India's Housing Finance Companies: Problems and Prospects

by H. Robert Bartell, Jr.

In the international housing finance arena, much is known and written about India's Housing Development Finance Corporation (HDFC). The company pioneered the establishment of private housing finance in India during the late 1970s. Although a number of comparable companies have been established in recent years and a few have prospered, HDFC still dominates the market with over 50% of the home mortgages originated. The quality of the company's management is admired, not only in India but in other countries as well.

Unlike some pioneers in housing finance in the developing world, HDFC's financial performance has been excellent. In addition, the company has recently expanded beyond its narrow housing finance focus by entering joint ventures with international financial giants in the fields of commercial banking (with the U.K.'s National Westminister), consumer lending (with the U.S.'s General Electric), and property management, and an international insurance venture is planned. These diversification moves have been made possible by a new government which since 1991 has taken a number of steps toward liberalizing the Indian economy, most particularly opening the door to increased foreign investment.

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While much is known about HDFC, its little brothers and sisters are not widely recognized outside the Indian market, and their performance as a whole has not been particularly impressive to date. This might seem puzzling when you consider that many of the newer housing finance companies (HFCs) in India are offshoots of major commercial banks, such as the State Bank of India, Canera Bank, the Bank of Baroda and Vysya Bank. In addition, the second largest HFC is sponsored by the Life Insurance Corporation of India, the giant, government-owned insurance monopoly.

It is noteworthy that HDFC was instrumental in the establishment of several of these competitors, for example, SBI Home Finance (the State Bank of India affiliate), Can Fin Homes (the Cavera Bank affiliate) and Gujarat Rural Housing Finance. HDFC continues to maintain substantial investments in these and other HFCs, and its executives serve on the boards of directors of several of its competitors. Despite HDFC and sponsor company support, none of these HFCs has as yet shown the same ability to prosper. It could be argued that their short history, most having been established in the late 1980s, a decade after HDFC, means that they are merely experiencing the problems of childhood.

Another explanation for the weak performance of the newer arrivals is that the Indian environment has changed to an extent and in a direction that makes it unlikely that many of HDFCs competitors can prosper to the extent that it has. In this view, HDFC is unique, having the advantages of being first, when it could set the basic parameters of the business. Now that it has achieved success, it is restructuring itself in recognition of the fact that the Indian economic and political environment is evolving rapidly and that housing finance is no longer a business with such a promising future. While the need for housing finance is still great in India, the industry, as it is presently structured, regulated and supported by government, may not be able to meet that need.

THE MARKET FOR HOUSING FINANCE

There is no question about the need for housing finance in India. The country is rapidly urbanizing, and population growth continues to be among the highest of the industrialized countries at 2% per year. Nevertheless, until recently, India's housing sector has been afforded a relatively low level of support from the government and the largely government-owned financial sector. Until the emergence of HDFC in the late 1970s, home buyers had no access to mortgage loans. This changed in the 1980s, as the government accorded housing finance priority status through a program of directed credit and the establishment of the National Housing Bank (NHB).

However, the existing financial institutions that were directed to allocate a portion of their lending to housing had virtually no experience in the home mortgage field. Rather than setting up mortgage lending departments, the banks

and insurance companies chose to establish separate, specialized housing finance companies along the model of HDFC. At about the same time, the NHB was capitalized by the Reserve Bank of India and charged with two primary roles—financial support for housing and regulation of the emerging housing finance companies. Financial support includes investment in various HFC's shares and refinancing (or loaning on the collateral of) housing loans originated by HFCs and others. Some direct project finance is also provided by the bank.

Regulation includes all the normal activities associated with prudential regulation of financial institutions, including permitted activities, capital and liquidity requirements, risk monitoring and general management oversight. Approval as an HFC by the National Housing Bank is essential to securing various tax benefits and access to refinancing. As a result, companies involved in housing finance strive to meet the regulatory requirements of the NHB.

THE INDIAN MORTGAGE MARKETS

Today, the largely government-owned financial institutions, including the NHB, supply about one-third of the funds flowing to the housing sector. Specialized HFCs account for another one-fifth. The remainder is supplied by government directly, and by provident funds and cooperative societies. However, when individual home loans, as opposed to project finance, are considered, HFCs supply almost one-half of the funds, followed by provident funds with one-quarter and banks and insurance companies with under 15%.

While HFCs have made substantial inroads into the private housing finance market and their loan portfolios have grown rapidly, it is estimated that only 25% to 30% of home buyers use mortgage financing, and the typical mortgage loan represents less than one-half of the purchase price of the home. HFCs have mainly served upper income segments of the population, since low household incomes and high house prices create a serious affordability problem for most families. Further, the segment of the population that can afford to borrow appears to have an aversion to formal finance, choosing instead to rely first on savings, and then on loans from friends and relatives. Thus, a large part of the enormous need for housing in India has not been translated into effective mortgage demand in the formal sector.

Despite the program of directed credit which has fueled the growth of HFCs and home lending in recent years, three major government impediments to the growth of private housing and housing finance remain. These are:

- The Urban Land Ceiling Act which limits the availability of urban land for private housing, thereby substantially increasing the cost of such housing.
- Foreclosure laws which result in lenders waiting as long as 15 years to obtain title to mortgaged property and default interest rates as low as 6% to 8% even though mortgages typically carry rates well above 10%.
- Property transfer and mortgage recordation fees charged by state governments amounting to 10% to 15% of sale prices, which not only raises the cost of housing but hinders the establishment of a secondary mortgage market.

While these impediments are widely recognized, efforts to reduce or eliminate them have not been successful to date.

THE FUTURE OF HOUSING FINANCE COMPANIES

Although economic, cultural and legal issues restrict the growth of formal housing finance in India, private sector housing finance companies in more highly developed countries have experienced severe difficulties with far fewer impediments of the sort prevalent in India. The source of these difficulties can be traced to the combination of a flawed regulatory structure for housing finance institutions and a rapidly liberalizing financial system. It is possible that the success of HDFC, the country's dominant mortgage lender, may cause India's leaders to overlook the dangers which these developments may hold for HFCs in the years ahead.

Upon returning from a month-long visit to India last summer to work with industry executives and regulators and after reflecting on the trends there and their longer run implications, I have concluded that Indian private housing finance companies may be moving in a direction not dissimilar to that of savings and loan companies in the United States during the post-World War II period up to 1990. While the direction may not be entirely parallel to the U.S., with the same disastrous consequences, the similarities are sufficiently close to be disturbing.

The similarities between Indian housing finance today and the U.S. during the period from about 1950 to 1980 can be categorized as follows:

1. High degree of specialization
2. Tight controls on pricing
3. Loose regulation of credit quality and financial soundness
4. Favorable taxation which enforces specialization
5. Management focus on growth at the expense of safety and soundness

SPECIALIZATION

Both the asset and liability sides of an HFC's balance sheet are tightly restricted, largely through the mechanism of National Housing Bank approval. HFCs must abide by a number of NHB rules in order to be eligible for fund-

ing by the bank and for special income tax treatment. In addition, mortgage loans refinanced by the bank must meet certain eligibility criteria. Since most HFCs rely heavily on NHB refinancing and the re-finance rates are below the cost of deposits, they have little choice but to adhere to these rules.

HFCs are limited to offering term savings accounts with maturities from one to seven years. No checking accounts are allowed. In addition to deposits, HFCs may borrow from the NHB by refinancing home loans, but the amount and terms of these loans are tightly controlled. Total borrowing, including deposits but not NHB refinance, is limited to a fixed multiple of equity funds (paid in capital and reserves).

On the asset side, home loans must comprise at least 75% of loans, and prescribed liquid assets must equal no less than 10% of deposits. Home loans have maturities of from 7 to 20 years, with fixed rates of interest and equal monthly installments which fully amortize the loan over its term. Prepayment penalties are not allowed under most circumstances.

Thus, HFCs resemble, in the limited range of products offered, the specialized housing finance institutions which existed in the industrialized, English-speaking countries (U.S., U.K., Australia, South Africa, Canada) after World War II. The predominance of long-term, *fixed-rate* mortgages in India mirrors the U.S. during that era. Most other countries chose to allow adjustable rate mortgages.

PRICING CONTROL

Interest rates on loans and deposits offered by HFCs are subject to prescribed ceilings. Loan rate maximums are set by size of loan. The maximum rate for smaller loans is less than the cost of deposits and lower than for larger loans. Maximum loan-to-house cost ratios are higher for small loans than for larger ones. In addition, loan origination fees are limited to 2% of the loan amount.

Market driven pricing would undoubtedly result in different pricing relationships. That is, interest rates and fees would be higher on smaller loans to account for the higher cost of origination and servicing. Higher rates would normally be charged for high loan-to-cost loans to cover the added default risk.

Since the NHB also fixes the refinance rate for loans, it therefore sets the spread which HFCs have to cover operating costs and losses on refinanced loans. For smaller loans, this spread is 2% (12% loan rate; 10% refinance rate). For larger loans, it is 1.25%. The largest loans have no ceilings, providing an incentive to HFCs to favor loans on more costly houses.

The maximum rate for HFC deposits is set at 14%. Commissions to deposit brokers are capped. Unlike commercial banks, HFC deposits are not covered by government insurance. Because of this, HFCs pay substantially more for deposits than banks. In addition, the inability of HFCs to offer checking accounts, which carry lower interest rates, means that their average cost of deposits is considerably higher than banks.

Government controls on pricing typically lead to low margins, and this is true for India's HFCs. Average interest spreads are less than 2%, as compared with about 4% to 5% for banks elsewhere. However, specialization often carries with it low operating costs. Under some circumstances, this can lead to acceptable returns on assets and equity. Continued success in this kind of financial business, however, requires stable spreads and low credit losses. Although they have been spared so far, India's HFCs could be exposed to substantial interest rate and credit risk in the future.

PRUDENTIAL REGULATION

Because home mortgage loans are considered less subject to default risk, prudential regulation and government oversight of specialized mortgage lenders has tended to be less stringent than that imposed on commercial banks. This appears to be true of India's HFCs. While capital requirements are similar to the IMF international capital standards, these require only one-half the capital for home loans as for other types of loans. In addition, the NHB imposes limits on leverage. Borrowed funds, including deposits, are restricted to 10 times equity capital and unallocated reserves for smaller and 15 times for larger HFCs. For purposes of this calculation, refinance loans from the NHB are excluded, which means there are no capital requirements for loans financed with NHB borrowings. A 15-times leverage ratio results in a 6.7% capital requirement, but this becomes very much smaller when NHB refinancing is added. Several of the newer HFCs have 15% to 20% NHB borrowings, which means that at the maximum leverage ratios, their required capital would be about 5%. While this might appear adequate under some circumstances, the practice of excluding refinancing from the leverage calculation means that as borrowings from the NHB rise, capital requirements fall. This appears to be an invitation to overleveraging.

The primary reasons for allowing HFCs to allocate up to 25% of their loan portfolio to non-housing loans appear to be to increase interest spreads and to reduce interest rate risk. However, these benefits are presumably at the expense of greater credit risk. This has clearly been the experience in other countries. Regulatory steps to mitigate this risk would include a limit on maximum loan size related to equity capital and limits on loans to one borrower. It does not appear that the NHB places regulatory restrictions on HFCs non-housing portfolio.

HFCs are heavily exposed to interest rate risk by the nature of their restricted balance sheet. That is, they finance a large volume of long-term fixed rate loans with much shorter term deposits. In periods of rising interest rates this can cause a sharp narrowing or elimination of interest spreads. There does not appear to be

much concern with interest rate risk exposure of HFCs at the present time. The argument that one hears is that home loans have significantly shorter actual maturities than contractual maturities in India because borrowers tend to repay quickly, more so than in other countries. Thus, there is less mismatch between asset and liability maturities than meets the eye. While there may be some validity to this argument, it has not been tested against periods of rising interest rates. Regulatory authorities in other countries have imposed an added capital requirement for lending institutions exposed to high interest rate risk. This does not appear to be the case in India.

TAXATION

HFCs benefit greatly from various provisions in the Indian tax laws. These include benefits to homeowners, which encourage homeownership and reduce its cost, and benefits to savers, which encourage savings in the form of deposits. In addition, HFCs are permitted to deduct a reserve equal to 40% of taxable earnings derived from mortgage lending, up to a maximum of 100% of their paid-in capital. This substantially reduces the company's effective tax rate, and the tax free reserve is counted toward capital requirements. Also, investors in HFC shares and debt securities benefit from substantial tax breaks. These tax subsidies serve to tie HFCs more closely to the narrowly defined area of housing finance and to discourage diversification which might lead to more stable companies in the long-run.

MANAGEMENT FOCUS

With the exception of HDFC, most HFCs are affiliates of much larger banks or insurance companies. Although affiliated, these HFCs are publicly held companies with traded shares. According to the NHB guidelines, at least 30% of the initial paid-in capital should come from the sponsor affiliate and an additional 20% from banks and other public financial institutions, including other HFCs and the NHB itself. At least two of the directors of the HFC must be representatives of the 20% investor category. As previously noted, HDFC has substantial investments in the stock of several other HFCs and has representatives on these boards.

While the bank- and insurance company-affiliated HFCs have public stockholders, senior management is typically appointed from the larger sponsor's staff and assigned to the affiliate for relatively brief periods. A number of commentators on this practice have observed that it leads to a lack of a clear, long-term vision and an emphasis on short-term results. Given the nature of the business and its regulatory structure, this usually means an emphasis on growth. With narrow and regulated interest rate spreads, short-run success means growing the loan portfolio as quickly as funding sources will allow. Credit quality is understandably a secondary consideration. This description clearly applies to some of the HFCs, but the absence of uniform and valid credit quality measures makes such determinations difficult at best.

Some industry people argue that credit quality is not really a serious issue because huge housing shortages and rapidly rising house prices in India mean that mortgage delinquencies and defaults do not lead to losses. Similar sentiments have been expressed by lenders in other countries with rapid house price inflation. Experience has shown, however, that these periods can be followed by house price deflation when the economy falters, with disastrous consequences to those lenders that promote growth at the expense of quality.

REFINANCE

In the last two or so years, NHB has reduced the volume of funding made available to HFCs by restricting the types of mortgages it will refinance and by narrowing the spread between refinance rates and the allowable interest rates on mortgages. It is not clear whether this is a change in policy direction or the result of temporary difficulties experienced by the bank.

In 1992, the bank was exposed to substantial potential losses because of apparent fraud. In addition, the Reserve Bank of India has been pressed into financing a portion of the central government's growing debt because of an inability to sell it to the public. As a result, the Reserve Bank may be restricting the access of its subsidiary, NHB, to the capital market. These factors may account for the recent slowdown in NHB refinancing. It is not clear, however, whether this is a temporary or a more-or-less permanent situation. It is clear that most HFCs have had to rely more heavily on deposits as a source of funding in recent years.

SUMMARY

Housing finance companies in India are, with one exception, relatively new and untested by adverse economic conditions. The regulatory structure is also relatively new, but it has encouraged some of the attributes of HFCs that led to serious distress in other countries during the 1970s and 1980s. These attributes are a narrowly constrained list of service offerings and tax incentives leading to excessive specialization and exposure to interest rate risk, government price controls which provide for narrow profit margins and a resultant emphasis on growth at the expense of credit quality and capital adequacy. These tendencies may not be restrained by regulatory authorities due to a lack of appreciation for the risks involved and/or a weak regulatory regime.

In the U.S., a similar dangerous brew was brought to a boil in the early 1980s by financial deregulation coupled with a monetary policy designed to bring inflation under control, even if that meant rapidly fluctuating interest rates. Undoubtedly these steps were influenced by growing international economic

integration and the realization that domestic policies which were inconsistent with the new international economic realities could not be sustained for long.

India appears to be going through a similar transition as it seeks to achieve greater economic growth through integration with the world economy. Assuming the country is successful in modernizing its economy and improving the lot of its citizens, the demand for housing finance will undoubtedly expand rapidly. Whether the existing housing finance company structure can accommodate that expansion, given its current structure, is problematical.

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