Housing Finance in India: An Overview

By Renu Sud Karnad

1.Indian Economy

India has had a meteoric economic rise since its liberalisation in 1991. Prior to this, India's true economic potential had never been tapped. For three decades post India's independence in 1947, the economy was unkindly labelled as having a "Hindu rate of growth" signifying a slow and stagnated GDP growth rate of 3.5% per annum. This was primarily attributed to the protectionist and interventionist policies being pursued by the government at that time. While the trigger to the 1991 economic liberalisation and reforms process was a result of a balance of payments crisis, the real opening of the economy bore fruit over the last decade. Between the period 2003 to 2008, India's GDP averaged 8.9%. Economic liberalisation prompted a dramatic increase in foreign investment into the country, fostered an increased pace of privatisation and augmented domestic consumption. With services predominantly driving India's growth story, sectors like financial services, information technology and outsourcing and telecommunications catapulted India into a new league.

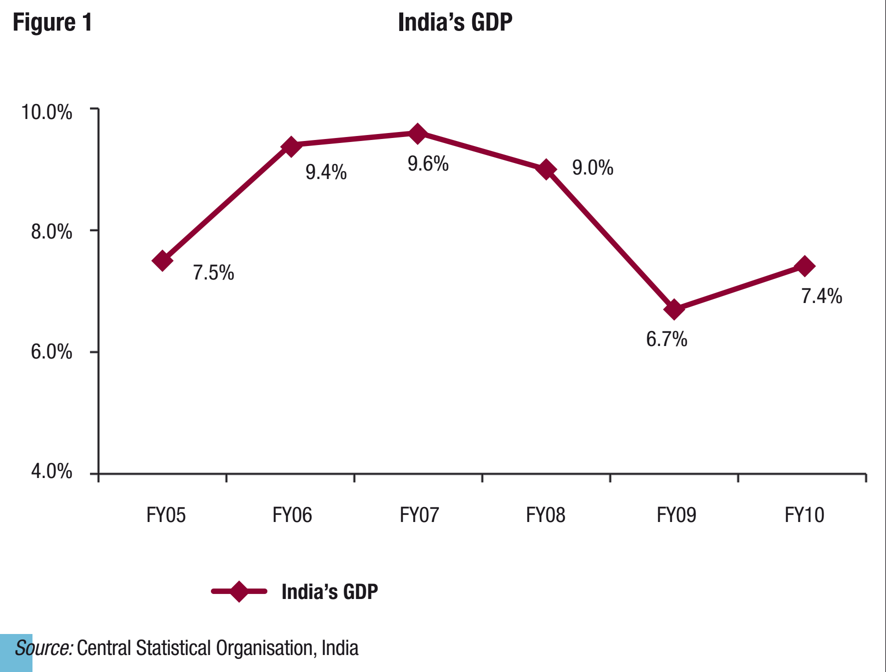
Moreover, what liberalisation did for India was to unravel its greatest strength - its demographics. 60% of India's population is under the age of 30 years. Increasing urbanisation, rising disposable incomes and better job opportunities has given rise to a new found confidence. As this generation strives for a better quality of life, key amongst their rising aspirations are to be homeowners.

India is a domestic driven economy. This is one of the primary reasons why the country remained unscathed from the global financial crisis. Despite the overall global slowdown, India remained the second fastest growing economy after China with a GDP growth of 7.4% for financial year 2010 (India's financial year ends on March 31). Since then, the economy continues to show resilience and is expected to return to its pre crisis GDP growth trajectory of 8.5 to 9%. The two fastest growing economies - India and China together, account for 40% of the world's population.

India, however, faces two key challenges that currently impede the country from attaining a higher rung of economic achievement - inadequate infrastructure and finding appropriate solutions for affordable housing. The housing shortage in India is acute 24.7 million dwelling units though unofficial estimates peg the shortage as high as 40 million. It is estimated that Rs. 5,100 billion (~US$ 109 billion) is required between the period 2007 and 2012 for housing.

2. Urbanisation

India has seen a gradual, structural shift from an agrarian based economy to a services and manufacturing driven economy. Urban areas or cities are now at the centre stage of the development process. Growing urbanisation not only represents a demographic shift in population but also signifies a social, cultural and economic transformation. Currently approximately 300 million people or 28% of India's population live in urban areas. According to a recent study by McKinsey Global Institute, by 2030, 40% of India's population or 600 million people will be living in cities. To put this number in perspective, it is twice the current population of the US. It is further estimated that 70% of India's employment will be generated from cities. To meet the growing demand, India will need to build between 700 million to 900 million square metres of residential and commercial space – equivalent to adding one Chicago every year! The growth of urbanisation critically depends on the necessary infrastructure to be in place to house, educate, transport and employ the moving masses. It is estimated that India needs US$ 1.2 trillion capital investment over the next



Source: Central Statistical Organisation, India

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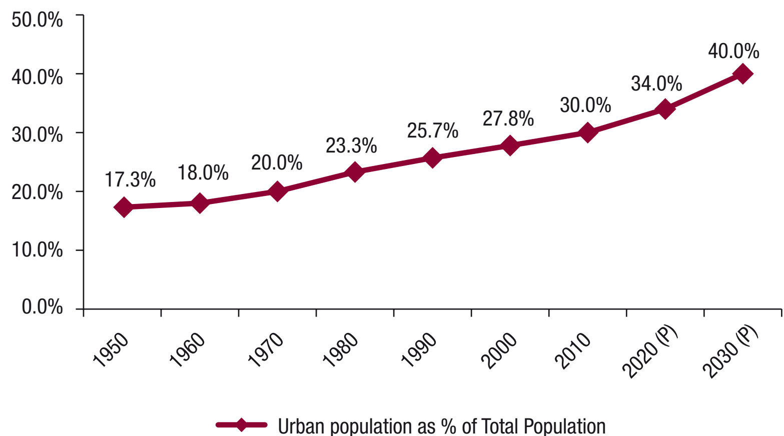
twenty years to meet the projected infrastructure demands of its cities.

With rapid urbanisation comes an acute pressure on housing. Further, the demand for housing will only increase in the coming years as India's middle class is expected to rise to 800 million by 2020 from the current 250 million. Thus, the need for widening the reach of housing finance across India is critical. Housing also plays an important role in terms of the multiplier effect it has on the economy due to its strong backward and forward linkages with various industries and as a direct and indirect employment generator. Alleviating the urban housing shortage could potentially raise India's GDP by 1 to 1.5%, besides having a decisive impact on improving the basic quality of life.

Figure 2 **Urban Population as % of Total Population**

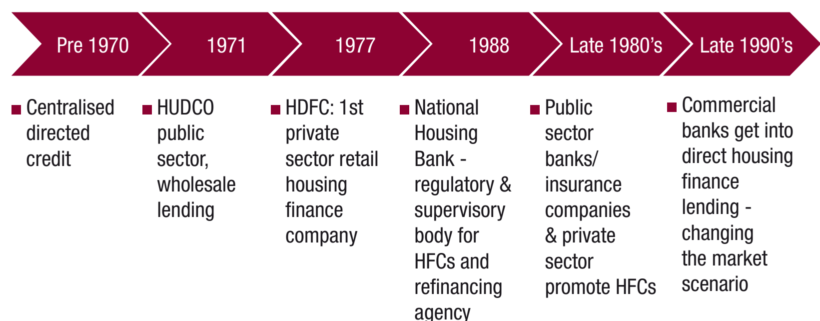


Source: Census of India 2001, HDFC Estimates

3. Evolution of Housing Finance in India

Until the 1970s, the government's support to housing was centralised and was directed through State Housing Boards and Development Authorities. In 1970, the central government set up the Housing and Urban Development Corporation (HUDCO) as a wholesale lender to finance housing and urban infrastructure activities. It was only in 1977 that the first retail housing finance company was established, Housing Development Finance Corporation - India (HDFC). When HDFC was launched, there were no foreclosure norms nor was there much access to long-term finance in India. Nonetheless, given the immense demand for housing finance and HDFC's emphasis on quality customer service, its success as a pioneer of housing finance in India served as a precedent for others to follow. In 1988, the National Housing Bank (NHB) was established as a 100% subsidiary of India's central bank, the Reserve Bank of India (RBI) to exclusively promote housing finance through a refinance mechanism and also to function as the supervisory and regulatory body for housing finance companies. Later in the late 1980s, other housing finance companies (HFCs) were launched by insurance companies, public sector banks and the private sector.

Figure 3 **Housing FinanceTimeline**



Source: HDFC

In the earlier years, commercial banks were reluctant to lend for housing and other retail loans as they preferred to finance the working capital needs of industry. Though several banks had set up housing finance subsidiaries, they mostly functioned as independent units with little support from their parent bank.

The turning point in the housing finance sector came in the late 1990s as commercial banks which had traditionally shied away from housing finance, entered the market. Against a backdrop of low interest rates, industrial slowdown, sluggish credit off-take and ample liquidity, banks recognised that if they had to maintain their asset growth and profit margins, they needed to shift their focus from the wholesale segment and build their retail portfolios. Housing finance in India has traditionally been characterised by low non-performing assets. This together with the fact that there was a vast demand for housing loans resulted in many commercial banks getting into the business of housing finance. Today, banks and HFCs are both key players in the housing finance market, with banks accounting for 70% of the market share. However, the top four players comprising HFCs and banks account for close to two-thirds of the market share. Though mortgage penetration in India has more than tripled from 2% of the GDP in the late 1990's to 7% today, this ratio continues to remain low, especially when compared to other Asian peers, where the ratio hovers between 12% to 25%. Thus, scope for the mortgage market to grow is immense.

4. Regulation of Housing Finance Players

The regulation and supervision of housing finance players in India is unique. The Reserve Bank of India (RBI) regulates the commercial banks while the National Housing Bank (NHB) regulates the Housing Finance Companies (HFCs). However, the NHB is a refinancing arm for both, commercial banks and HFCs.

There are fundamental differences between commercial banks and HFCs regarding taxation treatment, capital adequacy, liquidity requirements, deposit insurance and disclosure requirements. For instance, while banks are mandated to allocate 40% of their advances

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for priority sector lending[1], of which housing finance qualifies, HFCs are not bound by sectoral lending limits. When banks lend under direct housing finance, a loan up to Rs. 2 million (~US$ 42,550) qualifies for priority sector lending, however, when a bank does indirect housing finance, i.e. lends to a HFC for on-lending, a loan of only up to Rs. 500,000 (~US$ 10,640) qualifies for priority sector. Further, under the housing finance allocation, banks are mandated to earmark at least 3% of their incremental deposits to housing finance, though today most banks are lending in excess of this mandated allocation. In terms of capital adequacy norms, banks are required to maintain a minimum capital adequacy ratio of 9% as compared to 12% stipulated by NHB for HFCs.

Figure 4: Key Players in the Mortgage Market

Banks		Housing Finance Companies
Reserve Bank of India (RBI)	**Regulator**	National Housing Bank (100% subsidiary of RBI)
Access to low cost funds via current/saving accounts Extensive branch network	**Advantages**	Dedicated players, better customer service Lower operating costs
High operating costs Mandating direct lending, maintenance of cash reserve ratio & statutory liquidity ratio	**Disadvantages**	Higher funding costs Higher capital adequacy ratio

Source: HDFC

The advantages that banks have over HFCs is that they have access to low cost current and savings accounts while HFCs are only allowed to access term deposits with a minimum tenor of one year. On the other hand, HFCs typically have lower operating costs viz-a-viz banks.

5. Customer Profile

The typical average Indian middle class consumer continues to be relatively debt risk averse. Most borrowers are first time homebuyers acquiring a house for self-occupation. The loan to value ratio is rather low compared to many other countries since a borrower will prefer to first use his savings, borrow from friends and family and then opt for a loan. HDFC's customer profile is largely a salaried earner, the average loan size is Rs. 1.75 million (US$ ~37,230) and the average loan to value ratio at origination is 67%. The average age of the individual borrower has come down significantly in recent times. Today, the average age of a homebuyer is 35 years compared to the mid 40s a decade ago.

6. Improved Affordability

One of the prime reasons why home loans have increased rapidly in the recent period is due to improved affordability. For instance, 15 years ago in India, it would take around 22 times a person's annual income to be able to afford a modest sized home in a metropolitan city. Today, this affordability has improved to 4.7 times one's annual income. Despite property prices rising, affordability has improved mainly due to sharp increases in the income levels of people.

Secondly, the government's support towards housing is evident from the fiscal incentives provided on housing loans. Interest paid on a home loan is eligible for deduction to the extent of Rs. 150,000 (~US$ 3,190) and the principal repayment is also eligible for deduction to the extent of Rs. 100,000 (~US$ 2,130). These limits have been enhanced over the years. These tax benefits help to reduce the effective interest rate on a home loan.

7. Characteristics of Housing Loans

In India, housing loans are offered for a maximum of 15 to 20 years though on an average, the tenor at origination is about 13 years. Housing loans are repaid through equated monthly instalments, which consist of a principal and interest component. Thus the customer starts repaying the loan from the following month in which the housing loan is fully disbursed. Therefore, the lender begins to receive a part of the principal amount back as soon as the loan is fully disbursed. As a result, the effective duration of a housing loan gets reduced to around 7 to 7.5 years. Most Indians still prefer to repay their housing loans as soon as they can. For instance, when they get bonuses or any other windfall gain, many customers prefer to prepay their housing loans. This helps to further reduce the effective duration of a housing loan to about 5 to 5.5 years.

Until the late 1990s, the interest rates on housing loans were fixed. Once the banks got more focused on retail housing finance, the market gradually changed to floating interest rates. With floating interest rates priced lower than fixed rates, most customers opted for floating rate housing loans. During the present decade, floating interest rates on housing loans have varied from a low of 7% to a peak of 12% p.a. Over the last eighteen months, customers have shown a strong preference for dual rate home loans, where interest rates are fixed for a predefined initial period after which the interest rate on the loan is floating. From a pricing perspective, the dual rate home loan works well when the yield curve is steep i.e. there is a significant difference between short and long term interest rates. Thus in the initial period when the interest rate is fixed, the rate is lower than in the subsequent period when it becomes a floating rate. Currently, however, there has been a flattening of the yield curve, with short term rates having hardened more than long term rates. Thus going forward, the pricing and attractiveness of the dual rate home loan product will hinge on the movement of the yield curve.

8. Marketing and Distribution

Marketing and distribution plays an important role in determining the growth of a housing finance player. With strong competition, housing finance in India is clearly a buyers' market. Earlier, word of mouth was the most effective means of reaching out to new customers. Today, customers are more discerning. Due to competition, housing finance players have to reach out to customers rather than vice versa. Banks

[1] Priority sector lending: Certain sectors of the economy require to be prioritized in terms of credit availability and thus banks are mandated to lend to specified sectors such as agriculture, small scale industry, housing etc.

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have an inherent advantage of their large branch network, but the quality of service rendered may lack focus as housing loans are one of the many products being offered. Conversely, for a HFC, building up a large network is often time consuming and expensive. Technology and robust systems play a key role in helping players keep their operating costs at optimum levels.

An outcome of increased competition in the financial services industry has been the rise of Direct Selling Agents (DSAs) who provide door-step service. As competition intensified in the housing finance industry, several players handed over the reins of DSAs to increase their business. However, there have been instances wherein agents do not have the adequate information or expertise on housing finance and end up making disingenuous offers to consumers. Experience has revealed that it is prudent to use DSAs only to source loans, while the appraisal process should be done entirely by the lender. In India, there are no pre-qualifications mandated for DSAs selling home loans.

9. Sources of Funding for Housing Finance Players

While banks mostly rely on savings and current accounts to fund their housing portfolios, HFCs typically rely on diversified funding sources. In India, for many years long-term resources were not easily available. Earlier, one source of long-term funding was from multilateral agencies. For instance, HDFC, particularly in its early days was able to access resources from multilateral agencies such as the World Bank, the International Finance Corporation, the Asian Development Bank and the Commonwealth Development Corporation amongst others. Unless an institution has the expertise to manage the foreign exchange risk, such borrowings were not easy to handle.

In the 1980's and the early 90's, it was difficult to hedge a foreign currency liability and foreign exchange covers were available for up to a maximum of 6 months only. Fortunately, today there is far greater sophistication in the financial markets and it is possible to hedge foreign currency liabilities in a number of ways and for long periods of time through a variety of sophisticated hedging instruments.

Insurance companies typically look for long-term assets. In India, until 2000, there was only one government-owned life insurance company. This severely restricted the ability to tap long-term resources. However, post 2000, the Indian government privatised the insurance sector. Today there are 23 life insurance companies operating in India and these companies are growing rapidly. Insurance companies look to invest in long-term assets and as a result, there has been a considerable deepening of the long-term debt market as well. Needless to add, housing finance providers have benefited since they issue long-term bonds which are mostly subscribed by insurance companies and provident funds.

The other sources of funding that HFCs in India rely upon are loans from commercial banks. These tend to be of a shorter tenor. Housing finance providers also get medium to long term funding from the National Housing Bank under its refinance window.

Securitisation of mortgage loans is another source of funding, though it has not really taken off in India. Housing loans have to be seasoned for at least one year before the originator can securitise the loans. Buyers of mortgage-backed securities (MBS) typically hold on to these investments, hence the MBS market is still fairly illiquid.

HFCs in India, unlike commercial banks are not allowed to have current or checking accounts, but instead are permitted to issue term deposits with a minimum tenor of 1 year and a maximum tenor of 7 years. It is prudent for HFCs to have a mix of wholesale and retail funding. Typically, wholesale funds tend to be cheaper than retail funds since retail funds entail higher administrative and marketing costs. However, in a high or volatile interest rate environment and in times of tight liquidity, retail funds are a more stable source of funding.

10. Impact of the Global Financial Crisis

India was not directly affected by the global financial crisis because the exposure of Indian banks to complex securitised products was limited. Financial institutions in India are conservative and offer plain vanilla, amortising home loans. Furthermore, mortgage loans are given in India based on an evaluation of the cash flow of the borrower rather than based solely on the property value.

Indian banks have by and large been resilient throughout the financial crisis. Unlike many Western banks, which had toxic assets and complex securitised products, the credit quality of Indian banks continues to be of high quality. Even though bank credit grew by 30% per annum during 2005-07, there was no significant relaxation of lending standards. Further, to prevent the build up of speculative asset bubbles, the central bank had taken several pre-emptive measures such as prohibiting banks from financing land transactions, raising risk weights and tightening provisioning requirements on commercial real estate loans.

India, however, was not completely decoupled from the global financial crisis. The collapse of Lehman Brothers in September 2008 resulted in a liquidity crunch in India. Confidence in the financial system had been shaken. Indian banks too turned risk averse, resulting in a credit freeze. This triggered a domino effect and the liquidity crunch affected several sectors including real estate.

It was particularly difficult for the real estate sector during the period October 2008 to March 2009 as many overleveraged developers found themselves on the brink of a disaster. Part of the problem lay with developers that had gone on a land-buying spree as they were flush with funds in the pre crisis period. A lot of money had come into housing and real estate through the foreign direct investment route. However, much of this funding was really high cost debt masquerading as equity. With the equity markets also crashing, resource raising became extremely difficult. Against a backdrop of rising interest rates and tightening liquidity, many developers had to resort to borrowing at very high interest rates to prevent defaulting.

Meanwhile negative economic sentiments also resulted in consumers preferring not to buy property. Since developers needed the cash flows and did not want to hold on to their unsold stock, residential property prices dropped by 20 to 25% across India. With property prices becoming more realistic, buyers returned back to the market. During this period, developers also shifted their focus from the luxury segment to the mid-market and affordable residential market where the demand is always high. The affordable housing segment offers the advantage of high volumes and shorter construction and sales cycles, which helps reduce the working capital requirements of developers.

Fortunately during this critical period, the central bank and government also undertook several swift measures to ensure stability in the financial system, which included providing special liquidity facilities, adopting counter cyclical prudential norms and to encourage home buyers, the government offered a 1% interest subsidy on home loans for houses costing up to Rs. 2 million (~US$ 42,550).

As economic sentiment revived, the residential sector showed considerable improvement. Many developers now have much cleaner balance sheets and are less leveraged. However, post

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December 2009, residential real estate prices have once again rebounded, surpassing peak levels of 2007-08. Residential real estate prices in certain pockets of the country have touched unsustainable levels, though the demand for housing continues unabated.

11. Affordable Housing: Challenges & Opportunities

Greater emphasis needs to be placed on increasing the supply of affordable and low cost housing. In India, low cost housing is primarily aimed at Economically Weaker Sections (EWS) and Low Income Groups (LIG) and both these segments need intervention and support from the government. Households having an income less than US$ ~110 per month are termed as EWS, while LIG are those that have an income that is greater than US$ ~110 per month and up to ~US $ 210 per month.

Defining affordable housing is a challenge. Affordability has to factor in various facets - location, household income, spending and saving patterns and demographic factors like the size of the household. Clearly a one-size-fits-all approach does not work, but broadly, in the Indian context for housing affordability, the cost of a house should not exceed 4 to 5 times the annual household income and the rent or loan instalment should not exceed 30 to 40% of the monthly household income.

The high cost of land in cities is one of the greatest hindrances in providing affordable housing. At the lower income level, slum rehabilitation schemes through public private partnerships have worked well in some pockets. This scheme entails a vertical development of the slum sprawl with the developer being allowed a higher floor space index (FSI). The developer provides slum dwellers with permanent structures - typically a one-room tenement with an attached bathroom free of cost, while the developer benefits from the surplus land, which can be used for commercial purposes.

The other problem with affordable housing is that if it is built in far flung city outskirts where the land may be cheaper, there are often no takers for such homes since the necessary infrastructure in terms of mass rapid transportation systems, schools, hospitals and other civic amenities may not be available. To make affordable housing a reality, key stakeholders have to ensure that infrastructure and housing development happens simultaneously.

Figure 5 **Rural Housing Constraints**

Source: HDFC

12. Rural Housing

Within the low-income group, housing problems in the urban and rural areas are vastly different. For instance, housing remains unaffordable to a vast population in urban areas due to distortions in land prices. On the other hand, in rural areas, housing inadequacy is reflected in the mismatch between desired and actual housing quality. The requirement of housing finance in rural areas is predominantly for the upgradation of houses – especially for improving basic amenities such as access to drinking water, sanitary facilities, cooking space and better power connections.

Given that rural areas account for 70% of India's population and 57% of the housing shortage in India, rural habitat development is crucial for the sustainable and inclusive growth of India. While several initiatives have been taken by the government in terms of various schemes for the provision of rural housing, owing to the scale of the problem, they have not always yielded the desired results and hence there is a need for greater intervention.

One of the major constraints associated with rural housing is the non-availability of tangible security for housing loans. Rural lands are often fragmented, which has resulted in conflicting records of land owners and non availability of title deeds. There are further complications due to restrictions of ownership, usage and transfer of agricultural land. The biggest hindrance is the restriction on taking agricultural land as collateral for lending for non-agricultural purposes.

Other challenges with rural housing include difficulties in estimating the level of income of borrowers - particularly agricultural income which fluctuates, depending on the vagaries of the weather. However on a positive note, the rural economy is seeing a distinct shift away from the predominance of agriculture. It is estimated that over 35% of rural households are now engaged in non-agricultural activities.

Despite the formal sector's attempts to make in-roads into rural financing, informal sources of finance continue to dominate. In fact, in the lowest income groups, over 70% of loans are taken from moneylenders and relatives/friends. Needless to say, moneylenders continue to be exploitative and charge usurious interest rates. Formal finance options are still few. It is estimated that rural housing finance credit forms only 11% of the housing loan portfolio of commercial banks.

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13. Financial Inclusion: the way forward

In India, there is now a growing recognition that the country's aspirations towards achieving a sustainable double digit growth rate can only happen if there is a complete commitment to financial inclusion. This necessitates an integrated financial infrastructure which will ensure that all segments of the population get access to the formal financial sector. Financial inclusion will catapult India into the next wave of economic prosperity. Providing effective housing finance solutions across all income segments will form a crucial component of India's financial inclusion agenda.

Housing finance players, policymakers and other stakeholders need to work together and strive towards the challenge of housing more people in India. The provision of housing finance is a logical extension of the "Fortune at the Bottom of the Pyramid". This is because nothing can be more beneficial to a nation than a property owning democracy. A successful and sustainable existence of civilised society depends on having the greatest possible number of people who have a stake in society. Being a homeowner gives one a secure and direct stake in society. Thus housing more individuals must form one of the most important goals of the country.

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