interesting outcome of increased competition in India has been the rise of cross-selling of products and services. Cross-selling includes offering privileged savings accounts and credit cards, but more importantly is an opportunity to take advantage of the strong synergies between housing and insurance; this is why both life and home insurance products are actively promoted to customers on top of home loans. While some of the larger commercial banks and HDFC have insurance subsidiaries and cross-sell their own brand products, the smaller housing finance companies have also entered into special arrangements with external insurers to sell insurance products to their own customers.

Prepayments

Though generally prepayments are correlated with interest rates, this has not been the case in India. The country still lacks a well-developed model to accurately forecast mortgage prepayments, and if anything, customers' lingering debt-averse attitudes play a more crucial role in prepayment patterns. The typical reasons behind widespread loan prepayment in India include windfall gains, maturing insurance policies, and higher incomes. Many borrowers still prefer to free themselves from loan constraints as soon as they can. This debt-averse attitude is beneficial to housing credit institutions as it reduces the effective life of a loan.

With its long history, HDFC provides a good opportunity to assess prepayment patterns. It has had a consistent prepayment level ranging between 10 and 12 per cent of the loans outstanding in the books at the beginning of a financial year. The only period when HDFC prepayments increased slightly out of this range was when other banks made an aggressive push into the housing finance market at a time when interest rates were decreasing. It was at this juncture that HDFC recognised the need to stem further prepayments by encouraging customers to convert

high-cost fixed-rate to floating rate loans for a fee. In their eagerness to build market share, several banks offered extremely low interest rates and sought to refinance existing loans. This strategy did not work too well when the interest rate cycle swung upward again. HDFC, for one, has always maintained a prepayment charge of two per cent of the outstanding balance in the case of a fixed rate loan or if the loan is refinanced on commercial terms. Initially, some banks waived prepayment charges, even on fixed rate loans. Today, however, in a more rational market, most lenders levy a prepayment charge on fixed rate loans, but generally do not levy any early redemption charge on floating rates.

CHAPTER 5: THE PERFORMANCE OF HOUSING FINANCE INSTITUTIONS

As is the case in some other countries, in India both specialised lenders and commercial banks provide housing credit. Across the world, a debate continues on the merits and demerits of dedicated housing finance companies. In India, these are regulated by the National Housing Bank, while commercial banks come under the supervision of the Reserve Bank of India. There are inherent differences between the two types of institution, especially in the liability structures, as well as certain fundamental differences in their regulatory requirements.

Commercial banks have rapidly expanded housing-related disbursements, thereby increasing market share. Whereas in the year 2000 housing finance companies accounted for 70 per cent of disbursements, five years later their collective share had decreased to 36 per cent, with banks accounting for 64 per cent of all housing finance disbursements (NHB, 2005).

What is significant, however, is that overall housing finance disbursements over the past five years have grown at a CAGR of 38 per cent and this growth momentum is expected to continue. According to SSKI India Research, mortgage finance is expected to grow at a CAGR of 20.7 per cent between 2005 and 2009.

The Performance of Housing Finance Companies

In 2006 a total of 44 housing finance companies were registered with India's National Housing Bank, of which only 22 were authorised to take deposits from the public (NHB, 2006). Although housing finance companies have continued to step up lending, most are feeling the strain, especially on the resources side, on account of the increasing dominance of banks in housing finance.

The specific advantage of housing finance companies is the well-developed skill set they owe to their specialist status. Since land issues are in the purview of individual States in India, each State sets its own rules and regulations, and knowledge of local markets is essential to ensure that prudent lending takes place. Smaller housing finance companies tend to be niche players. However, within the housing finance company sub-set, barely 10 are active retail housing lenders. Given HDFC's size and dominant position, it is almost unreasonable to include it in any comparisons between housing finance institutions. HDFC's total assets are 3.3 times as large as those of the second largest housing finance company. *(See Appendix 1 for summarised balance sheets*

Table 5.1: Housing Finance Disbursements *(INR billion; USD billion in italics)*

Institution Category	2000	2001	2002	2003	2004	2005
Housing Finance Companies	98.12	126.39	146.14	178.32	208.62	260.00
	2.25	*2.72*	*2.99*	*3.75*	*4.78*	*5.94*
Banks	35.97	55.53	85.66	235.55	328.16	457.00
	0.83	*1.19*	*1.75*	*4.96*	*7.53*	*10.43*
Others	7.01	8.68	6.78	6.42	6.23	-
	0.16	*0.19*	*0.14*	*0.14*	*0.14*	-
Total	**141.10**	**190.60**	**238.58**	**420.29**	**543.01**	**717.00**
	3.24	***4.10***	***4.88***	***8.85***	***12.45***	***16.37***

Source: NHB 2003, 2004, 2005

and profit and loss accounts of major housing finance companies.)

Based on admittedly insufficient data, it does appear that the average size of housing finance company loans is lower compared with that of commercial banks (which is currently around INR 850,000 (USD 18,889). Only 25 per cent of housing loans disbursed by specialist companies were above one million rupees (or USD 23,047) (NHB, 2004). This may be evidence that housing finance companies are catering to a niche segment.

Housing finance is a low-margin, high-volume business. Even a large provider like HDFC has traditionally worked on low spreads of 2.15 to 2.20 per cent. The debate over the survival of smaller housing finance companies is becoming louder in India. While smaller institutions have been bought out by the larger ones, some housing finance companies have ended up merging into their parent bank, as has been the case with Vibank Housing and Andhra Bank Housing. Ironically, the housing finance company promoted by State Bank of India, which was known as SBI Home Finance, has wound up operations after being saddled with extremely high non-performing assets.

For most housing finance companies, funding has become an ever-greater challenge. HDFC has been able to access a wide variety of funding sources at rates comparable with the best in the market, owing to its high credit rating. LIC Housing Finance Limited, the second largest housing finance company, receives funding support from the Life Insurance Corporation of India, the largest public sector life insurance company. Otherwise, the smaller housing finance companies depend on commercial banks, which today prefer lending directly when it comes to housing-related business. These smaller lenders also receive limited support from the National Housing Bank. A few are authorised to take deposits from the public *(For further details, refer to Appendix II, Salient Features of Guidelines for Housing Finance Companies.)*

The Performance of Commercial Banks in Housing Finance

The focus of commercial banks in India has clearly been on building up their retail portfolios. In 2005 this was evidenced by the dominance of housing loans in bank assets, as they accounted for half of the combined retail portfolio. As at March 31, 2005, housing loans accounted for 24 per cent of total loans and advances and six per cent of the total assets of the banking system (RBI, 2005).

Table 5.2: Retail Portfolios of Registered Commercial Banks *(INR billion; USD billion in italics)*

Items	2004	2005	% Growth
Housing Loans	894	1,347	51%
	20.50	*30.75*	
Consumer Durables	63	38	-39%
	1.44	*0.87*	
Credit Card Receivables	62	84	36%
	1.42	*1.92*	
Other Personal Loans	871	1,201	38%
	19.98	*27.42*	
Total Retail Loans	**1,890**	**2,670**	41%
	43.35	***60.96***	

Source: Reserve Bank of India, Trend and Progress, 2004, 2005

Table 5.3: Bank Lending to Housing Finance *(INR billion; USD billion in italics)*

	2002	2003	2004
Direct Housing Finance Disbursements	85.66	235.53	328.16
	1.75	*4.96*	*7.53*
Indirect Housing Finance Disbursements	57.01	67.96	98.45
	1.17	*1.43*	*2.26*
Investments in NHB/HUDCO Bonds	4.78	34.91	27.17
	0.10	*0.73*	*0.62*

Source: NHB Trend and Progress Report, 2004

In terms of direct housing loan disbursements, the Indian private sector banks are those that have gained considerable ground and continue to do so. Indirect lending to housing finance by banks is still increasing, but banks' investment in National Housing Bank and HUDCO bonds has been decreasing in the recent period. This is because since April 2006 these bonds no longer qualify as priority sector lending.[2*] Banks are now concentrating on direct lending.

2 * For those banks looking to become more involved in 'priority' sectors, i.e., agriculture, small-scale manufacturing, microcredit, housing and education loans, the Reserve Bank of India has mandated a target of 40 per cent of aggregate advances on this type of lending.

Incremental Returns on Housing Finance

In line with global trends, Indian interest rates were low between 2000 and 2004 and there was ample liquidity in the economy. During that period, rates on housing loans fell by approximately 675 basis points, while yields on 10-year government securities fell by 'only' 582 basis points over the same period. Against the backdrop of extremely low interest rates driven by competitive pressures, a CRISIL study entitled *"Low Incremental Returns on Housing Finance to Harden Rates"* estimated that Indian banks' incremental returns on housing loans in 2004 had dropped to as low as 9.01 per cent, compared with 18.8 per cent the previous year. The drop was even more dramatic for housing finance companies, with returns falling to 6.93 per cent as against 20.53 per cent the previous year. However, while CRISIL estimated the incremental returns for housing finance companies as a subset: HDFC was not included, as its considerably larger size and superior performance would have skewed the numbers significantly.

Asset Quality

Maintaining asset quality in housing finance involves sustained surveillance and monitoring as funds are lent over long periods. Although the business is characterised by relatively lower non-performing asset ratios compared with other sectors, until recently it saw a slight increase in that respect. This was probably an outcome of banks' initial rush, when many

granted loans without the requisite credit, legal or technical appraisal skills.

In 2004, CRISIL estimated that the proportion of banks' non-performing housing loans (lagged by one year, owing to the fact that portfolios are not sufficiently seasoned) was 3.3 per cent, compared with 5.33 per cent for housing finance companies (excluding HDFC on account of large size and superior performance). HDFC has always been characterised by low non-performing loans – under one per cent of its portfolio, calculated on a 90-day overdue basis.

For many years there were no foreclosure norms in India, and this is one of the reasons why earlier providers of housing credit had to develop skills to ensure that loans would be repaid. Courtroom procedures sometimes would take as long as 20 years to reach a conclusion. A much-needed reform for recoveries came in 2003 with the advent of The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act 2002 (SARFAESI). One of the objectives of SARFAESI was to remove recoveries from the ambit of the courts. As a result, a creditor is now allowed to acquire the property of a defaulting borrower who fails to pay within 60 days of being given notice. Appeals can only be made to a specialised Debt Recovery Tribunal within 45 days. This rule has proved to be extremely successful. According to the "Doing Business in 2006" report by the World Bank and IFC, the time it takes to enforce a security in India has shrunk from 10 years to six months due to minimal court involvement (World Bank, 2006).

As lenders took more advantage of SARFAESI, the numbers of recoveries have been significantly higher, especially for chronic and wilful defaulters. It is estimated that the ratio of bad loans in the housing sector has further declined by some 0.5 to 0.75 per cent, as compared with some three per cent previously (Financial Express, 2006).

Statutory and Regulatory Frameworks

A twofold regulatory structure – i.e. the Reserve Bank of India, which oversees banks, and the National Housing Bank, which regulates housing finance companies – on occasion results in duality of rules; this in turn induces regulatory arbitrage and creates loopholes in the overall framework (World Bank, 2004). There are fundamental differences between commercial banks and housing finance companies regarding taxation treatment, capital adequacy, liquidity requirements, deposit insurance and disclosure requirements. Convergence on these differences is required in order to provide a level playing field.

Lending Norms

While banks are required to allocate resources for priority sectors, of which housing finance is one, housing finance companies are not bound by sector-based lending limits. When banks lend under direct housing finance, a loan up to INR 1.5 million (USD 33,333) qualifies for priority sector lending; however, when the bank grants indirect housing credit, i.e. lends to a housing finance company for on-lending, the amount qualifying as priority sector lending is reduced to a maximum INR 500,000 (USD 11,111). Moreover, under the housing finance allocation, banks are mandated to devote at least three per cent of incremental deposits to housing finance, though today most banks are lending in excess of this mandated allocation.

Capital Adequacy and Prudential Norms

As mentioned earlier, banks are regulated by the Reserve Bank of India, and housing finance companies by the National Housing Bank. Banks are required to maintain a minimum capital adequacy ratio of nine per cent, as against 12 per cent for housing finance companies. The difference may be explained by the fact that the business of housing finance companies is concentrated in a single sector. In effect, this means that for every INR 100 of an individual housing loan, a bank is require to maintain INR 6.75 of capital, as against nine rupees for housing finance companies (based on a 75 per cent risk weighting).

In the past, risk weightings (for the purpose of calculating the capital adequacy ratio) on housing loans have not moved in tandem – for instance, when banks were encouraged to expand housing credit, the risk weighting was 50 per cent, compared with 75 per cent for housing finance companies. When the risk weightings were set to 50 per cent for both types of entities, the regulators dispensed with the loan-to-value (LTV) ceiling (earlier, loans with a loan-to-value ratio in excess of 75 per cent would carry a higher risk weighting).

When the regulators believed that the housing finance market was heating up somewhat too fast, risk weightings for individual loans were increased from 50 to 75 per cent, and from 100 to 150 per cent for commercial real estate loans. These higher risk weightings appear to be rather stringent in view of the standards set by the 'Basel II ' international agreement on capital ratios, which set risk weightings of only 35 per cent for individual housing loans and 100 per cent for commercial real estate loans.

Investments by banks in mortgage-backed securities issued by housing finance companies carry a 75 per cent risk weighting. Ironically, investments in mortgage-backed securities issued by banks continue to carry a 100 per cent risk weighting.

Another difference between the two regulatory frameworks lies in the time lags between the guidelines issued by each of the regulators. Inevitably, the Reserve Bank of India takes the first step and NHB follows suit.

Both banks and housing finance companies are required to report non-performing loans if overdue for 90 days. Banks are mandated only to disclose non-performing loans segment- wise, rather than by type of product. Therefore, banks' reported non-performing housing loans are generally only analysts' estimates rather than actual numbers.

Banks are required to maintain a provision of 0.4 per cent on standard assets. However, from April 2006 onwards, they must also maintain a provisioning of one per cent on standard housing loans in excess of two million rupees (USD 44,444) and on all commercial real estate lending. So far, the National Housing Bank does not require housing finance companies to maintain any provisioning for standard assets. This effectively means that for every INR 100 it lends, a bank must maintain a provision of one rupee in its books. However, HDFC does maintain provisions on standard assets. *"It [HDFC] effectively self-regulates by hewing to more prudent standards than would be required by the National Housing Bank's regulations"* (World Bank, 2004).

Deposits

Most banks fund retail portfolios through savings and current account deposits. Bank term deposits are insured up to INR 100,000 (USD 2,222) per deposit. In contrast, housing finance companies are only allowed to raise term deposits for maturities ranging between one and seven years and these deposits are not insured.

Banks are mandated to hold a statutory liquidity ratio (SLR) of 25 per cent on all their liabilities while housing finance companies are required to maintain a SLR of 12 per cent only on public deposits. Moreover, while banks must maintain a cash reserve ratio of five per cent, housing finance companies are not mandated to do so.

Further discrepancies between the banking and the financial sectors have been introduced by the Finance Act 2006: interest on bank deposits with maturities of five years or more is deductible from total income up to INR 100,000 (USD 2,222), while interest on deposits at housing finance companies is fully taxable.

Taxation Issues

Taxation regimes also vary between banks and housing finance companies. For instance, banks are allowed a deduction on their provisioning for non-performing assets under Section 36(1) (viia) of the Income Tax Act 1961. This provision, however, is not available to housing finance companies.

On the other hand, under Section 36(1) (viii) of the same Income Tax Act, a housing finance company

is allowed to transfer up to 40 per cent of taxable profits from long-term housing finance to a special reserve and claim this amount as a deduction in computing tax liability. This provision helps to bring down the effective tax rate of a housing finance company to a much lower level than the stipulated corporate tax rate. To make use of this tax provision, certain banks have floated housing finance companies registered with the National Housing Bank, where housing loans are marketed, distributed and serviced through the housing finance company but are funded and booked in the bank's balance sheet.

CHAPTER 6: FUNDING SOURCES FOR HOUSING FINANCE

Banks and housing finance companies have inherently different funding sources. Banks have an advantage in terms of funding with their access to deposits (low-cost savings and current accounts). National Housing Bank directives do not allow housing finance companies to offer checking or notice accounts. A concern for commercial banks is that with the rapid growth in housing portfolios, they risk adding to the asset-liability mismatch on their balance sheets as they fund more long-term assets with short-term liabilities.

Funding Sources for Housing Finance Companies

Sources of funding for housing finance companies include deposits, institutional borrowings (domestic and international), refinancings from the National Housing Bank and their own capital.

In 2004, 45 housing finance companies were registered with the National Housing Bank, of which 24 were authorised to take deposits from the public. On a consolidated basis, these housing finance companies reported INR. 85.65 billion (USD 1.97 billion) in net own funds and a combined paid-up capital of INR 29.41 billion (USD 0.68 billion) as at March 31, 2004 (NHB, 2004).

Public deposits (on which statutory liquidity ratios must be maintained) used to be a major source of funding for housing finance companies in India. However, as interest rates began to decline, the interest earned on the government's competing savings instruments remained considerably higher than what was on offer from housing finance companies, making these relatively unattractive. Moreover, while retail funds provide a generally stable form of resources, the cost of funds is typically higher, due to higher administration costs and brokerage fees for the agents who help secure these deposits.

Housing finance companies are allowed to offer term deposits for maturities of one to seven years, with penalties for early withdrawal. They are also allowed to raise deposits up to five times their net own funds.

Borrowings from commercial banks also represent a major source of funding for housing finance companies. In the current environment, most banks prefer to offer shorter maturity loans. For creditworthy customers, banks generally roll over the loans. Floating rate loans offered by banks are linked to their respective prime lending rates, the Mumbai Inter Bank Offered Rate (MIBOR) or the Commercial Paper Reference Rate. Other sources of funding from the capital market include bonds and debentures, where subscribers are banks, provident funds, insurance companies and mutual funds.

While a few of the larger housing finance companies have in the past been able to tap international resources from multilateral/bilateral agencies and the syndicated bank market, in November 2003 the Reserve Bank of India issued a notification preventing any financial intermediary (i.e., bank, financial institution, non-banking financial company, including housing finance companies) from tapping foreign commercial credit markets. However, housing finance companies are permitted to issue Foreign Currency Convertible Bonds (FCCBs) for up to USD 500 million, provided they fulfil three specific criteria. First, the company's minimum net worth in the previous three years should not be under five billion rupees (USD 111 million). Secondly, the housing finance company should have a dual listing on the Bombay Stock Exchange (BSE) and the National Stock Exchange (NSE). Thirdly, the minimum size of the FCCB should be equivalent to USD 100 million. In September 2005, HDFC issued a USD 500 million equity-oriented, five-year zero-coupon FCCB with a conversion premium of 50 per cent over the initial reference price. As of writing, HDFC

Table 6.1: Refinancing Disbursements *(INR billion; USD billion in italics)*

Institution	2002	2003	2004	2005
Housing Finance Companies	7.05	17.67	18.46	20.61
	0.14	*0.37*	*0.42*	*0.47*
Banks	0.77	7.90	12.75	54.04
	0.02	*0.17*	*0.29*	*1.23*
Others	2.42	1.53	1.31	0.35
	0.05	*0.03*	*0.03*	*0.01*
Total	10.24	27.10	32.52	75.00
	0.21	*0.57*	*0.75*	*1.71*

Source: NHB Annual Reports

remains the only housing finance company that has raised funds through a FCCB.

Refinancings from the National Housing Bank

The smaller housing finance companies rely on the National Housing Bank for refinancing. Table 6.1 shows the refinancing disbursements by the National Housing Bank over the past few years. As housing loans have picked up, so have refinancings. As at June 30, 2005, the National Housing Bank had disbursed a cumulative INR 206.41 billion (USD 4.7 billion) in refinancings.

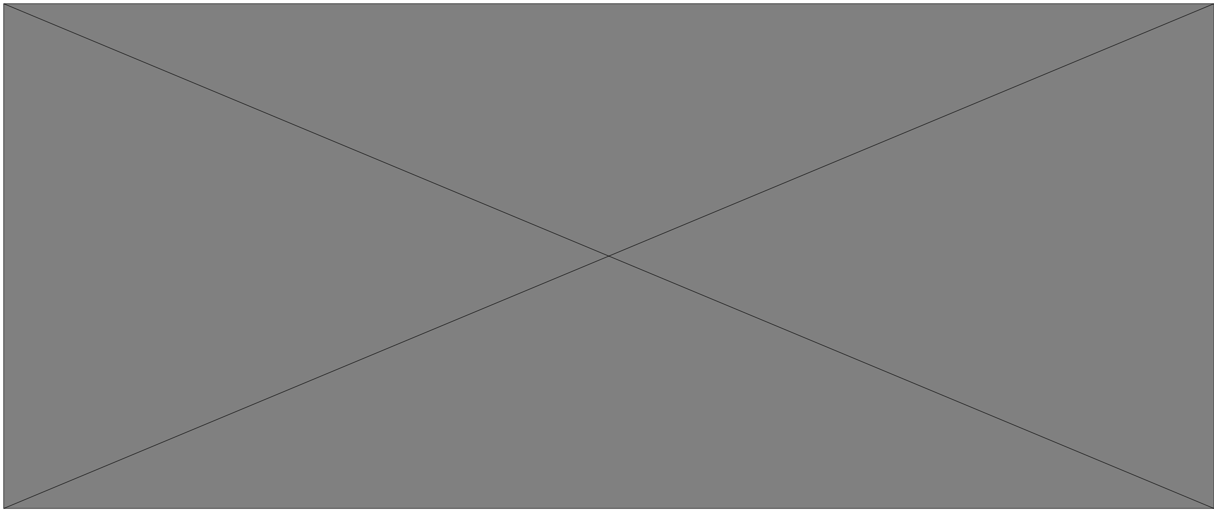
It must be noted here that the National Housing Bank is finding it increasingly difficult to raise low-cost resources at competitive rates for on-lending for refinancing purposes. As at June 30, 2005, NHB total assets stood at INR 189.48 billion (USD 4.3 billion) while its borrowings stood at INR 160.13 billion (USD 3.66 billion). The National Housing Bank raises most of its resources from capital gains as well as taxable and tax-free bonds. NHB also issues short-term commercial paper (CP), contracts lines of credit with commercial banks and borrows from the Reserve Bank of India. Since the National Housing Bank predominantly raises resources from the market, doing so at low costs has become more of a challenge. As NHB needs to earn a spread on refinancing rates, these can prove fairly high for smaller housing finance companies. But since most housing finance companies do not feature top 'AAA' credit ratings, their ability to raise funds at competitive rates is also constrained.

The National Housing Bank's ability to raise resources will become increasingly difficult, since its bonds no longer qualify as 'priority sector' lending for banks. This situation has been further exacerbated by amendments in the Finance Act 2006, whereby NHB bonds no longer qualify for capital gains tax exemption.

Securitisation

In India, debt securitisation remains in its infancy. After the first pilot issue in 2000, securitisation has proven itself as a viable method for financial firms to maintain capital adequacy and improve liquidity. However, some obstacles remain, such as lack of standardisation in terms of underwriting procedures, lack of rationalisation of stamp duties across States and lack of clarity in taxation. Most investors in mortgage-backed securities (MBSs), which include commercial banks and mutual funds, can only hold these instruments to maturity since they tend to be illiquid. This is because the Securities Contracts (Regulation) Act1956 does not recognise mortgage-backed securities under the definition of 'securities'. As a result, MBSs are barred from stock-exchange listings and trading. A bill has been introduced in Parliament to lift these obstacles, but is still pending.

The Securitisation Structure



Still, in a bid to ensure the orderly development of the securitisation market in India, the Reserve Bank issued guidelines in February 2006. These impose stringent provisions on the accounting treatment of the securitised assets in the books of the originator. For instance, any profit/premium arising on account of sale should be amortised over the life of the securities. Some market institutions felt that this was too restrictive, objecting that if an asset is sold and at a profit, it must be accounted for immediately, especially since the Reserve Bank of India has already prescribed stringent criteria for 'true sale' of assets (Rajwade, 2006).

Another inconsistency appears on the capital charge on credit enhancements. In India, the element of first and second loss support has been quite high, due to the fact that there is no market for 'mezzanine' finance, or any buyers for mezzanine-type instruments (Kothari, 2006). Originators in India must put up strong first/second loss support for securitisation transactions. If the originator provides the credit facility, then 50 per cent of the first loss and second loss facility must be deducted from capital. This has proved to be somewhat of a deterrent on securitisation, as it acts as a further drain on capital.

Another drawback of the February 2006 RBI guidelines pertains to the second loss facility if it is provided by a third party. In this case, the enhancement is treated as a direct credit substitute with a 100 per cent credit conversion factor and a 100 per cent risk weighting covering the amount of the facility. Such variation in capital charges, depending on who provides the enhancement, seems to be lacking in consistency (Rajwade, 2006).

As raising resources was becoming increasingly challenging for smaller housing finance companies, it was envisaged that these might have to convert into pure originators. This would require them to transfer the assets to a larger institution in the form of a portfolio sell- out or through mortgage-backed securities, rather than continue to raise resources themselves in order to fund the business. As a result, these institutions could earn a fee-based income for originating and servicing housing loans. This is one of the primary reasons why it is essential for the secondary mortgage market to deepen and become more active.

Table 6.2: The Securitisation Market in India *(INR billion; USD billion in italics)*

	2002	2003	2004	2005
Total Mortgage-backed Securities Issued	0.80	14.80	29.60	33.40
Number of Transactions	*0.02*	*0.31*	*0.68*	*0.76*
	3	10	15	15

Source: ICRA, 2005

Need for Diversified Resources

Since demand for housing finance is so strong in India, current conditions suggest that the greater challenge lies in raising low-cost, long-term resources.

It has been a long-standing demand of housing finance participants, and especially specialised financial firms, to be allowed access to pension fund monies. These funds occupy a prominent place in the financial savings of the household sector, are long-term in nature and originate with the salaried segment of the Indian population. The primary objective of pension funds is to provide social security for its individual members. It would therefore be apt if a portion of these resources was invested in the housing sector. Housing finance satisfies the need for social security and therefore eminently qualifies for funding from pension funds. Currently, however, these funds can only stick to the rigid investment patterns set out by the government.

International resources, especially lines of credit from multilateral/bilateral lending agencies, provide alternative long-term funding. In the past, a few of the larger housing finance companies with adequate credit ratings have raised international resources through the Global Depository Receipt route, the syndicated loan market and from international lending agencies. These included the World Bank, the Housing Guarantee Programme of the United States Agency for International Development (USAID), the Commonwealth Development Corporation, the Asian Development Bank, the International Finance Corporation, Deutsche Investitions und Entwicklungsgesellschaft MbH (DEG) and Kreditanstalt fuer Wiederaufbau (KfW). Smaller housing finance companies have not been able to access the international market.

Besides insurance companies and provident funds, India does not feature any sources of funding with an appetite for long-term assets. As a result, it is increasingly difficult to match the loan maturities on offer – 15 to 20 years – with long-term resources at reasonable costs. In a bid to avoid further mismatch, some banks have decided to restrict housing loan maturities to a maximum 10 years.

Both the Reserve Bank of India and the National Housing Bank have issued guidelines on asset-liability management, stipulating the maximum permissible negative gaps in various time segments. The regulators have also mandated the setting up of Asset-Liability Management Committees to review and monitor liquidity positions and interest rate gaps on a regular basis.

CHAPTER 7: LOW-INCOME HOUSING FINANCE IN INDIA

The majority of India's population, and especially the urban poor living in slums, lack access to housing finance from the formal sector. Beyond bodies like HUDCO, no specialised institutions cater to the needs of the low-income segment in India. There is thus an urgent need to address the institutional and regulatory aspects of this situation, as well as to strengthen and expand the capacity of financing institutions, including community-based organisations, to respond to poor households' needs for housing credit.

Range of Access

Reliable data on low-cost housing and mortgage penetration in India is hard to come by. The bulk of the research focuses on 'formal' financing institutions, while the poor depend primarily on the 'informal' financial sector which relies on financial agents and moneylenders. The financial terms and conditions of housing loans in the various sub-markets are summarised in Table 7.1.

The Informal Sector

This sector is relatively accessible to low-income groups. It consists of non-mortgage based lending where the borrower is free to determine the purpose for which s/he wants to take a loan. The size of the loan is rather small with a relatively high rate of interest. Maturities are short- to medium-term, with flexible repayment schedules.

Credit providers in the informal sector can be split into personal lenders, commercial lenders and financial self-help organisations. Personal lenders encompass friends, relatives or neighbours and these

Table 7.1: Low-Income Housing Loans under Various Providers

Market Type	Accessible	Collateral	Purpose of Loan	Term	Repayment*
Informal Sector	Yes	Often social	Defined by the borrower	Short - medium	Flexible
'Semi-formal' financial institutions	Yes	Often mix of conventional and social	Defined by the borrower or fixed	Short - medium	Flexible
Public Sector	Difficult	Conventional	Fixed by the lender	Long	Fixed
Formal Private Sector	Unlikely	Conventional and social	Fixed by the lender	Medium - long	Flexible
Non-Governmental Organisations	Yes	Conventional and/or social	Fixed by the lender	Medium – long	Flexible
Community- Based Organisations	Yes	Social	Defined by borrower	Short - medium	Flexible

Source: Smets, 2004

** Repayments can be tailor-made to individual customer requirements.*

deals are based solely on trust. Moneylenders and pawnbrokers can be classified as commercial lenders since they provide money on a commercial basis. Although such lenders prove to be extremely efficient in disbursals and recoveries, they tend to charge exorbitant rates of interest compared with formal financing institutions. Financial self-help organisations include schemes like *'chit'* funds where people can pool savings and obtain loans.

Semi-Formal Financial Institutions

Institutions recognised by the Reserve Bank of India such as licensed *chit* funds, moneylenders, pawnbrokers and finance corporations come under the semi–formal sector. This recognition carries an ability to go to court in case of default, but such instances are in reality unlikely. Moreover, these institutions are not authorised to take on banking activities or accept deposits.

Licensed *chit* funds offer cheaper housing loans than formal specialised firms but exclude the poorest, since members contribute relatively high sums of money. Moneylenders and pawnbrokers use personal collateral, that is, any material possessions of the borrower. Finance corporations deal mainly with clients who are able to pledge conventional collateral. Loans granted from these types of institutions are specified for a stated purpose with fixed repayment schedules.

The Public Sector

Public housing finance for the urban poor is accessible only with difficulty. The public sector institutions active in housing finance include the National Housing Bank (which is also the regulator), HUDCO, NABARD (the refinancing institution for Regional Rural Banks), public sector commercial banks as well as city development authorities and municipal corporations, some of which act as financial intermediaries. These bodies encourage beneficiaries to invest their own monies in their dwellings, but do not offer savings deposits. The beneficiaries are granted larger housing loans than what may be available from informal sources. To make housing loans affordable for the urban poor, direct subsidies are granted toward construction costs (e.g., the VAMBAY scheme, outlined later in this chapter) and/or indirect subsidies on interest rates. The latter could be in the form of the interest differential subsidy amounts being remitted directly in the HFC loan accounts of the borrowers, so as to bring down their loan liability. These loans are characterised by conventional mortgage lending, feature longer-term maturities and are repaid in equal monthly instalments (EMIs).

Private 'Formal' Sector

Access to housing credit from specialist companies is difficult for low-income categories in India. The lending criteria set out by formal financial institutions are more appropriate to the lifestyles of the middle-level income group. To obtain a housing loan, a combination of conventional (i.e., assets that can be mortgaged) and non-conventional 'collateral' such as peer pressure is required. Lack of mortgage insurance is also a reason why the private formal sector bypasses the low-income segment.

Non-Governmental Organisations and Community-Based Organisations

Many policymakers believe that non-governmental organisations (NGOs) and community- based organisations (CBOs) can serve a large segment of the housing finance market. These are considered to be more efficient and effective since they tend to have 'grassroots' presence among the poor. Although NGOs have access to the poor, examples of such bodies providing or facilitating home loans are still a rare phenomenon. However, some NGOs and CBOs are slowly becoming involved in this segment. The purpose of the loan is generally fixed, conventional and non-conventional collateral is required, the loan maturity is medium to long and the repayment schedule is flexible. *(Smets, 2004,)*

Government Sponsored Low-Income Housing Finance Programmes

The Housing and Urban Development Corporation Ltd. (HUDCO) was incorporated in 1970 and came as the first government-led initiative focusing on the social aspect of housing and utility provision. However, since then, successive governments have launched a variety of programmes aimed at eradicating the housing finance gap which the poor continue to face.

Role of HUDCO

HUDCO earmarks more than 50 per cent of its housing finance portfolio for 'low-income groups' (LIG - defined as households with incomes between INR 3,200 and 7,000 (or USD 72 to 156) and those known as the 'economically weaker section' (EWS - defined as households with monthly incomes under INR 3,200 (or USD 72). Such schemes provide for differential interest rates (e.g., these could be 50 – 175 basis points lower than prevailing market rates), longer repayment schedules (up to 15 years) and higher loan components for lower cost units. The scheme features cost ceilings and loan limits for various income groups linked to the prevailing cost of construction in a particular region. However, HUDCO's operations for mass housing programmes are constrained by its dependence on State government guarantees. Generally, all loans to State government bodies and public sector borrowers functioning under the States are required to carry a State government guarantee. In lieu of this, HUDCO also accepts bank guarantees. HUDCO also provides housing finance assistance for house construction or upgrading of the conditions of 'economically weaker sections' through NGOs. In certain cases, HUDCO also considers extending lines of credit to NGOs. In addition, technical assistance is also made available to State Housing Boards and NGOs for implementation of such schemes.

HUDCO also implements the central government's sponsored 'Night Shelter Scheme' for urban footpath dwellers, which includes shelter and sanitation facilities.

Valmiki Ambedkar Awas Yojana (VAMBAY)

In 2002 the Government of India launched a scheme called the '*Valmiki Ambedkar Awas Yojana*' (Valmiki Amebedkar Housing Scheme for the Slums) (VAMBAY). The rationale is to provide financial assistance towards improving the living conditions of urban slum dwellers below the poverty line. Importantly, VAMBAY beneficiaries are given a freehold land title to their property, ensuring that the recipients are granted a sense of security.

Under the VAMBAY scheme, funds are available for the upgrading of existing units or for the construction of alternative dwelling units. A separate component also caters to basic amenities such as sanitation and water supply. The amount allocated for the building of a new house ranges from INR 40,000 (USD 889) to INR 60,000 (USD 1,333), depending on the population of the city. For example, in a Tier-II city like Pune, the amount allocated to a single family is INR 50,000 (USD 1,111). Half of the sanctioned amount is provided by the central government and the balance is to be matched by the relevant State government. The cumulative subsidies thus granted by the central government in the past three years were INR 5.3 billion (USD 117.78 million) towards the construction of 246,035 dwelling units and 29,263 toilet bowls (NHB, 2004). However, the VAMBAY scheme is likely to be reviewed and replaced by the new Jawaharlal Nehru National Urban Renewal Mission.

Indira Awas Yojana

The *'Indira Awas Yojana'* (Indira Housing Scheme) (IAY) was launched in 1986. The main objective of the programme is to provide grants for the construction of houses to rural families living below the poverty line, including scheduled caste, scheduled tribe and freed bonded labourers. Since 1996, IAY benefits have also been extended to ex-servicemen, widows or next-of-kin of defence personnel and paramilitary forces killed in action, irrespective of incomes. However, this remains subject to the condition that they reside in rural areas, do not benefit from any other shelter rehabilitation scheme and are houseless, or in need of shelter or shelter upgrading.

The IAY scheme does not allow contractors to take any part in the construction of IAY houses. The spirit of the IAY scheme is that the house should be constructed or delivered not by any external agency, but by the ultimate occupier of the house.

Under IAY, costs are shared between central and State governments on a 75:25 basis. Grant assistance is provided to the extent of INR 25,000 (USS 556) per house for normal areas and INR 27,500 (USD 611) for hilly areas.

An evaluation shows that while the IAY programme has certainly enabled many EWS families to acquire 'pucca' houses, the number of beneficiaries is limited given the resource constraints.

The Two-Million Housing Programme

The Two-Million Housing Programme was launched in 1999 to complement other state sector housing schemes. The goal was to provide financial assistance to low-income groups through formal financials firms. The Ministry of Urban Development and Poverty Alleviation monitors the scheme. As the name suggests, the Two-Million Housing Programme aims to provide two million dwelling units every year, of which 700,000 units in urban and 1.3 million units in rural areas. However, the annual target has not been achieved in any year since inception. The overall cumulative achievement has been about 74.8 per cent (NHB, 2004).

The Twenty-Point Programme

The Twenty-Point Programme (TPP) was first announced in 1975. The basic objective is to improve the quality of life of the poor and under-privileged population of the country. The programme envisages the nation's commitment to various socio-economic aspects such as poverty, employment, education, housing, agriculture and land reforms, irrigation, drinking water and others.

At the central government level, the progress of the TPP is monitored and reviewed by the relevant ministries and ultimately by the Ministry of Statistics and Programme Implementation, which evaluates progress at a macro-level.

State governments make investments for EWS housing through respective annual budgets. Organisations like HUDCO, which grants loans to the extent of 15 per cent of its resources, add to the overall resources available. Refinancing is also available from the National Housing Bank to States, co-operatives and other organisations involved in the construction of EWS housing.

Bilateral and External Assistance

Various projects relating to EWS housing and slum improvement in India's urban areas are underway with the help of overseas funds in collaboration with the Ministry of Urban Affairs and Employment. These projects are funded by the Overseas Development Administration, Kreditanstalt fuer Wiederaufbau (KfW), Germany, the Japan Bank for International Co-operation (formerly known as the Overseas Economic Cooperation Fund) and other such agencies.

The UK Department for International Development (DFID) supports slum improvement projects in a number of Indian cities, in collaboration with India's Ministry of Urban Affairs. At present DFID supports the Andhra Pradesh Urban Services for the Poor and the Kolkata Urban Service for the Poor programmes.

Prior to 1999, Germany's KfW had committed assistance to the extent of 110 million Deutschemarks (DEM) in grants and another DEM 70 million in loans to HUDCO for the purposes of EWS housing schemes. KfW had also provided a DEM 25 million loan and a DEM 62.4 million grant to HDFC to undertake and finance low-cost housing and micro-credit programmes for EWS groups.

Private Sector Initiatives

Private sector initiatives for EWS and LIG groups include financial intermediation by NGOs, micro-finance institutions, housing finance companies and banks. For instance, SEWA Bank in Ahmedabad, Gujarat, grants housing loans to such groups out of its own funds and also offers technical assistance to

women through its sister organisation, the Mahila Housing Trust. In South India, the DHAN Foundation has promoted self-help group federations that access housing loans from financial firms for onward lending to members. In Kerala, several NGOs mobilise funding from private institutional sources for housing credit purposes.

Loan schemes operated by NGOs, micro-finance institutions and CBOs appear to be more sustainable for low-income groups, as suggested by recovery rates of over 90 per cent.

CHAPTER 8: ASSESSMENT AND PROSPECTS

The housing finance market in India has undergone unprecedented change in recent times. This evolution has been interesting, especially for any developing countries looking to establish or strengthen their own primary housing finance markets. HDFC was established as India's first retail housing finance company and moved on to broaden and develop the market base by co-promoting three housing finance companies (GRUH Finance, Can Fin Homes and SBI Home Finance). In effect, HDFC promoted its own competitors. In a third stage, market participants had to re-assess the way they carried out their business, as the tide of competition rose to an almost unsustainable level with the aggressive entry of banks into housing credit. And finally, the current stage features a few dominant institutions with large-scale operations.

As mentioned earlier, India today is a good example for developing countries looking to kick off their primary housing markets. The Indian experience is of special import as it shows that housing finance institutions have been successful despite unfavourable conditions (such as lack of foreclosure norms for several years, poor access to long-term funding sources, lack of clear titles and of reliable statistics on housing or consumers, and an acute shortage of housing units). Rather than waiting for the government and regulators to create a favourable environment to foster a proper housing finance system, the market developed despite these constraints.

Pre-requisites for Well-Functioning Housing Finance Systems

Listed below are six prerequisites for a well-functioning housing finance system that are valid for any country:

- Sound macro-economic policies: Low mortgage interest rates underpinned by sound macro-economic policies are more important in developing mortgage markets than tax incentives and subsidies.
- Keep transaction costs low and mortgage registration systems efficient.
- Concentrate on getting the "primary market" right, e.g., transparent property rights, mortgage and credit registration as well as efficient mortgage collateral and repossession procedures, before creating a "secondary market" to finance those loans.
- Create transparent markets for lenders through approved valuation methods, house price indices and data on the mortgage industry.
- Protect and inform the borrowers, for instance, by helping them compare mortgages products.
- Access to long-term funding sources and other instruments such as covered bonds and mortgage-backed securities. *(Hardt & Costa, 2003)*

Lessons to Learn

Rising Housing and Real Estate Prices

In 1995, India experienced a sharp property market crash where several hands were burnt. Real estate developers, many of whom were fly-by-night operators, had overstretched themselves in terms of funding and subsequently abandoned projects, leaving customers in the lurch. On top of this, in the run-up, there were more speculators than genuine homebuyers, leading to spiralling prices which in turn made housing unaffordable for the common man. Subsequent to the crash, prices reached more realistic levels, housing became more affordable and price stability largely prevailed over the next decade. The odd marginal increases in property prices were driven by factors like better-quality construction and added amenities.

In 2005, two significant regulatory amendments were adopted that gave a boost to India's real estate market. First, 100 per cent foreign direct investment under the automatic route was authorised in town-

ships, housing, built-up infrastructure and construction-development projects. These guidelines were amended in 2005 to make foreign direct investment in the sector more attractive. The minimum area to be developed is 10 hectares for serviced housing plots, or a minimum built-up area of 50,000 sq. metres for construction of development projects. The minimum capitalisation requirement is USD 10 million for a wholly owned subsidiary and five million US dollars for joint ventures with Indian partners. The original investment cannot be repatriated for three years after completion of minimum capitalisation. These amendments augured well for the real estate sector as they opened up additional sources of funding. The other significant measure emanated from the Securities and Exchange Board of India, when the financial supervisory body authorised venture capital funds to invest in real estate. Currently, over a dozen real estate venture funds operate in India, having raised money from both domestic and international investors. A recent report by PricewaterhouseCoopers said that venture capital flows into the sector over the next 18 to 30 months could reach some USD 7-8 billion, with the US alone committing almost USD 2 billion to the Indian real estate market (PwC, 2005).

In this euphoria, though, more money has been chasing fewer quality real estate assets, leading to a spiralling of prices once again. House prices in major Indian cities have escalated by 50 to 100 per cent over the course of 18 to 24 months (DNA, 2006). Commercial real estate prices have seen even sharper increases than housing prices. It is believed that this increase is largely driven by speculators and fuelled by liberal funding mechanisms. This is an unfortunate development, as it tends to push genuine homebuyers out of the market. At the time of writing, expectations were that that the market would soon undergo a price correction.

Need for Caution in a Booming Market

It is essential that housing finance institutions exercise caution in their lending, and particularly so in an overheating market. The Reserve Bank of India has taken several steps to reduce banks' exposure to real estate and prevent reckless lending. Some of the recent measures include an increase in the risk weightings of individual loans (from 50 to 75 per cent) and of commercial real estate loans (from 100 to 150 per cent). The central bank has also raised provisioning requirements for banks (from 0.40 to 1.00 per cent) on standard housing loans in excess of two million rupees (USD 44,444) and on real estate loans. On top of these, a RBI directive has cautioned banks to refrain from lending projects without having regulatory clearances in place. Critics of these measures believe that market forces must be allowed to prevail and that *"central banks should not be in the business of trying to prick asset bubbles."* Despite these stringent measures, some lenders have not reduced their pace of lending. These are no doubt areas of concern, especially since some institutions continue to lend at high loan- to-value ratios, thereby running a risk of negative equity should there be a property price correction.

In 2006, bank loans to commercial real estate rose by 84.4 percent, the highest credit growth recorded in any sector, though on a smaller base (RBI, 2006-07). Moreover, some institutions continue to lend to developers for land purchase purposes in the absence of any requisite approvals. This leaves lenders running the risk of holding imperfect land titles. Understandably, though, land purchases must be funded as they are the equivalent of raw materials for developers. A prudent approach, particularly in a heated market, would be to ensure that the developer has a sizable equity in the land being funded and that the security cover is at least 1.5 times the loan amount.

Lenders must also be more cautious when customers purchase multiple units, as this fuels speculation particularly in boom times. To discourage purchase of multiple units for speculative purposes, the regulator could consider imposing a higher risk weighting only on such loans and insist that the customer's equity is at least 70 per cent of the loan amount. Similarly, even in the case of first-time borrowers, if the loan-to-value ratio is, say, in excess of 75 per cent, only then should a higher risk weighting be assigned. This could prove to be more effective than the current policy where the regulator has imposed blanket

risk weightings for all loans. At the same time, such differentiated weightings would mean that prudent lenders would not be mandated to allocate excess capital without good reason, either.

Need for Self-Regulation

In the recent period, some groups of larger developers have made attempts to devise a model code of conduct. These initiatives, however, are still in a nascent stage. Some of the issues that they are trying to address include transparency and full dissemination of information to customers. For instance, in India there are no standardised norms for property. This leaves developers free to market and sell property based on 'carpet area', built-up area or 'super built-up area'. It has been a longstanding demand from some leading captains of the housing finance industry to standardise norms and sell property only based on the more transparent 'carpet area' criterion, which represents the actual space that the buyer can occupy. Another potential avenue for successful self-regulation would be to encourage developers to make it a norm to offer warranties for defects in building materials, wiring, plumbing and other structural defects. This would encourage better quality constructions.

Many financial firms in India have been lobbying for developers to move towards a mandatory rating of builders and development projects. Such a move would have a two-fold effect. First, it would make it easier for a consumer to know which builder is trustworthy and would help financial firms to ensure that the borrower's project will not become stuck in needless litigation or land acquisition issues. This in turn would enable financial firms to identify riskier propositions early on and pre-empt any possible default. Secondly, mandatory ratings would force builders to be much more forthcoming about projects and their financial aspects, thereby allowing only viable projects to attract financing.

As far as financial firms are concerned, the Indian market is mature enough today to adopt a self-regulatory model code of conduct, similar to the one adopted by the Council of Mortgage Lenders which, in the UK, represents more than 98 per cent of mortgage lenders. Lenders must be transparent with regard to cost structures and customers must have easy access to information where they are able to make comparisons across all lenders and products.

The Way Forward for India

The Indian housing finance market has developed considerably in the recent period, but against a backdrop of poor mortgage penetration; the following measures and recommendations would, if implemented, bring more depth to this market.

Broadening the Market Base

Need for an Independent Floating Rate Benchmark

Introduction of new products pertaining to housing finance would broaden the base of the market. While most lending is on a floating rate basis, the benchmarks are not independent. This is because they reflect the respective prime lending rates of the lending institutions. This suggests a need to explore the creation of an independent benchmark for adjustable rate mortgages which can be adopted by all institutions, thereby leading to more credibility, especially in the case of upward movements in the benchmark.

Mortgage Insurance

Mortgage insurance is mandatory in some countries if the loan-to-value ratio is high, but is completely missing in India. Two major advantages accrue if mortgage insurance providers are allowed to operate. First, it would enable the customer to obtain funds on easier terms, without putting high down-payments on the mortgage. As of this writing, India imposes no regulatory restrictions on loan-to-value ratios, and some loans carry ratios as high as 90-95 per cent. Such lending poses a major risk to financial firms in case the borrower defaults. Moreover, most mortgage loans in India are granted primarily to salaried individuals. Mortgage insurance could enable financial firms to tap into other categories, like low-income or self-employed individuals. Secondly, in some countries where mortgage insurance

is available, mortgage loans generally carry lower risk weightings. These would leave financial firms with more resources to lend out.

Even though the National Housing Bank has begun to set up a Mortgage Credit Guarantee Company, the regulatory framework and risk norms are still under review by the Reserve Bank of India. Unfortunately, this has been pending for over three years as of this writing.

Better Access to Credit History

India has no easily shared method of verifying a client's credit history or loan record. This has resulted in a rising number of fraud in housing finance (for further details, refer to Appendix IV). There have been instances of clients taking out multiple mortgages on the same property from different lenders or providing fake documents for sites that do not exist. To enable access to better credit customer history and prevent malpractice, some important steps have been made in the recent period.

India's first credit bureau, known as the Credit Information Bureau (India) Limited (CIBIL) was set up in 2003 by the State Bank of India and HDFC, although by now many Indian and foreign financial firms have a stake. CIBIL works on the principle of reciprocal information, where only members of the group can access data. Today the database combines over 20 million records from 30 different members (HDFC, 2006).

In 2005, citing rising fraud in the system, the National Housing Bank set up a 'Fraud Management Cell' to document the cases reported by housing finance companies. Since then, the NHB has collated this data and issued circulars detailing causal factors and suggesting remedial action.

Regulatory Issues

Need for a Level Playing Field

Since the Reserve Bank of India carries out the regulation and supervision of mortgage lending in parallel with NHB, there is a need for improved consistency. *"Two regulatory frameworks – one for banks and one for housing finance companies – opens up scope for regulatory arbitrage and may impair competition. The National Housing Bank has sought to address this shortcoming by replicating, though imperfectly, the Reserve Bank of India's prudential norms. However, major differences still prevail…"* (World Bank, 2004). While the option of a single regulator has been discussed in India, any such move is unlikely in the immediate future. Nonetheless, efforts in favour of a level playing field should continue to be encouraged.

Removing Conflicts of Interest

The NHB's role as a promoter of housing credit should be considered as well fulfilled. However, serving as both regulator and equity investor in housing finance companies creates an unnecessary conflict of interest (World Bank, 2004). At the time of inception, the NHB's mandate was to promote the housing finance sector. Today this role is no longer required. In particular, there is no longer any rationale for the National Housing Bank to provide equity investments, which create conflicts of interest as regulator and investor. Besides, in 2005, NHB investments in housing finance companies were hardly significant, accounting for less than one per cent of its total assets.

Funding Issues

Access to long-term funding is crucial for housing finance providers. Hopes are that the Reserve Bank of India will amend its external commercial borrowings guidelines to authorise financial intermediaries to access the international market. Moreover, in order to make such borrowing attractive, the erstwhile exemption of withholding tax on international borrowings by housing finance companies must be restored.

Commercial banks are another major source of borrowing for housing finance companies in India. Under current exposure norms for banks, the single borrower limit is capped at 15 per cent of the capital funds of the bank. It has been recommended that the exposure norm be enhanced for banks lending to housing finance companies. This is because when

housing finance companies borrow from banks to on-lend funds to individuals, the exposure is diversified as against a bank lending to a business entreprise for working capital needs, or for a specific project where the exposure is concentrated on the company itself. This would enable housing finance companies to borrow more from banks.

Moreover, since the primary mortgage market is now on a sure footing in India, more efforts should focus on deepening the secondary market. Given India's present pre-eminent position as a favourable investment destination, several international investors have expressed interest in offshore securitisation. The regulator would do well to consider issuing suitable guidelines to facilitate this, albeit with adequate checks and balances. Moreover, a deeper secondary mortgage market would enable more recycling of funds and reduce capital adequacy requirements.

Building an Information Database

Finally, if a viable and efficient mortgage market is to develop, sound and extensive information on the real estate market and borrower behaviour must be available. Going forward, the need is for a single, combined market database which can be continuously updated and shared between all market participants. This would facilitate the development of a more efficient, sounder housing finance market in India. It has been recommended that the National Housing Bank would be best suited to take on the task of developing this database.

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APPENDIX I

Key Highlights of India's Housing and Habitat Policy, 1998

The highlights of the Housing and Habitat Policy 1998 ("the new policy") and major differences with the earlier National Housing Policy 1994 ("the old policy") are as follows:

The new policy aims for surplus in the housing stock in the country. The aim of the old policy was to reduce the number of homeless people.

The National Housing Policy 1994 focused primarily on housing activities. The related issues of supporting infrastructure and environment did not receive much attention. The new Housing and Habitat Policy seeks to address the whole issue of urban and rural settlements. The new policy recognises the environmental issues and seeks to promote sustainable development of habitat. It provides for planned growth as well as sustainable use and consumption of natural resources.

The previous Housing Policy called for a progressive shift in the government's role from provider to enabler. The role of other agencies including in the private and co-operative sectors, etc., had not been clearly spelt out. The new policy, while re-iterating the above shift in the role, goes further and provides for the vulnerable sections of society.

Basic infrastructure services like water supply, sanitation, power supply, etc., have been made an integral part of housing development under the new policy. The urban planning process would include urban transport as a necessary component. The earlier Housing Policy did not focus on these supporting services.

The new policy recognises the role of technology in the housing sector. It emphasises energy efficiency and energy-saving building materials, waste recycling, waste as raw material, and use of locally available raw materials.

The new policy focuses on the need for skill upgrading, training and employment in the housing construction sector. Building industries are one of the largest employers of female workers and their biggest exploiter in terms of wage disparity. The policy recognises the role of female workers in the construction sector and provides for their training, skill upgrading, adequate safety in hazardous construction activities and access to supervisory level.

The new policy recognises the threats that major natural calamities like floods, earthquakes and cyclones pose to the housing stock. It advocates pre-disaster mitigation techniques like construction/retrofitting of dwellings in disaster-prone regions to prevent or reduce loss of life and shelter.

The new policy also places strong emphasis on legal and administrative reforms in the housing sector. It spells out the streamlining of various regulatory procedures and provides for time-bound approval of projects. (PIB, Government of India, Archives).

APPENDIX II

Financial Summaries of Select Housing Finance Companies in 2005

	HDFC Ltd.	LIC Housing Finance Ltd.	Dewan Housing Finance Ltd.	Can Fin Homes Ltd.	Sundaram Housing Finance Ltd	GIC Housing Finance Ltd.	GRUH Finance Ltd.
Summarised Balance Sheet							
Assets							
Loans	360,115.00	122,446.60	15,292.70	13,105.00	8,678.00	15,473.30	8,165.27
Investments	31,300.40	761.30	1,201.80	333.10	311.70	16.10	218.03
Fixed Assets (Net Block)	2,948.50	247.50	301.00	35.80	21.10	28.60	82.77
Net Current Assets/Others	10,941.10	(1,026.40)	766.10	188.60	167.30	419.20	341.31
Total Assets	**405,305.00**	**122,429.00**	**17,561.60**	**13,662.50**	**9,178.10**	**15,937.20**	**8,807.38**
Liabilities							
Share Capital	2,491.20	850.00	501.20	204.90	700.00	269.30	265.00
Reserves	36,339.80	11,100.50	1,394.70	1,320.70	236.30	965.20	469.54
Total Shareholder funds	38,831.00	11,950.50	1,895.90	1,525.60	936.30	1,234.50	734.54
Loan funds	366,474.00	110,478.40	15,665.70	12,136.90	8,241.80	14,702.70	8,072.84
Total Liabilities	**405,305.00**	**122,428.90**	**17,561.60**	**13,662.50**	**9,178.10**	**15,937.20**	**8,807.38**
Summarised Profit and Loss Statement							
Total Income	34,100.80	10,687.20	1,638.30	1,273.30	732.90	1,256.10	855.43
Total Expenditure	21,532.95	8,611.10	1,289.60	991.20	675.70	1,044.20	648.70
Gross Profit	12,567.85	2,076.10	348.70	282.10	57.20	211.90	206.73
Profit After Tax	10,365.53	1,437.20	271.30	211.20	40.10	177.70	167.08
Other Financials							
Dividend (%)	170	50	20	25	0	15	21
EPS (Rs.)	41.74	16.21	5.06	9.96	0.57	6.39	6.31
Book Value Per Share (Rs.)	179.00	140.59	37.83	74.46	13.38	45.84	27.72
Capital Adequacy Ratio (%)	13.40	15.00	16.46	18.92	18.27	12.30	15.71
Debt Equity Ratio	9.44	9.24	8.26	7.96	8.80	11.91	10.98

Source: Annual Reports, Capitaline Corporate Databases

APPENDIX III

GUIDELINES FOR HOUSING FINANCE COMPANIES

In the interest of the public and to promote a healthy and overall growth of housing finance companies in India, the National Housing Bank issued the Housing Finance Companies (NHB) Directions 2001, to every housing finance company in compliance with the National Housing Bank Act 1987.

Setting up a Housing Finance Company

To commence business, a proposed housing finance company must first establish itself as a company under the Indian Companies Act 1956 and then obtain a certificate of registration from the National Housing Bank. Further, a housing finance company incorporated after June 2000 is required to have a minimum net owned funds of INR 2.5 million (USD 55,556).

Acceptance of Deposits

Housing finance companies with net own funds under INR 2.5 million (USD 55,556) are not allowed to accept 'public deposits', that is, deposits essentially from individuals and trusts. Companies accepting public deposits are required to maintain a Statutory Liquidity Ratio of 12.5 per cent on these. Moreover, only housing finance companies with a credit rating of 'A' and above (i.e., a rating with adequate financial strength to meet repayment of principal and interest) from an approved credit rating agency are allowed to accept deposits up to five times net own funds. In the absence of this rating, housing finance companies can only accept deposits up to two times net own funds or INR 100 million (USD 2.22 million), whichever is lower. Deposits can only be accepted if they are held for a minimum period of one year and a maximum of seven years. The guidelines also impose a ceiling on interest rates and brokerage fees paid on public deposits. Since March 2003, no housing finance company is allowed to accept deposits over an annual 11 per cent rate and cannot pay brokerage or commission in excess of two per cent of the deposit amount collected.

Regarding repayments of deposits, no housing finance company is allowed to repay any public deposit within a period of three months from the date of acceptance. Should there be a withdrawal of the deposit after three months but within six months, no interest is payable from the date of acceptance. In the case of any premature withdrawal after six months but prior to the redemption date, the rate of interest is payable at two per cent below the deposit rate.

'Know your Customer' Guidelines

In line with international practice, Indian housing finance companies are subject to 'Know Your Customer' guidelines. The rationale is to prevent money laundering, criminal activity or financing of terrorism. Another goal is to enable housing finance companies better to understand customers and their dealings, in the process encouraging more prudent risk management. In line with these guidelines, housing finance companies are required to set out customer acceptance policies, customer identification procedures, monitoring of transactions and risk management.

The customer acceptance policy must ensure that no customer opens an account under a fictitious name and that they are categorised under a low, medium or high risk category. Secondly, customer identification procedures must establish the identity of the customer by using *"reliable, independent source documents, data or information"*. Thirdly, monitoring of transactions is mandated so as to ensure that no money is used for fraudulent purposes. The guidelines state that constant monitoring will enable a housing finance company to identify abnormal

activity and call attention to any large, unusual or complex transactions. Thresholds are to be decided based on a customer's risk profile. A risk management structure must be implemented by all housing finance companies to cover matters like management supervision , systems and controls, segregation of duties and training.

Prudential Norms

The guidelines also establish various prudential norms for housing finance companies on income recognition, accounting standards, asset classification, provisioning for bad and doubtful assets, capital adequacy and concentration of credit/investments.

Income recognition and accounting standards that housing finance companies are mandated to comply with are in accordance with those set out by the Institute of Chartered Accountants of India.

Since 2005, in line with international standards, non-performing assets have been recognised on the basis of 90 days overdue as compared to the earlier norm of six months past due. Housing finance companies are required to classify assets as follows: standard, sub-standard, doubtful and loss assets, with provisions for every asset class except standard ones. For sub-standard assets, a 10 per cent provision is required. As regards doubtful assets, provisions vary between 20 and 50 per cent depending on the period that the loan has remained a non-performing asset. A 100 per cent provision is required on loss assets.

Currently, housing finance companies are required to maintain a minimum 12 per cent capital adequacy ratio, with the total of Tier II capital not exceeding one hundred per cent of Tier 1 capital. The risk weights applicable on individual housing loans are 75 per cent, as against 150 per cent for commercial real estate loans.

Restrictions

National Housing Bank guidelines impose certain restrictions on housing finance companies regarding overall exposures to capital markets and investments in real estate. Moreover, the regulations also impose specific conditions on concentration of credit and investments.

Capital Market Exposure

Housing finance companies are not allowed to acquire shares, convertible debentures or units of equity-oriented mutual funds in excess of five per cent of total outstanding advances during the previous year. Within the overall five per cent ceiling, total investments in the capital market should not exceed 20 per cent of a housing finance company's net worth.

Real Estate Exposure

Housing finance companies cannot invest more than 20 per cent of capital funds in real estate, unless the property or building is for own use. Moreover, of that 20 per cent, at least 10 per cent must be invested in residential units.

Concentration of Credit/Investment

No housing finance company is allowed to lend to a single borrower in excess of 15 per cent of own funds and not more than 25 per cent to a group of borrowers. A housing finance company cannot invest more than 15 per cent of own funds in the shares of another company and no more than 25 per cent for a group of companies. Thirdly, housing finance companies are restricted from both lending and investing 25 per cent of their owned fund to a single party or 40 per cent to a single group of parties.

Reserve Fund

In accordance with Section 29C of the National Housing Bank Act 1987, housing finance companies are required to create a reserve fund and transfer at least 20 per cent of net profits every year before any dividend is declared.

Asset/Liability Management Guidelines

To help housing finance companies guard against interest rate and liquidity risks, the National Housing Bank introduced asset liability management

guidelines. The purpose of these guidelines is to ensure that housing finance companies assess various risks better and thereby alter their asset-liability portfolio in a more dynamic way. Housing finance companies have to monitor and submit statements to the regulator on structural liquidity, short-term dynamic liquidity and interest rate sensitivity. The guidelines also make it mandatory to create an Asset Liability Management Committee (ALCO) comprising senior management, i.e. the Chief Executive Office, executive directors as well as members with a background of investment, credit, resource management and information technology. Each housing finance company is required to set prudential limits on individual gaps in various time buckets with the approval of their board or management committee.

APPENDIX IV

GUIDELINES ON CAUSES AND REMEDIAL ACTIONS ON INCIDENCE OF FRAUDS IN HOUSING FINANCE

Point No. 1	
Type of Fraud	Fabrication of Income Documents like Income-tax return, salary slip, balance sheet, etc.
Severity of fraud	Low
Modus Operandi	Fraud typically arranged by borrowers in connivance with Direct Selling Agent/Estate Agent/Builders.
Mitigating factors/Suggestions for Preventive Cures	■ Verification of salary slips with employer. ■ Income Tax Department should upload on their websites lists of Income Tax payers and defaulters. ■ Salary amounts should be compared with Bank Statements. ■ Cross-verification of balance sheets. ■ Personal interviews with borrowers play very important role.
Point No. 2	
Type of Fraud	Loan amounts disbursed by way of cheque/Demand drafts are cashed in by third party/agents, etc.
Severity of fraud	Medium
Modus Operandi	Disbursed amount cheques are collected by the Agents/third parties from the borrower's bank and deposited in fictitious account opened for this purpose, and amounts are withdrawn from such bogus account.
Mitigating factors/Suggestions for Preventive Cures	■ Cheques should be issued in the name of bankers to the Builders with the bank account number on them. ■ Cheque should not be handed over to the borrower/agent/seller. Bank's Marketing Officials can be sent for delivery of cheque to the builders/sellers of property at the registered address mentioned in the title deeds.
Point No. 3	
Type of Fraud	Title documents are forged – Stamped documents forged by borrower customer/builder
Severity of fraud	High
Modus Operandi	Coloured Xerox copies of various documents are produced including encumbrance certificate, fake stamp papers, etc., which are difficult to identify/distinguish from the originals.

Mitigating factors/Suggestions for Preventive Cures	■ Tracking and sharing of all information among HFCs and Banks about blacklisted builders & developers. ■ Agreement for sale/document of title should be in DEMAT form. ■ In case of large-value loans, HFCs can approach the Sub-Registrar's Office to verify the genuineness of stamp paper/documents/registration receipts, etc.
Point No. 4	
Type of Fraud	Over-valuation of the property
Severity of fraud	Medium
Modus Operandi	The purpose is for the borrower to draw higher loan amounts in connivance with the builders/valuers. Property value is inflated by inclusion of various, fictitious expenditures and additional amenities, fixtures, legal charges, society advances, maintenance charges, etc..
Mitigating factors/Suggestions for Preventive Cures	■ Valuations over IRN 2.5 million should be carried out by two independent valuers. ■ Government should introduce a certification course for approved valuers. ■ HFCs should develop in-house expertise for property valuation.
Point No. 5	
Type of Fraud	Multiple financing
Severity of fraud	High
Modus Operandi	This fraud is based on fake documents that are produced to different banks/HFCs
Mitigating factors/Suggestions for Preventive Cures	■ Tracking & sharing of information among banks and HFCs about blacklisted builders & developers selling same properties to more than one buyer. ■ Agreement for sale/document of title should be in DEMAT form. ■ HFC should insist on the original title deeds of the landed property on which structure is built.
Point No. 6	
Type of Fraud	Cancellation of booking of flats/property, i.e., collusion between customer and builder
Severity of fraud	Medium
Modus Operandi	In this case, after availing the initial loan amount, the booking is cancelled and the borrower takes the refund directly from the builders.
Mitigating factors/Suggestions for Preventive Cures	Registration receipt issued by Registrar of stamp office should bear hypothecation clause, as happens with certificate of registration in case of auto loans.
Point No. 7	
Type of Fraud	Sale of property by loanee without clearing existing loan.
Severity of fraud	Medium
Modus Operandi	Property is sold through duplicate/fake title deeds even though legal title is with the HFC.

Mitigating factors/Suggestions for Preventive Cures	■ Equitable mortgage should be created at Registrar's office by deposit of title deeds. For this purpose all banks should represent to Central & State Government through IBA & RBI for enactment of necessary provisions. ■ Internal due diligence plays important role to prevent this type of fraud.
Point No. 8	
Type of Fraud	Mis-representation of end use of loan
Severity of fraud	Low
Modus Operandi	Loan taken for residential housing property. However, commercial property is purchased by availing such loan.
Mitigating factors/Suggestions for Preventive Cures	In order to ensure proper end use of loan, HFCs should detail officers for inspection/verification of property, whether property is residential or commercial.
Point No. 9	
Type of Fraud	Sale of property by builder without clearing/repaying Construction Funding Loan provided by banks/HFCs
Severity of fraud	Medium
Modus Operandi	Builders/property developers after taking Construction loan from banks/HFCs are selling developed ready flats/Galas/developed plots, etc. unknown to fund providers & without repaying construction funding loan.
Mitigating factors/Suggestions for Preventive Cures	■ This aspect of construction funding loan whether provided by the developer/builder or not, should be verified at project clearance level by banks/HFCs. ■ Original document should be called for verifications at the time of appraisal of any housing loans.

Source: Circular NHB(ND)/HFC(P&D)/15.3/6065/2003, National Housing Bank

India is home to over 1.1 billion people. With about one in every sixth person in the world living in India, housing assumes significant importance. The objective of this report is to trace the evolution of the Indian housing finance industry and highlight the changing role of the government, from direct participation in the housing and housing finance sector to taking on the role of a 'facilitator', thereby creating an enabling environment to encourage private sector capital.

The report analyses key triggers that have changed the housing finance market scenario, the prevailing trends and the main participants. The exponential growth of the past few years and the factors which may prevent housing finance from reaching a wider segment of the population are also reviewed. The report concludes with recommendations to enable the Indian housing finance sector to sustain its growth momentum.

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