Home Loans

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Brief review of the performance

The housing sector plays an important role in the economic development of the country. Every rupee invested in housing adds 78 paise to the GDP. Over 269 industries are directly or indirectly dependent on the housing sector.

There is an estimated shortage of 20 million housing units in the country with an estimated investment requirement of over Rs 1500 billion. In this context it is important to note that that the organized housing finance industry barely accounts for 30% of the home loans disbursed in the country.

The last few years have seen the home loans market growing at a CAGR of over 30 percent. The growth has been mainly fuelled by certain fiscal, social and regulatory drivers:

- Changes in demographic profile including increase in the rate of household formation due to structural shift from joint family system to nuclear family
- Ever increasing middle class, migration of population and increasing urbanization resulting in acute shortage of housing units
- Increase in disposable income levels due to decrease in marginal tax rates and increase in total income levels
- Tax benefits and other fiscal incentives announced in the Union Budgets
- Increasing affordability of housing property purchase due to declining interest rates and stable property prices
- Decline in the average house cost to annual income ratio to around 4-5 from 11-14 during the last decade resulting in an affordable EMI as a percentage of monthly income
- Aggressive lending by banks to the housing sector due to lower credit offtake by the corporate sector, attractive spread and lower non performing assets

The major players in Indian housing finance industry are the Housing Finance Companies ("HFCs"), Scheduled Commercial Banks, and Co-operative Banks. The total incremental disbursements of the HFCs and the Banks have increased from approx Rs 16,000 cr in 1998-99 to approx. Rs 39,000 cr in

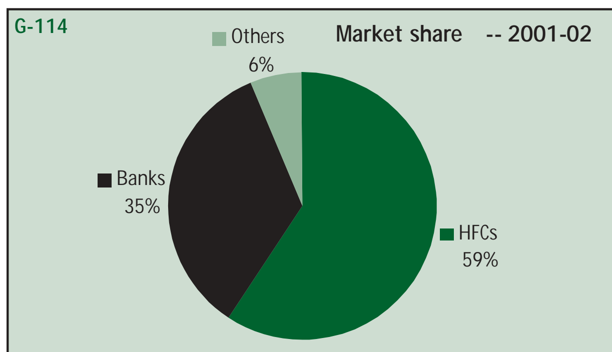
2002-03 with direct incremental disbursements[1] growing from approx Rs 10,500 cr to Rs 34,000 cr during the same period. The year 2002-03 has witnessed a growth of 29 percent in total incremental disbursements and 33 percent in direct incremental disbursements over that of last year.

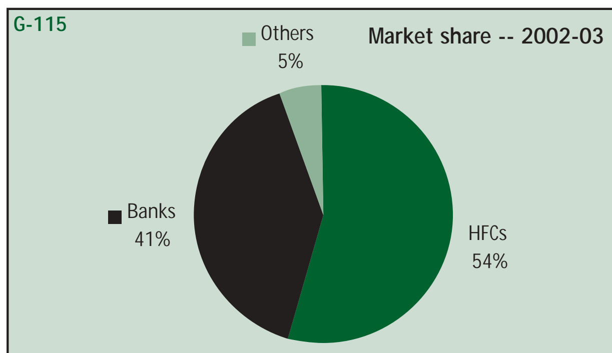
Total incremental disbursement less Bank loans to HFCs, Bank investments in NHB/HUDCO Bonds and Bank loans to employee

The incremental disbursements of HFC's is estimated to have increased by 21 percent to approx. Rs 18,000 cr with incremental disbursements of HDFC, the leading HFC increasing 31 percent from Rs 7,616 cr to Rs 9,951 cr during 2002-03. However, the aggregate market share of HFCs as a whole declined. The HFCs have mostly lost market share to the banks with the worst hit being inflicted on the small and medium HFCs.

The total outstanding loans of HFCs are estimated to have increased by 21 percent to Rs 46,500 cr in the year 2002-03. The share of the direct loans outstanding of HFCs to total loans outstanding is estimated to have declined from 74 percent in 2001-02 to 64 percent in 2002-03.

Reduced off take by the corporate sector has increased the banks focus on the retail finance market over the last 2 years with significant increase in disbursements to the housing finance market. Banks find the housing finance market an attractive segment to lend due to lower NPA levels, lower risk weightage and higher risk adjusted profitability. The total incremental disbursements of the banks have registered an increase of approx. 38 percent to Rs 19,500 cr. The total loans outstanding of the Banks to the housing finance sector have increased by 43 percent to Rs 48,000 crore.





The incremental direct disbursement market share for the years 2001-02 and 2002-03 shows that the HFCs have lost significant market share to the Banks

Major developments during the year

The year 2002-03 witnessed the commercial banks becoming aggressive players in the home loans market and a dramatic fall in interest rates across all maturities. This fall in interest rates was driven by the decreasing bank rate and the increased competition with in the banks themselves and between the Banks and HFCs. There was a growing emphasis on the adjustable rate loans due to the decreasing interest rate scenario.

In presenting the Union Budget for 2002-03 the Hon'ble finance minister announced that National Housing Bank would launch a Mortgage Credit Guarantee Scheme, which would be provided to all housing loans thereby fully protecting lenders against default. Towards this end the Asian Development Bank (ADB) approved an investment of up to US$10 million equivalent in November 2002 to help pioneer the first mortgage guarantee company for India. Mortgage financing through the India Mortgage Guarantee Company (IMGC) will help narrow the housing shortfall. The India Mortgage Guarantee Company will improve the efficiency of housing finance and protect mortgage lenders such as banks and housing finance companies in cases of borrower default.

The housing finance industry is getting increasingly commoditised. Competition within the sector is ensuring that players offer consumers flexibility and features to choose from. Features such as adjustable rate plans, lower processing fees, monthly rest, low interest rates, low EMI, lower margin money, no pre-payment penalty have become common across the industry.

The creation of IMGC will:

- Generate a greater volume of mortgage lending in the Indian market
- Lower down payment requirements to as low as 5%
- Broaden the eligibility for mortgages, and
- Extend mortgage repayment periods by up to 25 years

These changes will, in turn, support capital market development by promoting securitization and increasing home ownership.

Organized as a public limited company, IMGC is sponsored by the National Housing Bank (NHB) of India and the Canadian Mortgage and Housing Corporation. Other main shareholders are the International Finance Corporation, and ADB. The total project cost is estimated at US$40 million in paid-up capital. Finishing touches are being given to IMGC, which is expected to formally come in to existence in September of this year. The schemes from IMGC are expected to be launched by January '04

With the enactment of The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act 2002 (The Securitisation Act), banks have been empowered to attach assets of the defaulters without intervention of lengthy and time consuming court procedures. This would help the banks for speedier foreclosure of home loan accounts in default.

NHB is also operationalizing the foreclosure laws, which will enable the HFCs to foreclose the defaulting account and apply to the recovery officer for sale of mortgaged property. Easier foreclosure laws coupled with the proposed mortgage credit guarantee scheme of the NHB are expected to release non-performing funds of HFCs for lending.

Products and Services

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There is a growing trend among Banks and HFCs to include the cost of registration, stamp duty, society charges and other associated costs while sanctioning loans to differentiate and make the home loans products more attractive. This has resulted in further lowering the threshold limit for buying a house

For differentiation of their home loan products, companies are also resorting to offering of free add-ons such as life insurance, credit cards and consumer loans at reduced rates for furnishing the house.

Several housing finance companies have now begun to offer tailor-made loan schemes to renovate, repair, extend, convert or otherwise improve one's home. Companies like HDFC and others provide home improvement loans for purposes like external repairs, water-proofing, roofing, internal and external painting, plumbing and electrical work, tiling and flooring, grills and aluminum windows, construction of underground or overhead water tanks, paving of compound walls and setting up borewells, among other things.

Some of the major players in the housing finance industry have started organizing property fairs, wherein the projects of different construction companies are brought together and bundled with a lower than normal interest rate loan product. Such initiatives are expected to result in a more organized housing market and more value for the customer.

On the services front the housing finance companies have begun addressing concerns of borrowers through counseling and legal advisory services on matters pertaining to property's title, its technical evaluation, its pricing etc. Customer relationship management is emerging as one of the key areas of competition to win over new customers. Housing finance companies have been upgrading their technology and investing in sophisticated systems for sourcing, processing and managing information pertaining to home loan customers.

As the scope for product differentiation is increasingly getting limited, the housing finance companies will increasingly compete on the strength of their service quality. Rendering technology-enabled value added services would enable the housing finance companies to better withstand the competition.

Challenges from a risk management perspective

India still has a long way to go in building a robust institutional/ regulatory framework from a risk management perspective in the housing finance sector. Housing finance lies at the intersection of three priority areas for the development of emerging economy like India — the strengthening of domestic financial systems, the financing of a one of the largest asset classes in the economy, and the provision of a critical social good. Policy makers not only in India but in other emerging economies are challenged to build sound housing finance systems due to an increasing number of middle class people, and growing urban populations demanding home ownership. The policy framework has to be carefully structured on a solid foundation - including laws, property rights, foreclosure procedures and mortgage markets. Risk management has to be an integral part of such a framework.

The major areas of risk experienced in the housing finance process are legal/regulatory, market risks (demand factors and competition), credit risk (borrower and collateral), operations risk (for lending enterprises), interest rate risk, and liquidity risk.

There are various legal and administrative impediments in India, which are hindering the growth of the mortgage securities market in India. These impediments are in the nature of archaic laws such as Urban Land Ceiling (and Regulation) Act, Rent Control Act, varying and high rates of stamp duty across different states, restrictive foreclosure process etc.

Management of credit and operations risk is the foundation of any strong housing finance system. This is because, regardless of the source of funding, or the macro-economic and legal conditions, effective lending techniques and strong loan management skills are the first line of defense against loss. The Indian housing finance industry has one of the lowest credit loss rates as a retail customer rarely defaults on the payments of loans, which is the largest investment for an individual. The historically low default rate is also a function of low loan to value ratio, which has been on account of low loan sizes, an outcome of high interest rates reducing the loan eligibility at a given income level. As a result of which the loss to a defaulting customer could have been much higher due to the high amount of equity involved in the transaction. However going forward the default rates could increase as decreasing interest rates and higher cost to income ratios is reducing the loan to value ratio. This has the potential of increasing the credit losses of the players

in case of inadequate credit appraisal or recovery systems. The defense strategies for managing increasing default rates fall into three basic categories: borrower strength, collateral strength, lender techniques and various forms of insurance.

The first line of defense against loss is making good loan decisions; the second is managing the asset effectively, with risk sharing entities coming last. Credit risk insurance is only activated after the lender has done everything possible to avoid a loss on the loan.

Credit risk management in the Indian context means the housing finance company has to develop certain in-house/local standards for measurement of a borrowers' ability and willingness to repay the loan for the long term, apply those standards, measure the performance and continually make adjustments to the standards based upon results. Operations risk management means establishing the internal capacity to make good credit decisions (reduce risk of loss), while at the same time managing the assets so that costs are minimized. With the exception of HDFC, banks and other housing finance companies have little experience in credit and operational risk and management in the housing finance sector.

In this context the proposed Mortgage Guarantee Company (MGC) could have a significant influence on the housing finance market provided if the MGC is able to offer reasonable risk pricing for credit and default risk. With MGC in place offering attractive credit risk mitigation, the housing finance could see many more new players offering home loans with the market becoming more competitive. There is a lot of optimism at the NHB on the growth prospects of the mortgage market and the expectations are also running high on their ability to streamline mortgage legislative environment; this could further bolster the market growth and lower the cost of mortgages.

Asset liability mismatch increases the interest rate and liquidity risk profile of the HFCs and Banks. The tenure of housing loan has consistently increased from 5 years in the past to 15-20 years at present, however the asset remains in the books of the lender for 8-10 years. Banks have the ability to largely mitigate this risk due to access to diversified resources and lending options. The banking sector, every year, gets around Rs 400-450 billion in savings and demand/current account deposits, out of which around 75-80 percent can be considered as core float and is largely long term in nature resulting in banks being largely protected from asset liability mismatch risk. However differences in the maturity profiles of assets and liabilities continue to be of major concern for HFC's.

In future, the ability to foreclose defaulting mortgage assets will become a key competency for profitability in housing finance market. HFCs and Banks are increasingly looking at smaller towns for growth. Some HFCs are expected to follow a new business model of becoming the originator of loans, and thereafter securitising to one of the larger players. As a result, these players will book the revenues (processing fees) upfront and thereafter transfer the assets to a larger player (commercial bank or general public) in the form of portfolio sell out or a MBS. However, only HFCs with the ability to raise good quality assets and having adequate distribution channels are likely to survive the competition.

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