

## **CHAPTER IX**

### **ASSESSMENT & PROSPECTS**

The recent growth in housing finance business and the increasing competition has benefited the customers significantly. Besides product and process improvisations, the major players in the market are also strengthening their distribution channels and are increasing their advertising expenditure. But the growth has not been without spatial imbalance. While certain states/ regions of the country obtained greater share of the housing finance as compared to their less fortunate counterparts, the growth also remained largely focused to the middle and upper income strata mostly concentrated in metropolitan/ urban areas or at least in major towns.

The low credit disbursements for housing by their rural branches are constrained by various factors e.g. non availability of clear land title, difficulties in assessing repayment capabilities of rural masses due to irregular income pattern etc., resulting in higher credit risk. There is, thus, a felt need for formulation of an appropriate mechanism and the modification required in the existing regulatory framework to enable the primary lending institutions to increase the flow of funds to meet the housing credit needs of the home loan seekers in rural areas. This requires designing of an appropriate integrated loan product having built-in flexibilities in repayment schedule, rate of interest, margin requirement, security etc., specific modification in prudential norms especially relating to NPA norms and classification of assets, evolving uniform appraisal standards and documentations, resource mobilization strategies for reducing the cost of funds, etc. In order to develop an integrated product design with an appropriate framework for the lending institutions, a well coordinated approach and effort of all stakeholders is also necessary.

There is a definite need to encourage and enthuse the lending institutions through appropriate incentives by way of fiscal benefits. The lending institutions should be encouraged to transfer part of the fiscal benefits to the borrowers by way of lower interest rates. The fiscal concessions presently being extended to promote home ownership in the country are almost entirely availed of by the urban/metro population and the rural segment is presently left out as most of the home loan borrowers in rural areas are not income tax payers. Hence, one way of equalizing the fiscal incentives across the country could be through this route.

Besides the growing concern for rural housing shortage and appropriate mitigation of the same, the time has come for the Indian housing finance sector to engage itself in evaluation of the possibility of systemic failure and safeguarding from that. The cut-throat price competition in the form of continuous lowering of interest rate that has become a matter of concern. The interest rate range of 11.50-18.50%

prevailing in April 2000 in the HFC segment came down to 8.75-13.75% in May 2003 and further to 7.50-12.00% in December 2003 under fixed rate option and the floating rate range was 7.00-10.00% in December 2003. In case of the banking sector, the interest rate range offered by the public sector banks came down from 11.50-16.25% in December 2000 to 7.50-11.00% in December 2003 under fixed rate option with floating rate options offering 50-100 basis point lower rates. The intense price competition resulted in sub-PLR lending rate in most of the cases. The interest rate war also resulted in taking over of loans between primary lenders. Although the Reserve Bank of India has prohibited the inter-bank taking over of loans to be considered under 'housing finance achievement' under the yearly stipulated allocation, no such restriction is in place for taking over from HFCs by banks. Besides, in a situation where interest rates start rising, the default-risk is also likely to rise as the equated monthly installment starts rising under the floating rate contracts.

With the growing competition, the lenders are coming up with innovative products and services offering the customers a wide variety to choose from. The speedier processing loans, efficient advisory service and waiver of associated charges & requirements also resulted in a customer friendly environment. But it has not been a case of unmixed blessing always. The dilution in appraisal norms, lack of due diligence may also affect the asset quality of housing finance sector.

At present, the housing finance business is operating through a very thin spread. Many small private HFCs without strong parent backing are gradually losing market share in the medium to long term. HFCs have higher cost of funds as compared with banks as they depend on priority sector sub-PLR loans from banks, fixed deposits, NHB refinance and in some cases low cost loans from multilateral agencies. Most private HFCs (excluding HDFC) do not enjoy the highest investment grade rating by credit rating agencies, which further increases their cost of funds. As a result, HFCs, in general, either have lower spread as compared with a bank or are not able to match rates with banks. In the face of a fierce competition and desperation for survival, these HFCs resort to sub-standard appraisal norms at origination of loans. Thus, in future, there is a serious possibility of degradation in asset quality of the small and medium sized HFCs if they are not able to price their home loan products competitively. On the other hand, the banking sector, being a relatively new entrant in housing finance market, needs to upgrade housing credit management and home loan processing skills.

It has been reported to NHB that unscrupulous borrowers in connivance with builders / property developers have defrauded a number of primary lending institutions mainly the housing finance companies, commercial banks etc. by obtaining multiple finance against the same property / or through submission of fake/ forged/ stolen documents including fake title deeds.

Keeping in view the above, the HFCs were advised to take extra precautions while accepting / verifying the documents, handing over the loan disbursement cheques, verifying the credentials and bonafides of the borrowers / vendors etc. Accordingly, branch level functionaries have to be vigilant in this regard. HFCs are required to review the existing system and controls and plug the lacunae therein to prevent occurrence of such frauds. The Board of Directors may be kept apprised, on a periodical basis, of the irregularities revealed and the likely loss on this account.

As the commercial banks have become very active in the retail housing loan market, RBI is also initiating suitable measures to curb the banks resorting to undesirable practices to increase their market share.

With the risk-weights on housing loans being reduced to 50% from 100% irrespective of the loan-to-value (LTV) ratio, the lending institutions are poised towards more aggressive practices, softening of collateral requirements, competitive pricing (under-cutting) and high LTV loans. Till date the default rate in the housing finance industry is extremely low as compared to the default rate in case of corporate loans. A study by FICCI in 2003 shows that this rate stands at as low of 1.47% in case of home loans. However, all over the world, it has been empirically verified that loan default rates are more in the case of home loans with higher LTV ratios. Studies have also revealed that the probability of default and loss severity of these loans is also higher.

In India, it is observed that when the risk weight was 100% the lenders exercised greater caution and diligence which had the effect of controlling the risk and protecting the assets from any potential impairment. In the aftermath of the lower risk-weight prescription, there has reportedly been a marked dilution in the quality of assets, appraisal standards, collateral requirements etc.. The changed scenario is clearly a regulatory concern, which needs to be addressed in order to mitigate or de-risk the housing finance sector. Lending operations need to be standardized through appropriate and pro-active regulatory prescriptions that reduce the likelihood of systemic crisis, as part of responsive regulation operating in an interactive mode.

With decline in the value of the property, high LTV loans can easily convert into negative equity with borrower most likely to default (low willingness to pay even though he has the ability). In such situations, the borrower would most likely prefer to default on the loan even though he has to surrender the property, which now would command a much reduced value in the market.

A prudent financial system should account for the greater risk of high LTV loans by adopting a higher capital risk-weighting for these loans. Prudential regulations in financial systems require that when financial institutions issue a loan, they set aside a portion of their capital base as a reserve against the event that the loan

should default. International banking standards, as recommended by the Basle Committee, indicate that this capital ratio requirement should be determined by the risk basis of the asset. With the Basle II recommendation suggesting 'granularity of portfolio', there is a need to assess the risk of each asset separately and assign appropriate risk weight instead of imposing a uniform risk weight across the asset class.

Another key concern area for housing finance markets is increase in the interest rates and the asset-liability mismatch. With the average tenure of loans in the case of housing finance, being more than 10 years (at origination) in majority of the portfolio, and the option of fixed rates loans offered, lenders could face problems of running an asset-liability mismatch, given the shorter tenure of their liabilities (mainly consisting of term deposits, comprising around 52 per cent of the total liabilities for banks and more than 30 percent for HFCs).

However, the industry analysts do not forecast a significant increase in the interest rates in the short to medium term, given the liquidity and inflation scenario. Banks have been pushing the variable rate of interest products in order to overcome this risk by offering lower interest rates. Banks can partly utilize and attribute core long-term funds, such as savings and current account funds (comprising around 33 per cent of the deposits in the banking system) to finance this segment. Also, banks can participate in the emerging RMBS market in order to transfer these risks to the entities that have a longer tenure on their liability profile (such as insurance companies).

A higher proportion of fixed rate to adjustable rate portfolio increases the interest rate risk while in case of adjustable rate portfolio, the interest rate risk gets passed on to the customer. In case, the interest rates move up, the probability of defaults may go up if adequate income margin for adjusting the increased EMI outgo is not made. (The maximum EMI affordable has been considered at around 40 per cent of the monthly household income).

NHB has taken a few measures to reduce the impact of interest rate risk in the housing finance companies. For instance, the ceiling on interest rate payable by HFCs on public deposits has been brought down to 11 per cent per annum. Further HFCs having an asset size of Rs100 crore or public deposits of Rs20 crore or more have been advised to put in place an effective asset liability management system. Under this, HFCs are required to furnish half yearly returns to NHB. NHB has also been drawing the attention of the HFCs to the incidence of unhealthy practices as and when brought to its notice and advising them to take appropriate measures to prevent such instances taking place in their organizations.

A recent CRIS-INFAC study shows that in 2001-02 estimates that take-over loans are around 50 per cent of the incremental direct disbursement by banks and around