AGENCY FOR INTERNATIONAL DEVELOPMENT

PROJECT DATA SHEET

1. TRANSACTION CODE: C (A = Add, C = Change, D = Delete) — PD-AAR-392

Amendment Number: 1

DOCUMENT CODE: 3

2. COUNTRY/ENTITY: INDIA

3. PROJECT NUMBER: 386-HG-002

4. BUREAU/OFFICE: ASIA

5. PROJECT TITLE (maximum 40 characters): Private Housing Finance for Low Income Families

6. PROJECT ASSISTANCE COMPLETION DATE (PACD): MM 06 DD 30 YY 89

7. ESTIMATED DATE OF OBLIGATION (Under 'B.' below, enter 1, 2, 3, or 4)

A. Initial FY 84 B. Quarter 4 C. Final FY 88

8. COSTS ($000 OR EQUIVALENT $1 =)

A. FUNDING SOURCE	FIRST FY 84 B. FX	C. L/C	D. Total	LIFE OF PROJECT E. FX	F. L/C	G. Total
AID Appropriated Total						
(Grant) Central	(120)	( )	(120)	(250)	( )	(250
(Loan)	( )	( )	( )	( )	( )	(
Other U.S. 1. HG Loan	20,000		20,000		60,000	60,000
Other U.S. 2.						
Host Country						
Other Donor(s)						
TOTALS						

9. SCHEDULE OF AID FUNDING ($000)

A. APPROPRIATION	B. PRIMARY PURPOSE CODE	C. PRIMARY TECH. CODE 1. Grant	C. 2. Loan	D. OBLIGATIONS TO DATE 1. Grant	D. 2. Loan	E. AMOUNT APPROVED THIS ACTION (Central) 1. Grant	E. 2. Loan HG	F. LIFE OF PROJECT 1. Grant	F. 2. Loan
(1)	720	850	866		20,000	100	25,000	250	60,000
(2)									
(3)									
(4)									
TOTALS									

10. SECONDARY TECHNICAL CODES (maximum 6 codes of 3 positions each)

11. SECONDARY PURPOSE COD

12. SPECIAL CONCERNS CODES (maximum 7 codes of 4 positions each)

A. Code

B. Amount

13. PROJECT PURPOSE (maximum 480 characters)

Provide long term finance to lower-income households and broaden the exposure of the private housing finance sector to lower income borrowers and depositors. To enhance the ability of the private sector to raise domestic capital for housing finance activities.

14. SCHEDULED EVALUATIONS

Interim MM YY MM YY Final MM YY

15. SOURCE/ORIGIN OF GOODS AND SERVICES

☐ 000 ☐ 941 ☐ Local ☐ Other (Specify)

16. AMENDMENTS/NATURE OF CHANGE PROPOSED (This is page 1 of a ______ page PP Amendment.)

To authorize a $25 million second tranche of 386-HG-002 to the Housing Development Finance Corporation and provide $100,000 central funds for technical assistance in training, management systems and housing finance system development studies.

17. APPROVED BY

Signature

Title: Director, USAID/New Delhi

Date Signed MM DD YY

18. DATE DOCUMENT RECEIVE IN AID/W, OR FOR AID/W DOC MENTS, DATE OF DISTRIBUTI

MM DD YY

AID 1330-4 (8-79)

PD-AAR-392

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IAN-40934

Project Memorandum - India
386-HG-002(B)

I. SUMMARY:

A. Introduction

This Project Memorandum is submitted in support of an amendment to the Private Housing Finance for Low Income Families Project (386-HG-002) in India. HG-002 was approved in principal for up to $60 million in June, 1984, at which time $20 million was authorized for the first tranche. If approved, this amendment will authorize a second tranche of $25 million in HG loans to the Housing Development Finance Corporation (HDFC) and $120,000 in grants to support policy studies and training related to foreclosure practices, mortgage insurance mechanisms and secondary mortgage market development.

The Project Memorandum supplements the original HG002 Project Paper (June, 1984), summarizes the final evaluation of the earlier project with HDFC (386-HG-001), reviews progress to date on HG-002, and describes the program proposed for funding with the second tranche.

B. Issues to be Addressed Prior to Second Phase Authorization

In approving the first tranche of HG-002, the Asia Project Advisory Committee (APAC) stipulated that certain issues be addressed prior to authorization of a second tranche (See State 184345/01, Annex 1). The issues which were to be addressed during an evaluation of HG001 are discussed below and in more detail in Annex 4. The evaluation as called for by the APAC was conducted by consultants from the Urban Institute in March 1985. In general, the resolution of the APAC issues discussed below adheres to the recommendations advanced by the consultants engaged to evaluate HDFC performance under HG-001.

(1) The APAC concluded that HDFC's corporate loan program be reduced or eliminated, and directed that the evaluation team to consider and offer recommendations on the extent of reduction which should accompany authorization of the second tranche. As elaborated in the HG001 Evaluation the consultant team found the corporate loan program to be an appropriate use of HG funds. It provides a financially viable vehicle for serving a larger number of lower income households. This is true for three reasons: 1. corporate loans result in more units per rupee loaned than individual loans; 2. corporate loans, which have shorter terms and higher interest rates, enable HDFC to keep its progressive interest rate structure for individual loans lower than would otherwise be possible; and 3. the corporate program provides HDFC increased access to lower income households who, because of the nominal rent paid for worker

housing, are able to save funds for a downpayment for a loan for their own home in the community of their choice. The consultant team found that corporate housing provided large benefits to workers and evidenced no exploitive practices. They felt that the type of housing benefits provided by corporations as part of their overall compensation plan is appropriately left to labor union - management negotiations. Additionally the corporate loan program provides HDFC with a valuable tool for mobilizing resources from India's corporate sector by expanded contacts with corporations seeking housing loans and by negotiating deposit linked loans. Given the substantial socio and economic benefits of HDFC's corporate loan program the evaluation team did not recommend further reduction in HG support for the program. This view is incorporated in the design of this tranche.

(2) The APAC recommended that if increased HG funding were provided, it be tied to proportionately increased generation of local funds by the HDFC or other borrowers. As background to this issue, the evaluators concluded that "culmulatively, the team views HDFC's local resource mobilization efforts as enormously successful. The firm has diversified the number and type of investors and depositors, and it has continually sought to exploit 'niches' in the market that are often created or associated with an interest rate ceiling system. The firm seems particularly well-placed to develop the deposit market by reliance on brokers for individual deposits and the new technologies that are emerging in the gathering of deposits". While the analysis infra shows that proportionality has been more than maintained, and while the evaluation report notes that the IFC has projected, e.g., an increase of 150 percent in deposits over the next three years, it is not recommended that any proportionality covenant be imposed on HDFC because such a requirement could inhibit HDFC's rate of growth by reducing the Corporation's flexibility in responding to conceivable economic circumstances.

(3) The APAC raised various issues with respect to the Resident Advisor proposed for India, but deferred to the Mission for decisions on them in accordance with the terms of the Asia Bureau Experiment.

(4) The APAC mandated that the evaluation should include an engineering analysis of HDFC-financed units to verify reasonable compliance with basic engineering concepts in the construction of units financed under the HG program. Based upon findings by the team that HDFC's current construction inspection procedures are adequate, that its overall exposure is limited by highly conservative underwriting practices, and that actual inspections revealed no deficiencies, the evalution team concluded that "there is no reason for AID to undertake inspections of HDFC-financed units". The program described below conforms to this recommendation.

(5) The APAC mandated a full scale evaluation of HG001 to be conducted in January 1985. The scope of work was drafted by RHUDO and USAID and then reviewed and cleared by AID/W. The evaluation field work was conducted in March 1985 and the findings are summarized in Annex 4.

(6) The APAC instructed a covenant be inserted in the Project Agreement that HDFC agree to study its internal policies and practices and explore ways to provide increased home ownership by women. This decision was satisfied by Sections 5.01F and 5.09 of the AID/HDFC Agreement dated August 30, 1984 and HDFC submittal of November 12, 1984.

(7) The APAC directed the evaluation to address the policy impact of the program. The evaluation team stated "The realization of HDFC's financial record, as well as the development in India of a regulatory environment in which spontaneous development of a market-oriented housing finance system can occur, is in large part attributable to the firm's regulatory entrepreneurism." A host of regulatory changes/modifications and financial allocations effecting the housing finance sector on both the national and state levels have been the result of HDFC staff and Board efforts. HDFC has developed into a credible proponent for change and AID's initial support of the institution was a nontrival factor in HDFC's achieving this stature. In terms of future policy impact in housing finance sector development the evaluation team used the analogy of HDFC as the icebreaker. HDFC imitators have been and are being formed because of the environment being created by HDFC's success and continuing ability to constructively engage in a regulatory dialectic for system development. HG001 was a successful institutional development project, while with HG002 AID's focus shifts to systems development. The evaluation team's conclusion is that the appropriate vehicle for this endeavor is HDFC. This paper acknowledges concurrence of this approach.

(8) Finally APAC decided that an examination of the need for increased funding levels for HG support in India be addressed at a program review rather than the APAC.

C. Program Approach

The approach proposed here is to employ HDFC as the focus of an expansion of USAID to develop a viable private housing finance sector in India. A number of other options, including support for housing cooperatives and HDFC imitators have been considered and are considered less desirable at this time because, on balance, both the program and policy impacts of the alternatives are thought to be less than will result from continued support for HDFC. There are two principle reasons for this conclusion. Most importantly, HDFC has indicated its willingness to replicate itself through the contribution of equity and technical assistance to two other housing finance corporations. Hence, HG support for HDFC will, to some extent, be passed through to its progeny while saving the RHUDO from direct involvement in technical assistance. Secondly, HDFC has policy influence with the GOI that cannot currently be matched by any other potential private sector client. Its demonstrable ability to obtain policy changes supported by AID make it a valuable ally in our efforts to encourage the development of a market-driven financial system. From the standpoint of immediate benefits to low income households, continuing support for HDFC also appears to be warranted. Additional HG resources will be leveraged by expanding domestic debt to a level which will permit both deeper and broader market penetration through the opening of new branches and increased volumes at existing branches. Should subsequent events change the assessment of the relative desirability of non-HDFC borrowers, AID's strategy will change accordingly.

The strategy with respect to technical assistance is directed towards financial deepening, with the ultimate aim of establishing a secondary market for residential mortgage paper originated by private lenders. Initial steps will include policy papers and training related to the strengthening of foreclosure procedures, the initiation of mortgage insurance, and the marketing of mortgage paper.

D. The Program

The $25 million loan guaranty and related technical assistance advocated here is the second tranche of a three phase program designed to be spread over a five year period which began in 1984. This tranche is intended to support the stable growth of HDFC through the provision of additional long-term capital. The project would comprise two elements:

1. A Housing Guaranty Loan of $25 million to HDFC in FY 85; and

2. Technical assistance supported by $120,000 in grant funds to include three related studies: (a) an evaluation of current foreclosure laws and practices to determine changes needed to permit mortgage lenders to liquidate the security for their loans while protecting the rights of borrowers; (b) a consideration of the legal and economic viability of mortgage insurance; and (c) a study of the commercial feasibility of a secondary mortgage market or more modest mechanisms to permit primary mortgage lenders to dispose of high quality paper. In support of the studies described above, some grant funds will be used for HDFC staff training in the U.S. on these and related subjects. Additional grant funds would be used to improve HDFC's computerized management systems.

E. Recommendation

On the basis of the analysis developed below, it is recommended that $25 million be authorized as the second tranche of the program of Private Housing Finance for Low-Income Families in India. It is further recommended that $120,000 in grant funds be authorized in support of the policy and management objectives of the second tranche.

II. RECENT DEVELOPMENTS IN THE HOUSING FINANCE SECTOR IN INDIA

A. An Overview

The recent change of government in India appears likely, in the long run, to be accompanied by salutary changes in the general commercial environment in India. Although this justifies some measure of optimism with respect to mortgage lending because it should lead to higher rates of household income growth and to a generally more open economy, some caution is warranted. First, the new Prime Minister has indicated his intended policies only in their broadest configuration. The all-important details have yet to be discussed, much less implemented. Secondly, current uncertainties about the substance of the new government's policies and about the likelihood of their being effectively implemented have resulted in a slowing of mortgage lending as both potential borrowers and developers wait for a clearer definition of the opportunities.

Perhaps the most interesting revelations to date of the future directions of housing policy are provided by the recently published "Approach" to the Seventh Five Year Plan. The Approach starts from the general principles that increasing the rate of GDP growth is not enough to insure the distribution of economic benefits through productive employment and that therefore employment generation must be a specific object of policy. From this, it follows that "the expansion of labor-intensive construction activities for providing housing, urban amenities, roads and social infrastructure" should be among the particular objectives of the Seventh Plan.

Investment in housing is also defended in the Approach as needed to "improve greatly the physical well-being of the people and the environment in which they live". In rather strong language, the report notes that "housing has emerged as one of the most important felt needs of the country, perhaps next only to food. If further deterioration in housing shortage is to be prevented and shelter is to be provided to the net addition to the population, the number of additional houses required would be at least 17 million during the Seventh Plan period and 13.8 million four years thereafter. This is a collossal figure and nothing short of a major national program of housing development can hope to tackle it".

To promote a policy of decentralized development, the Approach advocates the development of infrastructure in smaller communities. Such development, it is argued, will attract industrial development and be followed by housing construction. More adventurously, the Approach argues that the government should acquire land in concentric circles around developing smaller jurisdictions, install infrastructure, and then resell the land at market values, using the profits to support additional investment and services.

The Approach focuses on infrastructure and housing finance rather than direct construction of shelter. It suggests that "the most crucial need in housing development is a quantum multiplicaion of institutions for housing finance and construction. The strengthening of the existing institutions like HUDCO and HDFC and the creation of new institutions like Housing Cooperatives and Building Societies would be necessary. There would have to be enlarged financial provision for all those institutions by enabling them to raise deposits from the market as well as to borrow from it through governement guaranteed housing bonds, etc. It is essential that an individual or an organization should be able to put in a limited saving with a building society, a cooperative housing society or some other institution, obtain the house and continue to save and make payment for the next few (say, 15 or 20) years".

The general and sometimes ambiguous wording of the Approach leave much uncertainty about the role of the public and private sectors in housing finance and development. In view of the almost complete failure of the Urban Land Ceiling Act and other attempts by the government to intervene in the Indian land market, the land acquisition and infrastructure development scheme advocated in this document could be expected to restrict housing supply and increase prices. On the other hand, if the "quantum multiplication of institutions for housing finance and construction" results in greater opportunity for private sector development, as opposed to the replication of public subsidy programs, then the possibility for progress is great. On the whole, however, the approach has an interventionist flavor which, if taken seriously, could retard the development of viable housing finance and development industries. For this reason, much of the technical assistance contemplated in connection with this tranche of HG-002 is directed at specific measures to expand the private sector and to demonstrate its effectiveness in satisfying housing demand.

B. Development of the Private Sector

HDFC's success in demonstrating that a considerable market exists for market rate financing of home purchase in India has spawned imitators. In particular, developers have been tempted to establish HDFC look-alikes in order to provide take-out loans for their projects. Similarly, leasing companies have seen mortgage finance operations as a potential means of expansion through deposit-taking. In the past year, a dozen such operations have started up. Although two have suspended operations, this level of interest means that even modest regulatory cooperation on the part of the government will sustain competition for HDFC in a market which appears to be much bigger than the current supply.

However, that cooperation may not be immediately forthcoming. A number of important concessions in tax and banking regulations which HDFC's reputation earned for it, although ostensibly general in application, have not been extended to any of the new lenders. Instead, the government has "unofficially" decided to delay the extension of concessions until new lenders prove themselves "reputable". This will apparently require a period of prudent and socially useful operations.

As is common elsewhere, current regulation of financial institutions in India distinguishes between banks and non-banking financial institutions (NBFI's). The Reserve Bank of India (RBI), India's central bank and the primary regulator of financial institutions generally requires that the debt, including deposits, of an NBFI not exceed ten times its equity. The RBI granted an exception to the debt-equity ratio limit for NBFI's which specialize in housing finance. Thus, for such institutions, there is currently no limit, e.g., on the amount of deposits which can be collected. In the scrupulously regulated financial markets of India, such unrestricted access to capital is of great potential value. For HDFC, this freedom and the concommitant dangers of over-gearing are limited by agreement with the IFC, which contributed a portion of HDFC's initial equity, to a 15:1 ratio. New entrants to the field would not necessarily be subject to IFC encumbrances and, partially as a consequence of the halo effect of HDFC's solid reputation, might be able to attract substantial deposits with only token equity investments.

Another major concession granted to HDFC has been to extend to its depositors the same partial exemption (up to Rs. 7,000 per taxpayer per annum) from taxation on interest earnings that are granted investors in other preferred sectors. The effect of this is to permit HDFC to charge lower interest rates than would otherwise be the case.

In addition to these accommodations, HDFC has gradually received a host of minor regulatory concessions which add up to significant deregulation of its operations. This does not mean the sector has been deregulated, however, since the bulk of the changes apply only to HDFC at this time.

There are two crucial implications of the fact that only HDFC has so far been given the privileges associated with classification as a "housing finance institution" within the NBFI genre. Most fundamentally, of course, HDFC currently has no serious competition. Although this does not appear to have affected their performance to date, it is not a healthy market condition. More positively, it creates a significant opportunity for HDFC to exploit their credibility with the government and their expertise by creating parallel institutions in markets HDFC does not now serve.

An obvious alternative strategy for HDFC would be to attempt to preserve its exclusivity in the marketplace while expanding as rapidly as possible. But the short-term commercial advantages of this approach would likely be off-set by the temptation of the govenment to regulate or nationalize a monopoly financial institution. So HDFC has, with a fair amount of urging by the government, opted for contributions of equity and technical assistance to two new lenders which, initially at least, will focus on markets which are peripheral to HDFC's own emphasis. These projects are described below.

1. GRUH Finance

GRUH Finance will be the first rural housing finance company in India. The main objectives of the institution will be to mobilize commercial funds to provide long-term housing finance to low and middle income individuals and cooperatives for repairs and extension of existing houses and for acquiring new houses in smaller urban and rural areas of Gujarat State. In the longer term it is expected to serve as a model for other private rural housing finance companies to be established in other States. The proposed objectives of the corporation are:

- to provide long-term housing finance to low and middle income individuals in small towns and rural areas of Gujarat State principally for upgrading the existing housing stock but also for new housing;

- to contribute to the mobilization of medium and long-term savings for long term housing investment in the Company's market area;

- to support the development of a state-level system of rural housing finance; and

- to promote the growth and development of the money and capital market.

The largest shareholders of the company will be HDFC, IFC and H.R.H. the Aga Khan, each of which will invest Rs 2.5 million (US$200,000) of an initially subscribed and paid up capital of Rs 20 million. Of the total initial equity, 57.5 percent will come from private companies and 42.5 percent from public sector entities. Shares will not be listed on the stock exchange. HDFC will provide technical assistance during the company's start up period but the new institution will operate independently under its own board and professional management.

The operations of GRUH, although modelled in large part after those of HDFC, will require some adaptation to its less concentrated and probably lower income market. The largest part of demand for its services is expected to come from households borrowing to upgrade or maintain existing units. Both the IFC and consultants engaged by HDFC have appraised the proposed project. The IFC recently approved equity participation and in its assessment noted that HDFC's support was a crucial factor in making its positive recommendation.

2. The Eastern Regional Housing Finance Corporation

It is proposed that a Eastern Regional Housing Finance Corporation will be established, with headquarters in Calcutta, to serve a large area of India in which HDFC is currently not particularly active. Its objectives as currently conceived will be:

- to provide long-term home purchase finance to middle-income and lower-income individuals, especially in Eastern India.
- to provide short-term finance to property developers in order to increase the stock of houses mainly for lower and middle-income households.
- to contribute to the mobilization of long-term and short-term institutional funds and household savings, for the purposes of housing investment.
- to support the development of a national system of housing finance including secondary market and mortgage insurance.
- to promote the growth and development of the capital market.

The expectation is that the Corporation will operate in a fashion very similar to that of HDFC. HDFC will provide both an equity contribution and technical assistance.

Both GRUH and the Eastern Regional Housing Finance Corporation are expected to be incorporated by the end of CY85 and operational shortly thereafter. The spawning of these new corporations is in line with the Government's goal of creation three new HDFC's within five years.

The current state of development of the private sector presents several opportunities to AID. Most importantly, the government is at a major policy juncture with respect to the proper role of NBFI's in home purchase finance. The successful development of HDFC has encouraged a cautious tolerance by the regulators of private housing finance. Modest additional support for HDFC and for development of progeny will promote further expansion and deregulation by broadening the consumer and institutional constituencies for liberalization.

In addition, expanding the volume of private mortgage lending will create opportunities for specialization, risk-sharing and financial deepening which are required of a mature institutional arrangement. Component development of a full system will take time and progress in stages. New actors in the primary market are essential but their creation, in and of itself, does not define the parameters of a system. So while the GOI's acknowledgement of the need for more primary private sector lenders is positive, it skirts the issues involved in establishing an overall framework. Viable foreclosure mechanisms which can lead to reasonable insurance practices are essential stepping stones to a market for mortgage backed paper. These are all critical elements of the system. AID's role here should be to provide assistance related to the legal and technical analyses required to promote the establishment of such services and, consequently, the system's parameters.

III. PROJECT RATIONALE AND DESCRIPTION

A. Need for the Project

Although the growth of HDFC has been remarkable by virtually any measure, the total number of units it will finance during the current fiscal year will equal about one-tenth of one percent of the number of shelterless Indian families. Thus, the importance of HDFC is not a consequence of its current loan volume but rather of its stimulative effect on the marketplace. Even if the scope of the problem could be narrowed to, say, financing home purchases by urban households with incomes between 30 and 70 percent of the median, HDFC is meeting only a small fraction of the effective demand, much less the need. Northeastern India is barely served by HDFC at all, and elsewhere HDFC has branch offices only in major cities for the most part. Its 13 offices are confined to 11 of India's 22 states. In spite of this, HDFC continues to be the only national private home purchase lender in India.

Accordingly, this project amendment addresses the need for further expansion and deepening of the private housing finance sector. Expansion will require both the continued elaboration of the HDFC branch network and the creation of additional private lenders. Deepening will involve support for the development of additional system components such as mortgage insurance and the eventual creation of a secondary market for mortgage paper.

The legal, economic and cultural context in which these developments must occur is far from ideal. The allocation of discretion to approve exemptions from regulations governing mortgage financing gives public officials continuing control over mortgage volumes, interest rates and entrance to the market. As a consequence, HDFC's many would-be competitors are being suppressed by an uncertain regulatory environment. There is a corresponding need to persuade the government to institutionalize regulations for housing finance institutions so that HDFC will have a market incentive to continue to improve its efficiency and price its various facilities aggressively.

A second contextual impediment is the near impossibility of liquidating real property held as security for home purchase loans. The time required to secure and execute a judgment through foreclosure is typically around eight years, which makes it irrelevant as a collection technique. On the other hand, for both equity and marketing reasons, foreclosures cannot be made so easy that borrowers can be unfairly intimidated by lenders. But some more expeditious means of foreclosing on the property underlying mortgage loans is essential to the maturation of the private housing finance sector. Current laws advance the use of extremely conservative underwriting practices which in the long run can curtail market and consequently system development.

That the State may be receptive for change is indicated by the fact that the Gujarat State Government has a "Public Notice [illegible]" which HDFC helped promote, which somewhat improves the position of creditors vis-a-vis recalcitrant debtors. HDFC has also done some preliminary work on including in its loan agreements a clause to convert such agreements to a sort of English mortgage in the event of default in payment terms.

A third problem is the continuing difficulty of making housing finance affordable to households with below median incomes. Partly as a result of the potential foreclosure problems described above, HDFC has adopted highly conservative standards of creditworthiness in [illegible]. For example, loan-to-value ratios are generally less than 70 percent. Because land prices, and therefore home purchase prices, are increasing at a rate in excess of incomes in most of HDFC's urban markets, low-income households must find ways to more highly leverage their resources if they are to remain in the market for residential housing.

B. **Detailed Project Description**

The long-term goal of this program, as enunciated in the initial Project Paper (Private Housing Finance for Low-Income Families, 386-HG-00[illegible]) is to develop a fully functioning housing finance system in India which raises its capital internally and which makes long-term shelter finance available to households with a wide range of income levels, including lower income households. The first step in this process was to demonstrate the commercial feasibility of private mortgage lending for low-income households. The second step was to show that government policies and practices could be changed in ways that would promote HDFC's development without violating other public objectives.

The third step, which will be assisted by this project, will be to support an environment which fosters housing finance system development by expanding expand the HDFC experiment through properly private mortgage lenders, by increasing HDFC's mortgage volume and by experimenting with new mortgage facilities. The objective of this step must be not only to create additional volume but also to insure that new lenders replicate HDFC's success in reaching households with incomes below the median. Since new lenders in India have and, in all likelihood, will continue in the near term to use loan procedures developed and tested by HDFC, it is important that the pioneer firm experiment with new loan practices which cater to lower income household needs.

A fourth level of development, the establishment of the prerequisites of a secondary market, can be no more than initiated with this project. No detailed analysis of the legal and practical impediments to a dependable foreclosure process has yet been done although the problem has long been salient. The production of such analyses will be an objective of this phase of the project because it must provide the underpinning for the development of mortgage insurance and, consequently, of marketable mortgage paper and mortgage-backed securities.

In sum, the objectives pertinent to this phase of the project will be:

(1) To assist the continuing expansion of HDFC's loan volumes, resource mobilization, and geographic distribution while maintaining its financial viability;

(2) To encourage HDFC to develop and implement new facilities designed to increase the number of low income borrowers able to purchase homes;

(3) To assist HDFC to help other private mortgage lenders develop in a manner similar to HDFC;

(4) To provide technical analyses and recommendations calculated to promote financial deepening, such as analyses of foreclosure laws and practices, mortgage insurance and the development of a secondary mortgage market; and

(5) To provide training for HDFC staff in alternative foreclosure [illegible] mortgage insurance schemes and secondary market programs.

AID will use HG resources for achieving these objectives. HG and grant funds [illegible] to assist HDFC [illegible] expansion and support their activities [illegible] to development of new housing finance institutions. This phase of HG-003 will include $ [illegible] million HG loan. This proposed [illegible] the $20 million authorized as the first phase of HG-002, and a total of $[illegible] million projected in two phases of HG-001. If this amendment is approved, $15 million will remain unauthorized from the $[illegible] million contemplated by the project paper for HG-002.

HG financing will be used for:

(1) Individual housing loans and those portions of corporate loans originated by HDFC for households with incomes below the urban median;

(2) Activities undertaken by HDFC to assist and support new housing finance institutions.

The evaluation team found that HDFC's ability to reach lower income borrowers was to some extent inhibited by its emphasis on "special programs" which were limited to be small in scale and difficult to replicate. The implementation agreement for the first tranche of HG-002 required that at least [illegible] percent of HG resources be used for "special programs". The team therefore recommended that AID abandon this approach in favor of encouraging HDFC to adopt more generally applicable practices. Accordingly, this project will call for HDFC to experiment with the development of new mortgage instruments which can be integrated into their regular lending practices and which are more attractive to lower-income borrowers. In order to effectuate the move to routine practice rather than special activities which cater to lower income needs the Project Agreement shall include a covenant which calls for HDFC to plan and begin implementation of a significantly large trial program for a "step up" mortgage facility and/or other mortgage instrument in order to increase the leverage of lower income households.

HDFC will administer and implement the HG program and will be the borrower. Detailed arrangements for the host country guaranty and assignment of foreign exchange risk will be specified in the implementation agreement.

The technical assistance components of the project are related to objectives (4) and (5) above. A total of $120,000 in grant funds will be made available for studies and training related to housing finance system development and management.

Given the GOI's request for information from HDFC and HDFC's own interest regarding foreclosure issues, mortgage insurance and secondary mortgage facilities, HDFC is likely to be the leader in efforts to have these concepts put into operation. HDFC's top management is a cadre of the most knowledgeable people in India concerning housing finance. They have worked to expand their knowledge of other countries and likewise try to provide their staff with films, literature and when possible field experience related to housing finance systems in other parts of the world. International experts have been more than favorably impressed with HDFC's grasp of the subject and the contextual opportunities and constraints.

US experts working with HDFC management and staff, both in India and the U.S. on analyses and recommendations for financial deepening and systems development which can be presented in policy dialogues will be the major thrust of the project's technical assistance activities. The proposal is to concentrate on three studies:

(1) an evaluation of current foreclosure laws and practices to determine changes needed to permit mortgage lenders to liquidate the security for their loans while protecting the rights of borrowers;

(2) a consideration of the legal and economic viability of mortgage insurance; and

(3) a study of the commercial feasibility of a secondary mortgage market or more modest mechanisms to permit primary mortgage lenders to dispose of high quality paper.

In support of these studies and to expand general HDFC staff capabilities a portion of the grant funds will be devoted to specialized training. This will take the form of: purchase of short courses, used by US institutions for training Saving and Loan staff, for adaptation by HDFC to the India context; specialized study tours of US housing finance institutions; in country training activities. Additionally some funds will be devoted to improving HDFC's computerized management systems in order to enhance income targetting capabilities and increased loan volume.

IV. UPDATED EVALUATION AND ANALYSIS OF HDFC

A. Overview Analysis

The rationale for continued funding for HDFC assumes, of course, that the Corporation has a demonstrated ability to use new resources effectively in the provision of housing for low-income households. To do this, HDFC must continue to increase its loan volume and develop new facilities while maintaining its profitability. In addition, the use of HG funds must be justified by continuing service to lower income households and the development of unsubsidized local sources of funds.

Table 1 shows that HDFC continued its rapid growth by nearly any standard. Gross loan approvals increased by more than a third and loan disbursements by more than a half between FY 82-83 and 83-84. The number of units financed increased by over 40 percent. Measures of profitability also continued their salutary trends. Net after-tax profits increased by one-third and HDFC increased its dividend from 10 percent to 12 percent.

An indirect indication of the continuing success of HDFC in reaching lower income households is shown by the fact that the average loan per unit has remained virtually constant in nominal terms for the past three years. More directly, the evalaution team found, based upon earlier studies including AID surveys, that nearly one-third of HDFC beneficiaries during the fiscal years 1982-84 were lower-income households.

TABLE 1
HDFC PERFORMANCE HIGHLIGHTS

OPERATIONAL HIGHLIGHTS

	1983-84	1982-83	1981-82	1980-81	1979-80
Gross Loan Approvals (Rs. Millions)	1,031.3	761.2	466.1	332.7	232.2
Loan Disbursements (Rs. Millions)	748.9	478.4	297.9	209.9	90.6
Number of Units (In terms of Approvals)	27,495	19,472	12,401	9,641	7,411
Average Loan per Unit (Rs)	39,000	39,000	38,000	35,000	31,000
Average Age of Borrowers (Years)	37	37	38	36	36
Cumulative Investment in housing sector made possible (Rs. Millions)	6,657.2	4,195.8	2,450.6	1,394.3	631.6

FINANCIAL HIGHLIGHTS - (Rs millions)

	1983-84	1982-83	1981-82	1980-81	1979-80
Profit After Tax	38.7	28.9	18.2	11.5	6.2
Shareholders' Funds (Net Worth)	169.1	142.4	123.5	111.8	106.2
HG Long Term Borrowings	796.4	399.8	168.3	132.7	10.6
Deposits	1,198.2	670.7	398.7	178.1	38.8
Housing Loans Outstanding	1,611.7	985.3	563.9	298.2	101.4
Net Worth per Share (Rs)	169.11	142.40	123.51	112.80	106.25
Earnings per Share (Rs)	38.71	28.87	18.18	11.49	6.24
Dividend	12%	10%	7.5%	5%	-
No. of Shareholders	14,213	14,046	13,901	13,527	12,077

Source: HDFC Annual Report

Loan approvals during FY 84-85 will increase to roughly Rs 1,440 million, broken down as follows:

Loans	Rupees Millions	Equivalent U$ Millions
Individual	1,090	92.37
Co-op Scocieties/LOC's	120	10.17
Corporate	200	16.95
Construction	30	2.54
	1,440	122.03

Loan disbursements over the same period will total Rs. 1.1 to 1.15 billion. During the first half of FY 85-86 (July through December, 1985) an additional Rs 650-750 million will be required for additional disbursements.

HDFC's resource mobilization efforts have grown proportionately with its lending activities. HDFC's CD scheme had deposits of Rs 1.19 billion in FY 83-84, compared with Rs 670 million in the previous year; this represents an increase of Rs 520 million (79 percent) over FY 82-83. Current projections are for an additional Rs 300 million to be received in FY 84-85.

HDFC's newer and much smaller "loan-linked deposit scheme" took in Rs 4.7 million in FY 82-83. These deposits increased 74 percent to Rs 8.2 million in FY 83-84, and are projected to increase further in FY 84-85.

Long-term finance has come from insurance companies, commercial banks, the sale of bonds and from the HG program. From Rs 100 million in FY 83-84, HDFC commercial borrowings are expected to triple to Rs 300 million this year. Proceeds from the sale of bonds will add an additional Rs 100 million to a like amount raised in FY 83-84.

Loans from insurance companies remained constant at Rs 130 million (Rs 100 million from the Life Insurance Corporation of India and Rs 30 million from the General Insurance Corporation of India) during FY 82-83 and FY 83-84. A slight increase to Rs 150 million (from the Army Group Insurance Corporation) is expected for FY 84-85.

HG borrowings have fluctuated from $20 million in FY 82-83 to $10 million in FY 83-84. An additional $20 million is projected during FY 84-85 from the first phase of HG-002. The $25 million proposed for authorization here is expected to be drawn down in FY 85-86.

In sum, the total projected increment to resources during FY 84-85 is Rs 850 million. Borrowed resources will increase by about Rs 550 million. Figure A shows the history of HDFC borrowings including projections for a somewhat reduced increment during FY 85-86.

This quantitative exposition, although providing general testimony to HDFC's continuing development, should be interpreted in the light of recent commercial events which may affect its future directions. For example, HDFC's current profitability is based in part upon its exceedingly low late payments rate (.36 percent). Although HDFC's loan agreements provide for a penalty of 1.5 percent per month plus collection costs for late payments, given the difficulties of foreclosing described above, a change in the payment ethics of HDFC's clients could have important negative implications for the balance sheet.

Secondly, it is becoming increasingly difficult for HDFC to obtain long-term loans from the government-dominated financial markets. While the new government may prove willing and able to reduce its stranglehold on capital allocation to some extent, such changes in either procedures or policies are not currently foreseeable.

Thirdly, HDFC's borrowings from commercial banks, which will comprise more than a third of its increment to resources during FY 84-85, are shrouded in restrictions which affect both profitability and HDFC's ability to reach low-income households. On the profitability side, HDFC's spread on the loans it makes to individuals from the proceeds of loans it receives from commercial banks cannot exceed one percent. Public and private sector lenders in other developing countries typically seek average spreads on the order of 3-4 percent. While other HDFC lendable resources are not similarly restricted, the market sets a limit on the extent to which HDFC can compensate for these low yields.

To some degree, HDFC has been able to offset low margins on individual loans financed from commercial bank borrowings with higher profits from e.g., corporate loans. However, HDFC's corporate housing lending is beginning to suffer from competition from public lenders such as the LIC, which has not lent to HDFC in recent years while increasing loans to corporations for housing schemes. Companies have always been able to borrow from the LIC (and from HUDCO) for employee housing schemes at interest rates below those of HDFC, but the cumbersome and time-consuming loan procedures of these public enterprises made HDFC comparatively attractive. Now, however, LIC has adopted HDFC procedures and forms and both LIC and HUDCO have increased their efficiency with the effect that their lower (subsidized) interest rates are pulling corporate customers away from HDFC.

HDFC is responding to these pressures in a variety of ways. Most directly, it is seeking a change in tax laws to permit corporations borrowing for employee housing schemes to deduct financing costs as a business expense. Secondly, HDFC is looking for new business. One such possibility is to begin making loans to state housing agencies which have previously borrowed primarily from HUDCO. Although some members of HDFC's board are reluctant to take on such clients because of the political entanglements likely to accrue to such lending, modest steps in this direction are being considered.

HDFC is putting increased emphasis on attracting individual savers. This represents a shift in its resource mobilization strategy from term loans and corporate depositors to household savers. Initial reliance on GOI institutions for long-term resources had met with difficulties in obtaining required approvals and delays in fund transfers following approvals. This encouraged HDFC to reduce its initial reliance on loans from GOI institutions for long-term resources. Now HDFC realizes that corporate depositors, although they deposit in bulk, are apt to withdraw funds, also in bulk, when more lucrative investment opportunities arise. HDFC, therefore, has decided that having a substantial base of resources from individual depositors is essential for long-term stability and growth.

To achieve this objective, HDFC has entered into brokerage arrangements with agents who receive a commission on deposits taken. These HDFC agents receive a fee of 1/2% per term year of the amount of deposits secured (i.e., for a 6 month deposit, the agent receives 1/4% of the deposit; for a 2 year deposit, 1%). There are currently some 1500 agents. HDFC hopes to increase the number of agents to 7-8,000 within 2 years by increasing the commissions to 1/2% per deposit year plus an additional flat 1/2% of the deposit. HDFC particularly seeks agents in big organizations with a large number of salaried employees, in chartered accountant firms which are apt to have clients who are looking for investments, and in small towns.

HDFC also proposes to increase individual deposits through expanded advertising. HDFC's budget for advertising will be about Rs 1.3 million this year, compared with Rs 700,000 last year. This increase is in part due to the fact that HDFC has finally received blanket permission to advertise. Earlier, HDFC had secured permission to advertise for deposits only if ads were approved individually by the Ministry of Law, Justice and Company Affairs. Recently, they have been exempted from this requirement.

In line with the strategy to increase access to individual accounts HDFC has opened three new branch offices this year, for a total of 13 in 11 states, and is planning the opening of its 14th branch next year. Instead of emphasis on branching into new states and untested markets, HDFC in the future will be more likely to open branches in areas of high demand which are currently being served by travelling HDFC staff from existing offices. This approach of following the market will increase the initial cost effectiveness of branching.

In the long run, this deposit mobilization strategy will help to decrease HDFC's reliance on borrowing from government sources. In the short run, however, increased HG lending will be essential to maintaining a high growth rate. Summary operational data are displayed in Table 2. Among other things, this information shows the efficiency of the corporate loan program where average loans per unit and unit cost are less than half of the corresponding values for individual loans. In addition, the much shorter terms of corporate loans means a faster roll-over of funds.

Table 2

INDIA

HOUSING DEVELOPMENT FINANCE CORPORATION LTD.

Operational Data
(as at June 30, 1984)

I. AVERAGE LOAN PROFILE

		Individuals	Corporate Borrowers
A.	Average loan per unit	Rs 43,000	Rs 20,000
B.	Average cost per unit	Rs 106,000	Rs 41,000
C.	Average loan/cost ratio	41%	49%
D.	Average cost/income ratio	4.47:1	-
E.	Average rate of interest	13.56%	14.68%
F.	Average term of loan	13.08 years	5.68 years
G.	Average age of borrower	37 years	-

Source: IFC

Basic income statement and balance sheet information is shown in the Tables in Annex 3. No serious problems are indicated there.

B. Phase I Project Progress

Implementation of the first tranche of HG002 is progressing satisfactorily. The Project Agreement was signed in August 1984 and HDFC anticipates entering the US market in July-August 1985 by which time GOI and AID approvals required for the $20 million loan transaction are expected. By December 1984 HDFC had eligible disbursements of $10 million which fit the criteria set for the first tranche of the project: at least 15% for special initiatives, less than 44% for corporate projects and the remaining for household borrowers with below urban median incomes. As at April the reported disbursements exceeded $15 million (using April 30 exchange rate).

As noted above HDFC has opended three new branch offices this fiscal year which exceeds the PP target of one new branch every 18 months. HDFC's low income action plan has been updated for the current year as required. Except for training, other output indicators for project progress are based on anticipated annual increases. Valid measurement will have to come from end of the year (June 30) records of activity albeit review of quarterly activities indicate that HDFC's growth is more or less as projected.

With respect to training HDFC has adapted a customer relations course developed by the U.S. Institute for Financial Education and held workshops for over three-quarters of their staff of just under 400. HDFC is also conducting computer awareness seminars and is preparing a three part audio visual presentation on the Indian Financial System, how HDFC fits into the system and HDFC's internal practices. The FY 84-85 trial Management Trainee Program was successful and will be continued and expanded to include a Graduate Trainee Program for functional specialists. AID has sponsored four persons at short term training sessions at MIT and one at Berkeley on various policy design and operational issues related to housing and housing finance. HDFC in turn has trained three persons from the Unit Trust of India, the major sponsor of the Eastern Regional Finance Corporation, in the operational aspects of a housing finance institution.

C. Financial Projections

Table 3 provides projections of HDFC activity through FY 87-88. As indicated HDFC's program to increase deposit resources will result in a net annual increase in deposits equal to term loans and bond resources by FY86-87. HDFC's volume of loan activity is expected to continue to increase at an annual rate of approximately 30% while the projected administrative expense per loan is expected to decrease slightly.

TABLE 3

HOUSING DEVELOPMENT FINANCE CORPORATION LTD.
FINANCIAL PROJECTIONS FY 84-85 THROUGH FY 87-88
(FY = JULY 1 - JUNE 30)

	84-85	85-86	86-87	87-88
Loan Approvals (Rs millions)	1140	1900	2500	3250
Loan Disbursements (Rs millions)	1100	1510	2000	2640
Net Increase in deposits (Rs Millions)	400	600	800	1000
Term Loans/Bonds (Rs Millions)	600	700	800	1000
Increase in net worth (Rs millions)	30	50	110	140
General Administrative Expense (% of average housing loan)	1.4%	1.4%	1.25%	1.20%

V. DEBT SERVICE CAPABILITY

India's long standing policy of selective and cautious use of borrowing has prevented the emergence of severe debt servicing problems. In this regard, Indian policy makers are acutely aware of the debt servicing crises experienced by other developing countries in recent years and from all evidence are determined to avoid this type of problem. India demonstrated its conservative approach to international borrowing by deciding to refrain from drawing down the last SDR 1.1 billion tranche under the Extended Fund Facility arrangement for SDR 5.0 billion agreed to in 1981 with the IMF and terminating the arrangement in May 1984.

The major change in India's financing of external debt in the medium term will be the continued rise in commercial borrowing and the decline of concessional assistance. India's credit rating, which is good and will likely remain strong, should provide it with the required access to international capital markets for commercial borrowerings. The Government of India (GOI) is aware of the higher debt servicing associated with larger borrowing in commercial markets and therefore will contain the debt service ratio within manageable limits by keeping close watch and control over future commercial borrowings.

Housing Guaranty borrowing under current market conditions is advantageous vis-a-vis alternative non-concessional sources of funds. The recent Housing Guaranty loan to HDFC was made on a floating rate basis at an effective interest rate of 9.3% (30 basis points over 90 day Treasury rate). In contrast Indian borrowing in the international capital markets has been at an effective rate of 10.62% (62 basis points over London Inter-Bank Offered rate).

TABLE 1-A-C

India's Debt Service Ratio (DSR): Receipts & Payments, IFY 1974-1990

	Debt service Ratio (%) (3)x100 / (2) (1)	Receipts on Current a/c ($mill.) (2)	Payment (principal + interest) ($mill.) (3)
a) Actuals			
1973-74	16.9	3,862	662
1974-75	14.3	5,147	737
1975-76	12.3	6,121	754
1976-77	14.2	7,726	1,093
1977-78	12.6	9,098	1,148
1978-79	10.8	10,271	1,143
1979-80	8.2	12,920	1,059
1980-81	7.1	15,254	1,078
1981-82	7.5	14,439	1,078
1982-83	10.1	12,828	1,299
b) Estimates			
1983-84	12.9	13,405	1,732
1984-85	15.8	14,613	2,244
1985-86	17.4	16,736	2,845
1986-87	21.1	19,206	3,975
1987-88	21.8	22,145	4,774
1988-89	21.3	25,790	5,439
1989-90	20.6	29.797	6,096

Table I A-C shows India's debt service ratio from 1973-74 to 1983-84 and estimates from 1983-84 to 1989-90[1]. The estimates show a rapidly rising debt service ratio through 1986-87 and then a stabilizing of the ratio through the end of the decade. The short term situation will be readily manageable; the medium term, difficult but nevertheless manageable. The GOI's economic survey for 1984-85 acknowledges that the Sixth Plan (1980-85) experience of comfortable Balance of Payment situation was aided by some special factors such as reduction in both the volume and value of crude imports, inflow from net invisibles, and capital flows into non-resident external accounts. The survey also shows that these factors may not operate to the same extent in the Seventh Plan period (1985-90). According to the survey "All this adds up to a somewhat uncertain and uncomfortable outlook for the balance of payments over the medium term. A major effort has to be mounted in the Seventh Plan to further accelerate the rate of growth of exports, and to reduce imports of bulk commodities."

The government, as part of the SDR 5.0 billion loan, worked out with the Fund an adjustment strategy that it hoped would allow the economy to integrate higher oil prices without sacrificing economic growth. The crux of the strategy was first to open up the highly protected Indian market to more import of intermediate and capital goods as well as foreign investment and technology. It was hoped that the influx of foreign equipment and know-hoe would, over the medium term, make Indian industry more efficient and energize the stagnant export sector. At the same time, the Government launched an investment program of $6-7 billion over five years aimed at greatly expanding domestic oil production. (In 1979-80 when oil prices were hiked, more than three-quarters of India's export earnings were being used to pay its oil import bill.)

So far the second part of the strategy has been far more successful than the first. Domestic production of crude oil has almost tripled and net oil imports have declined to only 37% of net non-oil export earnings in 1984-85. In fact, the improvement in the oil import account has been sufficient to contain the current account deficit to $2,926 million in 1983-84 or about 1.7% of GDP and $2,760 million in 1984-85 or about 1.4% of GDP. On the capital account, the balance of payments was bolstered by a continuing flow of remittances and a significant increase in deposits from Indians residing abroad which more than doubled in 1983-84 to reach the $1 billion level. As a consequence of the uncertain conditions in Gulf countries, these deposits dropped to $600 million 1984-85.

The following table shows the decline in India's trade deficit over the past several years in millions of dollars.

Year	Imports (includes net oil imports)	Exports (excludes oil)	Deficit
1980-81	16,204	8,504	7,700
1981-82	15,301	8,519	6,782
1982-83	14,290	8,290	6,000
1983-84 (Est.)	14,040	8,355	5,685
1984-85 (Est.)	14,501	8,724	5,777

To a certain extent the appreciation of the US dollar relative to the Indian rupee has limited growth of export earnings in dollar terms. More fundamentally, however, it is a reflection of the high cost and relatively low quality of many Indian manufactured exports. An additional factor has been the international recession, which reduced demand for many primary products and increased competition in areas where Indian exporters of manufactured goods had hoped to build a market presence.

A substantial increase in domestic oil production and relatively soft international oil prices were the main factors which accounted for the reduction in the trade deficit. Oil production rose by over 170% from 10.5 million metric tons in 1980-81 to estimated 29 million metric tons in 1984-85. At present 6 million metric tons of crude are exported each year; such exports will continue until all the country's refineries have been retrofitted to process Indian oil. Thus, as retrofitting is completed exports and imports will decline.

The following table also shows the impact of increased domestic production of crude oil (POL) on India's foreign trade in millions of dollars:

Year	POL Imports	POL Exports	Net POL Imports	Net POL Imports as % of non-POL exports
1982-83	5808	1200	4,608	57.4
1983-84	4689	1380	3,309	40.4
1984-85	4530	1570	2,960	37.4

Despite these improvements the medium term outlook for the balance of payments is uncertain. Growth of non-oil exports, as shown in the table on trade deficit, has been stagnant and marginally declining for the past few years; i.e. the estimated 1983-84 level was approximately the same as the 1980-81 level. Both the Government and many Indian businessmen acknowledge that Indian manufactured products have difficulty competing successfully in overseas markets. Also, it now appears that foreign assistance on concessional terms will not increase during the coming years. Thus, unless India can somehow increase its hard currency export earnings it will have to turn increasingly, as it already has begun to do, to commercial loans on harder terms for financing the rising flow of high technology imported capital goods that it will need during the second half of the eighties.

The Government clearly recognizes India's vulnerability, and in the context of its explicit policy of not exceeding debt service limits, imports may have to be limited during the planning period that will begin in 1985 although GOI will continue to liberalize its economic policies on imports and exports. This could result in India following a slower growth path. An alternative, imprudent borrowing, is considered highly unlikely in light of India's conservative record. The excellent interest rate India has obtained on recent commercial borrowings in the midst of the upheavals in international commercial markets reflects this assessment.

Net invisible receipts fell from $4,736 million in 1980-81 to an estimated $[illegible] million in 1983-84, but the drop was not as steep as expected. While remittances from Indians abroad, principally workers in the Middle East, have declined from the high mark of $2,[illegible] million in 1980-81, they now appear to have stabilized at about $1,[illegible]00 million, at least for this year and next. The major change in the invisible account was a sharp increase in interest payments on past borrowings, especially to the IMF and to commercial banks. Another negative factor was that GOI interest revenues have fallen because of reduced levels of foreign exchange reserves excluding gold from FY 82 onwards.

On the receipt side, net concessional aid disbursements increased from $1,546 million in 1980-81 to $1,691 million in 1982-83 and is estimated at $1,474 million in 1983-84. At present the World Bank accounts for more than half of gross aid flows. IDA commitments have been consistently declining during the 1980's: $1,[illegible] million in 1980-81, $1,088 in 1981-82, $776 million in 1982-83 and $672 million in 1983-84. While commercial rate loans from the World Bank will offset the decline in IDA commitments, the stiffer loan terms (20 years at near market rates) would cause concessional aid flows to decline. The terms of aid from bilateral as well as multilateral sources have hardened during 1980-81 to 1983-84: the amount of bilateral grants and its share in total bilateral aid declined; the deterioration was steeper in the case of multilateral sources; and grants from the Bank Group nearly halved from 83% to 44%.

A source of strength to the balance of payments in recent years has been the willingness of Indians residing abroad to hold their savings in the form of deposits in Indian banks denominated in rupees, dollars or sterling. To encourage these flows the GOI has placed a 2% interest premium on hard currency deposits by non-resident Indians over other domestic deposits and has guaranteed their convertibility without exchange risk. Thus a non-resident Indian can earn 13% annually on a 5 year certificate of deposit. While this rate of interest is higher than that India pays to the commercial banks, some observers believe the advantage of the non-resident deposits is that there is a strong possibility that they may not be repatriated for many years. Nevertheless it must also be recognized that these flows are sensitive to the level of interest rates elsewhere, principally in Europe and the U.S. If interest rates abroad were to go up, the GOI would have to match the increases or risk having the flow of non-resident deposit dry up or perhaps even turn negative. These deposits were only about $36 million in 1981-82 went up to $466 million in 1982-83 and $930 million in 1983-84, and thus contributed significantly to improve the capital account. However, in view of the uncertain conditions in Gulf Countries, these deposits have now declined to estimated $600 million 1984-85 and may decline further.

An increasingly important source of external funds is commercial borrowings and supplier credits. Though these are for shorter terms and considerably costlier than normal sources, the drying up of concessional aid makes some additional recourse to commercial borrowings inevitable. Total commitments of commercial loans including supplier credits increased from $1,102 million in 1980-81 to $2,104 million in 1982-83. Commitments are expected to amount to about $1,052 million in 1983-84. The bulge in commitments during 1982-83 occurred because of large borrowings to finance capital equipment for the Oil and Natural Gas Commission, the Rihand Thermal Power Project, and Air India. Disbursements of commercial loans were substantially less than commitments: they amounted to about $285 million in 1980-81, $585 million in 1982-83, and $789 million in 1983-84. In view of the resource constraints and the requirement of the private sector, the commitments are estimated to increase to Dols. 1.7 billion in 1984-85 and somewhat higher in 1985-86. Major Indian companies likely to seek such borrowings include: Reliance Textile Industry (Dols. 202 million); Lohia Machines Ltd. (Dols. 30 million); Zari Agro (Dols. 136 million); and Standard Motors (Dols. 10 million). In addition, public sector Air India and Oil and Natural Gas Commission are expected to borrow a sizeable amount. However, the GOI approach in this regard will be cautious because of the GOI policy to keep the debt service ratio within manageable limits.

As a result of increased pressures on the balance of payments because of the 1979 oil price increase, India obtained a 3-year SDR 5 billion loan from IMF in November 1981. Of this amount, India drew SDR 600 million in 1981-82, SDR 1,800 million in 1982-83, and SDR 1,500 million in 1983-84, for a total of SDR 3,900 million. Prompted by the decline in India's trade deficit over the past several years, India did not borrow the balance of SDR 1.1 billion and terminated the agreement in May 1984. There were good policy reasons for adopting this course. Chief among them was the fact that given the improvement in the current account, the final SDR 1.1 billion tranche of the IMF would buy little, if any, additional policy latitude for the GOI over the next year or two, but would increase the debt service burden in the late 1980's.

Gross foreign exchange reserves, excluding gold holdings, are expected to increase from $4,965 million in 1982-83 to $5,847 million in 1983-84 and $6,200 million in 1984-85, sufficient to cover about 5 months of imports. However, India officially values its gold holdings at only SDR 35,000 per ounce. If this were increased to the current market price, total reserves would covaer 8 months of imports.

In sum, the preceeding analysis shows that the second phase of the Housing Guaranty loan would be advantageous to India's debt service situation. The interest charge will be less than for funds it would otherwise borrow from commercial sources in the coming year. The underlying premise in making such a guarantee is that India will continue to show discipline in borrowing from international capital markets and coincidentally continue to maintain its excellent credit rating. Insofar as the past is an indicator of future performance, there is no evidence to indicate India will behave differently.

ANNEX 1

(E6) ACTION AID4 INFO AMB DCM2 ECON CHRON SOC 4

LOC: 33 859
22 JUN 84 1916
CN: 04270
CHRG: AID
DIST: AID

VZCZCBSA612FSC166
PP RUFTBK
DE RUEHC #4345/01 1741912
ZNR UUUUU ZZH
P 221643Z JUN 84
FM SECSTATE WASHDC
TO RUEHNE/AMEMBASSY NEW DELHI PRIORITY 0571
INFO RUMTBK/AMEMBASSY BANGKOK PRIORITY 0412
BT
UNCLAS STATE 184345

AIDAC

E.O. 12356: N/A
TAGS:
SUBJECT: APAC DECISIONS: PRIVATE HOUSING FINANCE OF LOW INCOME FAMILIES (386-HG-002)

BANGKOK FOR RHUDO

1. APAC MET ON MAY 24, 1984 AND APPROVED PROJECT PAPER WITH LOP FUNDING OF $60 MILLION OVER 5 YEARS AND AN AUTHORIZATION OF $20 MILLION IN FY 84. IT IS UNDERSTOOD THAT SUBSEQUENT AUTHORIZATIONS OF $20 MILLION IN FY 86 AND FY 88 WILL BE BASED ON PROJECT EVALUATIONS TO BE CONDUCTED IN FY 85 AND FY 87. THE APAC MADE THE FOLLOWING DECISIONS.

(A) CORPORATE HOUSING PROGRAM. THE APAC CONCLUDED THAT WHILE THE CORPORATE LOAN PROGRAM MAY HAVE BENEFICIAL EFFECTS, IT IS AN ELEMENT OF THE PROGRAM WHICH SHOULD BE REDUCED OR ELIMINATED OVER TIME FROM A.I.D. HG LOANS. THE APAC DECIDED THAT CORPORATE HOUSING NOT EXCEED 44 PERCENT OF THE FY 84 AUTHORIZATION. FOR SUBSEQUENT AUTHORIZATIONS, THIS PERCENTAGE WILL BE ELIMINATED ENTIRELY OR REDUCED ACCORDING TO A FORMULA TO BE WORKED OUT AFTER A 1985 EVALUATION OF THE FIRST HG PROJECT.

(B) INCREASED LOCAL SAVINGS MOBILIZATION. THE APAC NOTED THE RECENT ACCOMPLISHMENTS TO INCREASE LOCAL FUNDING OF HDFC TO INCREASE LOCAL FUNDING AS DESCRIBED IN THE PP. IT WAS SUGGESTED THAT INCREASED HG FUNDING LEVELS IN THE FUTURE MIGHT BE USED AS A LEVER TO FURTHER STIMULATE INCREASED LOCAL PRIVATE FUNDING FOR HOUSING. THE APAC RECOMMENDS THAT IF A.I.D. SEEKS HIGHER PROGRAM LEVELS FOR HG IN INDIA THAT THESE HIGHER LEVELS BE PROVIDED ON A PROPORTIONATE BASIS WITH LOCALLY GENERATED FUNDS. THE AMOUNT OF A.I.D.'S PARTICIPATION WOULD BE BASED UPON THE PERFORMANCE OF THE HDFC OR OTHER LOCAL INSTITUTION TO GENERATE LOCAL CURRENCY AND WILL BE WORKED OUT AFTER THE PROGRAM EVALUATION TO BE CONDUCTED IN JANUARY 1985.

(C) RESIDENT ADVISOR. THE APAC DISCUSSED VARIOUS QUESTIONS. FOR EXAMPLE, SHOULD THE ADVISOR BE AN

1/29.

EXPATRIATE OR A LOCAL NATIONAL? SHOULD SHE OR HE ATTEMPT TO CONDUCT THE STUDIES OR TO CONTRACT THEM OUT TO A LOCAL FIRM? SHOULD ADDITIONAL FUNDS BE SET ASIDE FOR THIS? SHOULD THE ADVISOR BE ASSIGNED TO WORK WITH A GOI AGENCY? WILL HE/SHE HAVE A ROLE IN ANY POLICY DIALOGUE WITH THE GOI OR THE HDFC? SHOULD HE OR SHE CONDUCT SITE VISITS TO INSPECT HOUSING PROJECTS OR ENGAGE A LOCAL ENGINEER TO DO SO? HOW WILL THE STUDIES BE ACCEPTED BY THE GOI OR HDFC? WHAT IS THE BEST METHOD TO INSTITUTIONALIZE THESE STUDIES?

THE APAC DECIDED TO BRING THESE QUESTIONS TO THE ATTENTION OF RHUDO AND THE MISSION. BUT IN KEEPING WITH THE ASIA BUREAU EXPERIMENT, THE RESOLUTION OF THESE ISSUES SHOULD BE DELEGATED TO THE MISSION TO DECIDE IN THE PROCESS OF PROJECT IMPLEMENTATION.

(D) TECHNICAL REVIEW/ON SITE INSPECTIONS. THE APAC DECIDED THAT THE FY 85 EVALUATION OF HG-001 SHOULD INCLUDE A ON-SITE INSPECTION/TECHNICAL REVIEW OF RANDOMLY SELECTED UNITS TO VERIFY REASONABLE COMPLIANCE WITH BASIC ENGINEERING CONCEPTS IN THE CONSTRUCTION OF THE UNITS FINANCED UNDER THE HG PROGRAM.

(E) EVALUATION. AS THE HG LOAN PROGRAM INITIATED THREE YEARS AGO WAS INTENDED AS AN EXPERIMENTAL OR PILOT PROGRAM, THE APAC DECIDED THAT A FULL SCALE PROJECT EVALUATION OF THE HG-001 PROJECT SHOULD BE HELD IN JANUARY OF 1985. AID/W WOULD ALSO LIKE TO PROVIDE INPUT AND CLEAR THE SCOPE OF WORK FOR THIS EVALUATION.

THEREFORE, RHUDO AND THE MISSION SHOULD DEVELOP A SCOPE OF WORK ASAP. THIS EVALUATION WILL CONTRIBUTE TO A DETERMINATION OF: 1) FUTURE YEARS PROGRAM LEVELS 2) THE PERCENTAGE OF HG FUNDS, IF ANY, TO BE DEVOTED TO HDFCS CORPORATE LOAN PROGRAM, 3) THE PERCENTAGE OF LOCALLY GENERATED FUNDS REQUIRED TO BE COMBINED WITH THE HG DOLLAR GENERATED FUNDS AND (4) WHETHER IT IS SUFFICIENT TO CONTINUE TO MONITOR HDFC'S TECHNICAL INSPECTION PROGRAM OR SHOULD A.I.D. THROUGH LOCAL ENGINEERS PERFORM TECHNICAL ON-SITE INSPECTION OF RANDOMLY SELECTED UNITS TO ENSURE REASONABLE COMPLIANCE WITH BASIC ENGINEERING STANDARDS IN THE CONSTRUCTION OF UNITS FINANCED UNDER THE HG PROGRAM.

F. PARTICIPATION BY WOMEN. THE APAC DECIDED THAT A COVENANT SHOULD BE INSERTED IN THE PROJECT AGREEMENT THAT THE BORROWER (THE HDFC) WILL STUDY IT'S INTERNAL PRACTICES AND POLICIES AND EXPLORE WAYS TO PROVIDE INCREASED HOME OWNERSHIP BY WOMEN.

G. POLICY DIALOGUE. THE APAC DECIDED THAT THE JANUARY

1988 EVALUATION SHOULD INVESTIGATE PAST IMPACT OF THE HG PROGRAM ON ACHIEVING POLICY CHANGES AS WELL AS THE FUTURE OPPORTUNITIES FOR POLICY CHANGES THROUGH NEW HG LOANS.

H. INCREASED FUNDING LEVELS. THE PROJECT COMMITTEE RECOMMENDED EXAMINATION OF THE NEED FOR INCREASED HG FUNDING LEVELS FOR INDIA BECAUSE OF THE SIZE AND SCOPE OF THE SHELTER PROBLEM. THE APAC REVIEWED THIS CONCERN AND DECIDED THAT THE ISSUE MIGHT MORE THOROUGHLY BE DISCUSSED IN A PROGRAM REVIEW RATHER THAN THE APAC MEETING.

2. AA/ASIA SIGNED GUARANTY AUTHORIZATION THIS DATE. TEXT OF AUTHORIZATION IS AS FOLLOWS:

PURSUANT TO THE AUTHORITY VESTED IN THE ASSISTANT ADMINISTRATOR, BUREAU FOR ASIA, BY THE FOREIGN ASSISTANCE ACT OF 1961, AS AMENDED (FAA), AND THE DELEGATIONS OF AUTHORITY ISSUED THEREUNDER, I HEREBY AUTHORIZE THE ISSUANCE TO ELIGIBLE U.S. INVESTORS (INVESTORS) ACCEPTABLE TO A.I.D. OF GUARANTIES PURSUANT TO SECTION 222 OF THE FAA OF NOT TO EXCEED TWENTY MILLION UNITED STATES DOLLARS IN FACE AMOUNT. THE GUARANTIES SHALL ASSURE AGAINST LOSSES (OF NOT TO EXCEED ONE HUNDRED PERCENT OF LOAN INVESTMENT AND INTEREST) WITH RESPECT TO LOANS, INCLUDING ANY REFINANCING THEREOF, MADE TO FINANCE HOUSING PROJECTS IN INDIA.

THESE GUARANTEED LOANS SHALL BE MADE TO THE HOUSING DEVELOPMENT FINANCE CORPORATION LIMITED (BORROWER) TO PROVIDE LONG-TERM FINANCING FOR LOW INCOME HOUSING.

THESE GUARANTIES SHALL BE SUBJECT TO THE FOLLOWING TERMS AND CONDITIONS:

1. TERM OF GUARANTY: THE LOANS AND ANY REFINANCING THEREOF SHALL EXTEND FOR A PERIOD OF UP TO THIRTY YEARS FROM THE DATE OF DISBURSEMENT AND MAY INCLUDE A GRACE PERIOD OF UP TO TEN YEARS ON REPAYMENT OF PRINCIPAL. THE GUARANTIES OF THE LOANS SHALL EXTEND FOR A PERIOD BEGINNING WITH THE FIRST DISBURSEMENTS OF THE LOANS AND SHALL CONTINUE UNTIL SUCH TIME AS THE INVESTOR HAS BEEN PAID IN FULL PURSUANT TO THE TERMS OF THE LOANS.

2. INTEREST RATE: THE RATE OR RATES OF INTEREST PAYABLE TO THE INVESTOR PURSUANT TO THE LOANS SHALL NOT EXCEED THE ALLOWABLE RATE OF INTEREST PRESCRIBED PURSUANT TO SECTION 223(F) OF THE FAA AND SHALL BE CONSISTENT WITH RATES OF INTEREST GENERALLY AVAILABLE FOR SIMILAR TYPES OF LOANS MADE IN THE LONG TERM U.S. CAPITAL MARKETS.

3. INDIA GUARANTY: PRIOR TO DISBURSEMENT OF ANY LOAN AMOUNTS PURSUANT TO THIS GUARANTY AUTHORIZATION, A WRITTEN GUARANTY TO INDEMNIFY A.I.D. AGAINST ALL LOSSES ARISING BY VIRTUE OF A.I.D.'S GUARANTIES TO THE INVESTOR

OR FROM NON-PAYMENT OF THE GUARANTY FEE SHALL BE PROVIDED IN A FORM SATISFACTORY TO A.I.D. BY A PUBLICLY-OWNED BANK IN INDIA AUTHORIZED BY THE GOVERNMENT OF INDIA TO PROVIDE SUCH A GUARANTY AND APPROVED BY A.I.D.

4. FEE: THE FEE OF THE UNITED STATES SHALL BE PAYABLE IN DOLLARS AND SHALL BE ONE-HALF PERCENT PER ANNUM OF THE OUTSTANDING GUARANTEED AMOUNT OF THE LOANS PLUS A FIXED AMOUNT EQUAL TO ONE PERCENT OF THE AMOUNT OF THE LOANS AUTHORIZED OR ANY PART THEREOF, TO BE PAID AS A.I.D. MAY DETERMINE UPON DISBURSEMENT OF THE LOANS.

5. OTHER TERMS AND CONDITIONS: THE GUARANTIES SHALL BE SUBJECT TO SUCH OTHER TERMS AND CONDITIONS AS A.I.D. MAY DEEM NECESSARY.

6. THE APAC COMMENDS RHUDO AND THE MISSION ON THE PREPARATION OF AN EXCELLENT PP. SHULTZ
BT
#4345

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ANNEX 2

THE HOUSING GUARANTY PROGRAM

STATUTORY CHECKLIST

INDIA

386-HG-002

ANSWER YES OR NO PUT PP PAGE REFERENCES AND/OR EXPLANATIONS WHERE APPROPRIATE

A. General Criteria Under HG Statutory Authority.

Section 221(a)
Will the proposed project further one or more ofthe following policy goals?

(1) is intended to increase the availability of domestic financing by demonstrating to local entrepreneurs and institutions that providing low-cost housing is financially viable;	Yes
(2) is intended to assist in marshalling resources for low-cost housing;	Yes
(3) supports a pilot project for low-cost shelter, or is intended to have a maximum demonstration impact on local institutions and national; and/or;	Yes
(4) is intended to have a long run goal to develop domestic construction capabilities and stimulate local credit institutions to make available domestic capital and other management and technological resources required for low-cost shelter programs and policies?	Yes

Section 222(a)
Will the issuance of this guaranty cause the total face amount of guaranties issued and outstanding at this time to be in excess of $1,958,000 | No |

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	ANSWER YES OR NO PUT PP PAGE REFERENCES AND/OR EXPLANATIONS WHERE APPROPRIATE
Will the guaranty be issued prior to September 30, 198~~7~~6?	YES
<u>Section 222(b)</u> Will the proposed guaranty result in activities which emphasize:	No
(1) projects providing improved home sites to poor families on which to build shelter and related services; or	No
(2) projects comprised of expandable core shelter units on serviced sites; or	
(3) slum upgrading projects designed to conserve and improve existing shelter; or	Yes
(4) shelter projects for low-income people designed for demonstration or institution building; or	Yes
(5) community facilities and services in support of projects authorized under this section to improve the shelter occupied by the poor?	Yes
<u>Section 222(c)</u> If the project requires the use or conservation of energy, was consideration given to the use of solar energy technologies, where economically or technically feasible?	N/A
<u>Section 223(a)</u> Will the A.I.D. guaranty fee be in an amount authorized by A.I.D. in accordance with its delegated powers?	Yes
<u>Section 223(f)</u> Is the maximum rate of interest allowable to the eligible U.S. Investor as prescribed by the Administrator not more than one percent (1%) above the current rate of interest applicable to housing mortgages insured by the Department of Housing and Urban Development?	N/A

ANSWER YES OR NO PUT PP PAGE REFERENCES AND/OR EXPLANATIONS WHERE APPROPRIATE

Section 223(h)

Will the Guaranty Agreement provide that no payment may be made under any guaranty issued for any loss arising out of fraud or misrepresentation for which the party seeking payment is responsible? — Yes

Section 223(j)

(1) Will the proposed Housing Guaranty be coordinated with and complementary to other development assistance in the host country? — Yes

(2) Will the proposed Housing Guaranty demonstrate the feasibility of particular kinds of housing and other institutional arrangements? — Yes

(3) Is the project designed and planned by A.I.D. so that at least 90 percent of the face value of the proposed guaranty will be for housing suitable for families below the median income or below the median urban income for housing in urban areas, in the host country? — Yes

(4) Will the issuance of this guaranty cause the face value of guaranties issued with respect to the host country to exceed $25 million in any fiscal year? — No

(5) Will the issuance of this guaranty cause the average face value of all housing guaranties issued in this fiscal year to exceed $15 million? — No

Section 238(c)

Will the guaranty agreement provide that it will cover only lenders who are "eligible investors" within the meaning of this section of the statute at the time the guaranty is issued? — Yes

ANSWER YES OR NO PUT PP PAGE REFERENCES AND/OR EXPLANATIONS WHERE APPROPRIATE

B. Criteria Under General Foreign Assistance Act Authority.

Section 620/620A

1. Does the host country meet the general criteria for country eligibility under the Foreign Assistance Act as set forth in the country elibility checklist prepared at the beginning of each year?	Yes
2. Is there any reason to believe that circumstances have changed in the host country so that it would now be ineligible under the country statutory checklist?	No

ANNEX 3

HOUSING DEVELOPMENT FINANCIAL CORPORATION LTD.

1. Income Statements and Selected Ratios

Year Ended June 30

	1979-80	1980-81	1981-82	1982-83	1983-84	6 Months 1984-85
	----------------	----------------	----------------	(Audited)	----------------	----------------
Income Statements (Rs millions)						
Interest on Housing Loans	5.7	21.5	53.6	104.2	176.2	122.2
Fees and Other Charges	4.2	7.2	9.5	15.6	20.4	12.5
Income from Investments	5.2	6.1	21.4	24.8	58.1	34.9
Total Income	15.1	34.8	84.5	144.6	254.7	169.6
Interest Expense and Other Charges	1.8	11.2	47.9	87.1	174.4	119.2
Operating Income	13.3	23.6	36.6	57.5	80.3	50.4
Operating Expenses	4.0	6.7	9.5	14.2	21.1	14.4
Profit before Tax	9.3	16.9	27.1	43.3	59.2	36.0
Tax Provision	3.1	5.4	8.9	14.4	20.5	10.5
Profit after Tax	6.2	11.5	18.2	28.9	38.7	25.5
Legal Reserve	3.7	6.7	10.8	17.8	24.6	15.1
Dividend	-	5.0	7.5	10.0	12.0	-
Previous Year's Profit (Loss) B/F	(0.1)	2.4	2.2	2.0	2.1	-
C/F to Balance Sheet	2.4	2.2	2.1	2.1	-	10.4
Ratios (% p.a)						
Profit after Tax/Average Net Worth	6.1	10.5	15.4	21.7	24.9	
Interest and Fees Earned/ Average Housing Loans	17.4	14.4	14.6	15.5	15.2	
Interest Expense and Other Charges/Average Total Debt	6.8	6.2	10.9	10.6	11.4	
Operating Income/Average Total Assets	10.3	8.1	6.6	6.0	4.8	
Interest Coverage Ratio	6.2	2.5	1.6	1.5	1.3	

INDIA

HOUSING DEVELOPMENT FINANCE CORPORATION LTD.

2. Projected Income Statements
(Rupees Millions)

	1984-85	1985-86	1986-87
Gross Income			
Interest on Housing Loans	305.7	460.5	658.7
Fees/Other Charges	33.5	45.2	58.4
Income from Investments	54.1	61.5	69.5
Other	-	-	0.7
Total Income	393.3	567.2	787.3
Financial Expense			
Interest on Deposits	153.8	208.8	285.8
Interest on Term Loans	138.7	219.1	310.4
Total Financial Expense	292.5	427.9	596.2
Operating Income	100.8	139.3	191.1
Operating Expenses	29.3	44.9	58.3
Profit Before Tax	71.5	94.4	132.8
Tax Provision	25.0	33.0	46.5
Profit After Tax	46.5	61.4	86.3

ANNEX 3-3

INDIA

HOUSING DEVELOPMENT FINANCIAL CORPORATION LTD.

3. Balance Sheets
(as of June 30)

	1979-80	1980-81	1981-82	1982-83	1983-84	6 Months 1984-85
	(Rupees millions)					
	(Audited)					
ASSETS						
Net Current Assets	28	104	85	183	410	286
Investments	19	13	29	31	122	95
Housing Loans	101	298	594	985	1,611	1,944
Fixed and Other Assets	8	9	13	14	20	27
Total Assets	156	424	691	1,213	2,163	2,352
LIABILITIES						
Deposits	39	178	399	671	1,198	1,249
Borrowings	11	133	168	400	796	908
Total Debt	50	311	567	1,071	1,994	2,157
Paid-in Capital	100	100	100	100	100	100
Reserves and Surplus	6	13	24	42	69	95
Net Worth	106	113	124	142	169	195
Total Liabilities and Net Worth	156	424	691	1,213	2,163	2,352
Debt/Equity Ratio	0.5	2.8	4.6	7.5	11.8	11.1

ANNEX 4

EXECUTIVE SUMMARY AND CONCLUSIONS:

from the

"Working Paper: The Housing Development Finance Corporation of India: Evaluation of the Housing Guaranty Loan."

1. EXECUTIVE SUMMARY AND CONCLUSION

Background

This section provides a broad overview of the Housing Development Finance Corporation (HDFC), its operations, and the approach of the evaluation team; as such it establishes a framework for the evaluation findings presented in the balance of this summary. Following a brief sketch of the origins and objectives of HFDC, we look at the types of loans it makes and its sources of funds to date. A final brief note describes the approach followed by the team.

The Housing Development Finance Corporation. HDFC began operations in May 1978, with the principal equity contributors being the Industrial Credit and Investment Corporation of India, the International Finance Corporation, and the Aga Khan Group. Initial paid up capital was $10 million. The founding of HDFC was significant in that it is the first private finance development institution dedicated to housing.

The primary objective of the Corporation is to provide long term finance to middle and lower income households, associations of individuals, and corporate bodies for the construction, purchase, and ownership of residential units. HDFC's purpose is to increase the housing stock in the country generally. Another HDFC objective is to mobilize long-term resources in the form of deposits and term debt and to transform short-term resources into long-term housing investment. A longer-term objective is to lead and support the development of a national housing finance system, and relatedly to foster the growth of the capital market in general.

In June 1984 (the end of the HG001 disbursement period) HDFC had nine branches scattered around the country in addition to its headquarters in Bombay. However, loans have been concentrated in the West and South regions of the country; and funds mobilization has been concentrated at corporate headquarters.

Types of Loans. HDFC engages in four types of mortgage lending. These include loans to individuals for acquiring a home, loans to corporations for workers' housing or for on-lending to workers for home acquisition (called the line of credit program), and loans to groups of homeowners who have formed an association for acquiring an apartment building.

An idea of the relative importance of these different types of loans is available from the following tabulation, which shows loans made in HDFC's fiscal year 1984 (the final year of HG001 disbursements) and cumulative totals.

Percentage Distribution of Loans by Type[a]

	Loans Made in FY 1984		Cumulative Loans Made	
Loan Type	Units	Amount Lent	Units	Amount Lent
Individual	72	82	69	78
Group	—	—	2	2
Line of Credit	3	4	4	4
Corporate	25	14	25	16
Total (percent)	100	100	100	100
Total Units/$	26,407	$100 mill.	79,760	$285 mill.

a. Excludes a small number of development period loans.

Sources of Funds. In addition to its initial equity, HDFC has generated funds to support its lending operations from deposits and borrowings — including term loans, the Housing Guaranty 001 loan, and most recently, selling its own bonds. The following tabulation shows the pattern of funds mobilized in the fiscal years ending in 1981 and 1984. These are flow figures; i.e., they show the sources of new funds raised.

Changes in HDFC's Sources of Funds

Over the Previous Fiscal Year

(percentage distribution)

Type	1984	1981
Deposits	57	86
Borrowings	43	14
bonds	(11)	—
term loans	(11)	(14)
HG loan	(22)	—
Total	100	100
Total (millions)	$ 93	$ 26
Increase year-to-year (percent)	86	82

The $20 million of the Housing Guaranty 001 Loan disbursed in 1984 constituted almost a quarter of the total funds mobilized in that year. A comparison of the two years shows HDFC's substantial diversification of sources over the period.

The Housing Guaranty Loan. The broad objective of the HG001 loan was to contribute to a fully functioning and viable housing finance system in India. In essence, the project purposes were to improve

HDFC's ability to raise additional domestic capital, accelerate the institution's development on a broad geographic basis, and to encourage HDFC to make more long-term loans which would directly benefit lower income households. An additional purpose, associated with the corporate lending, was to support GOI policy for decentralization of industry away from the largest cities. One of the goals established was that approximately one-third of the loan beneficiaries be households with incomes below the median income figure.[1]

The rationale and approach underlying the loan are well expressed in the Strategy Statement of the Project Paper:

> AID's strategy is to assist the HDFC, as a private sector institution, to expand its operations at a more rapid rate so that it can make a significant beginning in the provision of long-term housing finance to all income levels. By helping to expand HFDC's operations, the HG will not only contribute to increased earnings of the HFDC but should have a catalytic effect on HDFC's ability to attract additional investors, lenders and depositors because of the expanded operations. (pp. 11-12)

The $30 million HG001 loan was released in two tranches of $20 million and $10 million, respectively, in 1983 and 1984.[2] Although HDFC did not utilize the HG authority to borrow the guarantied funds until January 1983, the Loan Agreement permitted HDFC to apply the funds obtained to loans disbursed after July 1, 1981. The final liquidation of HG001 funds was in June 1984; hence, the time period over which the

1. For more on the project objectives, see Annex A.

2. Because of the time lag in transforming the guarantied loan as borrowed in New York into rupees supplied to HDFC by the borrowing Indian bank, $10 million appears in the HDFC financial report for FY 1982-1983 and the balance in 1983-1984. More information on key dates is provided in Annex B.

HG001 funds were used by HDFC to finance loans corresponds almost exactly to the three HDFC fiscal years 1981/1982 to 1983/1984.

A final aspect of the loan which is important to note at the outset is the evolution of the focus on lower income households over the period of the loan and particularly between the two loan tranches. The general target remained the same, in the sense that about one-third of HDFC's beneficiaries were to be lower income households. The change came in the mechanism for reaching them. In the original Project Paper it was envisioned that the primary, even sole, vehicle for assisting lower income households would be the corporate program for workers. Here the beneficiaries would be lower income households, even if they could not themselves afford the units they were occupying. As events developed, HDFC found that a considerable percentage (about 17 percent) of the households who were receiving loans in the individual loan program were also lower income households, as defined by the median income definition in the Project Paper. Thus, there was an increase in the number of vehicles used to serve the poor.

As part of the conditions for the second tranche of the HG001 loan, AID required HFDC to develop an explicit statement on serving lower income households and an action plan to begin executing it. This requirement should be thought of realistically as positive pressure on HDFC to go beyond what it had been able to achieve with less effort in this direction.

Lastly, note that in addition to the funds provided under the Housing Guaranty loan, AID also provided a $100,000 grant for technical assistance during the same period.

Evaluation Team Approach. The team, composed of two consultants and one person detailed from the U.S. Department of Housing and Urban Development, spent approximately six days in Washington and Bangkok (RHUDO/Asia) reviewing documents, discussing the HG001 project with AID staff and consultants previously directly involved with it, and discussing Indian housing finance and capital markets with World Bank staff. The team then spent two weeks visiting HFDC offices in India, both the headquarters in Bombay and three of nine (as of June 1984) branch offices — Pune, Madras, and Bangalore. The team was assisted while in India by an AID engineer who carried out a series of inspections of the quality of dwellings financed by HFDC.

The balance of this summary addresses the series of issues outlined in the terms of reference and concludes with an overall assessment of the success of the Housing Guaranty Program with HFDC over the 1981-1984 period and an outline of the balance of the report.

Resource Mobilization

HDFC has clearly accomplished the goals set for it with respect to mobilizing resources, minimizing the problems associated with the development of a viable financial institution, and affecting public policy to encourage the development of a cost-effective housing finance system.

As for its quantitative accomplishments, at the end of FY 1984, HDFC was more than 150 percent larger than had been projected by the initial IFC Proposed Investment Paper. It was 6 percent larger than the forecast made in the initial Housing Guaranty Project Paper; it had increased its reliance on financing through term borrowings to 40 percent of total borrowings, whereas the initial Project Paper forecast that term borrowings would increase from 34 to 45 percent. (By the end of calendar year 1984 the share of term borrowings had risen to 42 percent.) In the three year period taken to disburse the HG001 loan, it had raised 25 percent more resources in local markets than had been targetted as a desirable achievement level in two years by the initial Project Design Logical Framework.

On the other hand, it does not seem likely that the firm will achieve the longer term goal of directly raising $400 million of domestic resources within five years of the HG loan disbursement. For example, the most recent (December 1984) IFC balance sheet projections suggest that HDFC will fall approximately 15 percent short of the five year target. One must question, however, whether this goal, which implies an annual growth rate of 40 percent per year for an extended time period, is in the best interests of the firm. While it is clear that the firm can and has grown very rapidly, it is also clear that growth spurts in domestic resource mobilization, such as the 94 percent realized between FY 1983 and FY 1984, should be followed by periods in which such gains are consolidated. This consolidation of gains seems particularly important because of the sources and the context within which HDFC can raise as well as leverage other domestic resources.

There are three basic types of resources directly available to HDFC: (1) deposits, made by corporations and individuals; (2) term borrowings, made exclusively by large financial intermediaries, such as commercial banks and insurance companies; and (3) bond issuances that permit HDFC to tap the capital markets directly. In addition, perhaps equally important as its direct mobilization, HDFC can mobilize domestic resources indirectly in two other ways: first, by taking an equity position along with providing technical advice in other financial institutions that provide housing finance services to low income households; and, second, by helping to implement public policy changes that make the regulatory environment more conducive to the development of HDFC imitators. This section concentrates on the "traditional" sources, while the next two explore these other avenues.

Deposits. At the end of the 1984 calendar year, 58 percent of the firm's total debt derived from deposit schemes. The overwhelming share (about 85 percent) of these deposits come from corporations, of whom about 20 percent (mostly government owned corporations) make the deposits as part of a broader financial package in which HDFC then agrees to make individual housing loans available to the corporation's employees. Depending upon the overall composition of the financial arrangement, i.e. depending on the maturity and size of the deposit, HDFC has varied the ratio of housing loans to corporate deposits between three and two to one.

HDFC follows a similar "broader financial package" approach in its efforts to mobilize household deposits. A mortgage loan linked savings scheme has been tried and a plan based upon the German Bausparkassen program is in the planning stages. Both schemes, as well as the firm's outreach efforts to non-urban areas, are based on the notion that the advantages to depositors of placing their funds in HDFC are not strictly limited to the return on the deposits. Access to credit for households,[1] and the maturity structure of the deposit schemes and relative safety of return for corporations, are important considerations in the portfolio decisions that govern the growth of HDFC deposits.

In the context of the Indian financial system, which relies heavily upon centrally-imposed interest rate ceilings, such non-price competition is not surprising. HDFC attempts to find "niches" in the market in which the whole array of services it provides, not just the explicit return on the deposit, offers the depositor the highest overall implicit return. Thus, the growth of HDFC's deposits relies heavily upon an aggressive outreach program in which the non-price aspects of HDFC savings are explained to potential customers.

The growth of deposits is essential to the firm so that fund sources will be highly diversified. And credibility, market presence, and stability of the institution are the major ingredients in determining the demand for HDFC deposits. Because of the intangibility of these factors and their self-fulfilling nature, it is difficult to forecast deposit growth. Nevertheless, it is possible to argue that HDFC's record has been impressive in establishing itself and explaining the value of its services. Some evidence of this is provided by the IFC projection of a 150 percent increase in the firm's deposit base over the next three years.

Term Borrowings. HDFC's domestic term borrowings come from: (1) the Reserve Bank of India which provides an allocation level for funds from commercial banks; (2) three different insurance companies; and (3) a loan from the Industrial Credit and Investment Corporation of India.

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1. HDFC does not make previous deposits a condition for granting loans, but depositors doubtless feel more secure about their future loan possibilities.

Its international borrowings have been the HG loan and an IFC line of credit. Over the time period of disbursement of the HG001 loan, domestic borrowings increased by $27.4 million. In addition, in the past year the commercial banks have allocated up to $20 million of such loans for HDFC, the Army Group Insurance Company has loaned HDFC $15 million, and other armed services insurance funds have made smaller allocations.

The relatively long maturity of these loans and the lower level of staff effort needed to generate them makes them attractive to HDFC. Perhaps the central operational implication for HDFC of their use is their "lumpiness". For example, in FY 1984 the Reserve Bank of India, because of concerns about commercial bank profitability, allocated no commercial bank funds to housing after having allocated $10 million in each of the two previous years. If the funds were a significant share of HDFC's liabilities, such variability in funds could create obvious problems for a firm with a financial structure like HFDC's. On the other hand, as noted above, there have been encouraging developments towards greater diversification of funding sources.

Bond Issues. In the last fiscal year HFDC successfully issued its maiden public bond offering of $10 million. The success of the issuance has potentially important implications for the firm's growth and profitability; and it seems very likely that HG001 contributed significantly to this successful venture. In an interest rate ceiling-constrained financial system, timing is a very important factor in the success of a public debt offering. If market conditions are stringent, it is more difficult to get a full subscription, because the effective implicit market interest rate is much higher than the nominal bond rate. However, if less than full subscription for a maiden offering is obtained, it might well suggest that the market lacks confidence in the offering institution. Having the capacity to wait for a propitious moment for debt issuance may well have long-term consequences for corporate growth. It appears that the HG loan provided such capacity. HDFC received permission from the Ministry of Finance for a bond issuance without government guarantees in 1982, but waited until 1984 to make the offering. In the event, it was oversubscribed.

In the past year HDFC has issued $4.5 million in private placement bonds and has done some of the analytical groundwork necessary to determine whether bearer bonds might be an effective instrument to tap capital markets. If GOI were to approve the use of such an instrument it might be used to channel some of the alleged large amounts of black money into the formal financial sector. Such channeling, if it occurs on any significant scale, should also help resource allocation generally.

Other Forms of Local Resource Mobilization. HDFC is in the design stages of two particularly innovative ways to mobilize local resources. They are brought up at this point simply to indicate that the long term direct mobilization goal of $400 million over five years stated in the HG001 Project Paper may have been too narrowly construed.

Simply put, both proposals involve HDFC along with others taking a small equity position in housing finance institutions in locations currently under-served, i.e., rural Gujarat and the eastern area of the country. There is almost no question that equity participation by international agencies in these projects — which is in firm prospect — would not have been forthcoming without HDFC's participation and promise of technical assistance to these firms.

Cumulatively, the team views HDFC's local resource mobilization efforts as enormously successful. The firm has diversified the number and type of investors and depositors, and it has continually sought to exploit "niches" in the market that are often created or associated with an interest rate ceiling system. The firm seems particularly well placed to develop the deposit market by reliance on brokers for individual deposits and the new technologies that are emerging in the gathering of deposits.

Financial Management

The chief types of problems confronting a firm like HDFC are developing market acceptance and avoiding unnecessary risk exposure. The record on funds mobilization has been reviewed. Here the focus is on the four types of risk to which HDFC is exposed: default risk by households, interest rate risk, corporate loan risk, and commitment or sanction delivery risk.

Default Risk. In the Indian legal system foreclosure laws are such that a technical default on mortgage payment may take years to resolve. As a consequence the expected costs of default are very large. HDFC has clearly avoided this problem. It has done so through: requiring large downpayments by households; requiring guarantees from other individuals on about 30 percent of the individual loans; providing technical advice to borrowers on adjustments in construction and/or portfolio plans that will permit them to fulfill their aspirations more...

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efficiently; and by convincing state governments that HDFC loans should be eligible for payment through salary deductions.

The record speaks for itself. On over 76,000 loans they have had no individual loan defaults and their loans in arrears ratio is .3 percent, lower than those of building societies in the U.K. and considerably lower than U.S. rates. The record on preventing default is perhaps the chief reason why the IFC is willing to take an equity position in a rural housing finance scheme in Gujarat State.

Interest Rate Risk. The firm has carefully structured its assets and liabilities so that there is very little interest rate risk exposure. Not only is there very little imbalance between the maturities of its assets and liabilities, but loan terms also include a fall-back clause that permits HDFC to increase interest rates if it so chooses. This provision is tantamount to giving the firm a catastrophic insurance policy. A shift in the interest rate structure that had such onerous implications for the U.S. thrift institutions cannot impose similar costs on HDFC. While HDFC does perform some maturity intermediation and has made it clear that it will not raise rates unless it has to, it nevertheless has protection against large shifts in financial circumstances.

Corporate Risk Exposure. Because HDFC makes loans to corporations and to blocks of employees of particular corporations, the firm is exposed to the same type of risk as would be a commercial bank that lent to corporate borrowers. The team reviewed HDFC's decision-making process for such loans and found that each firm's balance sheet and prospects are closely reviewed as part of the loan decision. The team sees these practices as effective.

Sanction Risk Exposure. By agreeing to make credit available if a household can get the other necessary resources together, HDFC also affects the construction of housing of those who ultimately do not make use of the commitment. Because a household knows that a certain amount of funds will be available if it liquidates other assets, borrows from parents, buys land, etc., it may be willing to undertake these actions even if in the end it does not use HDFC funds. HDFC staff estimate that about 7 percent of their loan sanctions are not disbursed, and that about half of these cancelled sanctions occur because the household got money elsewhere.

HDFC has minimized its risk exposure in this area in three ways: (1) reducing the ratio of sanctions to disbursements from 2.56 to 1.29 over five years; (2) leaving its commitment open-ended as to the interest rate it will charge; and, (3) diversifying its depositors and investors so that rationing decisions by another financial institution or government regulator have less effect on its ability to deliver on its agreement.

In sum, HDFC has clearly moved aggressively into housing finance intermediation. Equally clear is the cautiousness of the institution. Under present operating practices it is subject to very little risk exposure. Furthermore, its debt to equity ratio is much lower than those thought prudent for U.S. financial institutions that have been much more risk exposed.

Policy Impacts

The realization of HDFC's financial record, as well as the development in India of a regulatory environment in which spontaneous development of a market-oriented housing finance system can occur, is in large part attributable to the firm's regulatory entrepreneurism. As the first institution of this sort in India, i.e., neither a bank nor a non-financial firm, HDFC has had to seek modifications to a number of regulations that constrained its operations. For example, initially HDFC could not advertise for deposits; its deposits had to be of at least six month maturity; the tax treatment of the deposits was more onerous than that on commercial bank deposits; trust funds could not make such deposits, and after they were permitted to do so their tax treatment was still onerous; provident fund savings could be used for housing payments but not HDFC mortgage payments; mortgage payments could not be deducted from the salaries of many workers by employers; and, the firm's eligibility to receive fund allocations from other large financial intermediaries, e.g., commercial banks, had yet to be determined.

A good deal of principal staff time (on the order of 15 percent) has gone into the development and marketing or proposals and recommendations for regulatory changes. All the above mentioned regulations have been changed or modified as a direct result of HDFC staff and Board efforts. Furthermore, while this kind of staff expenditure does not seem inordinate, it has been very effective. For example, in one of the Chairman's previous capacities he was aware of a modification made to the Indian Trust Act of 1882 that enabled the

Indian Unit Trust to avoid a bout of disintermediation. He used this experience to propose HDFC as the second private sector exception to this act, making it eligible for trustee status for charitable trusts. Achieving this stacus has not only permitted charitable trusts to invest in HDFC, it as well gives the firm the equivalent of a AAA credit rating.

HDFC's regulatory entrepreneurism also plays a large role in the firm's allocations of commercial bank funds. In 1978 a Reserve Bank of India commission (the Shah Commission) recommended that the commercial banking system could play an important role in the development of the housing finance system. As a result of this study the RBI agreed that commercial banks should allocate $100 million to housing finance. The following year RBI allocated another $150 million. Ultimately HDFC was able to obtain over $40 million of these funds through persistent lobbying.

In sum, the regulatory change and shift in financial allocational emphasis has helped to establish ground rules to enable the private sector to become increasingly interested in housing finance services. Two firms have recently been listed on the Bombay stock exchange to engage in such activities. One of these is a diversified financial services firm with over 150 branch offices. Thus, HFDC can expect increasing competition for the funds allocated by large financial intermediaries. In the future it will not just compete with public sector firms for housing credit allocations. However, given the GOI's recent pronouncements on the need to expand such allocations, it seems likely that the supply of funds should expand, at least in the immediate future, at least as rapidly as the increase in competing demands.

Low Income Targeting of HDFC Loans

The Housing Guaranty loan had the explicit objective of increasing HDFC's emphasis on loans that provide housing for lower income households. An objective set by AID at the outset of HG001 was that one-third of HDFC's beneficiaries should be lower income households. Before the second tranche of the loan guaranty could be used, AID required HDFC to develop a low income policy statement and an implementation plan enumerating specific measures the firm was taking or intended to take to reach more lower income people.

The Record. During the period that HG001 funds were being used, HDFC's fiscal years 1982-1984, approximately 30 percent of all the beneficiaries of HDFC loans were lower income households, following the definition agreed to by AID and HDFC of 1200 rupees per month (about $120). This income level was intended to reflect the income distribution of the urban portion of the Indian population. This 30 percent total is made up of both individual borrowers and beneficiaries of HDFC's Corporate Loan Program.

Among loans repayable by individual borrowers, including line of credit and group loans, HDFC data shows that 17 percent of borrowers had incomes below 1200 Rs./mo. at the time the loan was sanctioned. This is confirmed by a file search undertaken by AID which concluded that 18 percent of the loans sanctioned between December 1982 and December 1983 were to households below 1200 Rs./mo.

HDFC management reports estimate that 79 percent of the workers intended to occupy housing built with an HDFC loan repayable by the corporation had incomes below 1200 Rs./mo. The team's visits to seven corporate housing projects confirmed that the types of workers for whom the housing was planned are indeed living there.

The team's finding is that HDFC's record represents effective achievement of the goal that approximately one-third of households benefitting from HDFC loans have incomes below 1200 Rs./mo.

Low Income Policy and Plan. HDFC's approach to attempting to reach a broad range of income levels, including a substantial number of those below median income, has been to try through its loan processing practices to overcome barriers to qualifying lower income applicants for loans. This is done to the extent feasible within the standard structure and underwriting rules established for the individual loan program. Otherwise HDFC has moved slowly and cautiously in a number of areas where it was believed that innovations might reach additional lower income borrowers without compromising the firm's financial integrity. For example, HDFC has experimented with some variants on its standard loan terms, but has been reluctant to do this on a broad scale. There has been rather more emphasis placed on special projects of a highly individual nature.

Standard Practices. HDFC's standard loan terms include an indirect cross-subsidization of lower income borrowers through its schedule of interest rates for loans at different amounts. Borrowers of less than Rs. 20,000 usually have incomes below 1200 Rs./mo. and are charged 12.5 percent, slightly below HDFC's marginal borrowing rate of about 13.3

percent. HDFC outreach to potential borrowers includes considerable emphasis on groups likely to include lower income people -- factory workers, low paid public employees such as schoolteachers and postal workers, and residents of smaller towns within the region covered by each HDFC branch office. There has been a growing emphasis on customer relations in HDFC staff training, which may be particularly important for lower income people who have difficulty getting through the fairly complex and rigorous loan application process.

Finally, the underwriting of HDFC loans emphasizes working through the special problems of applicants who do not on first review appear to be able to afford the loan. HDFC technical staff advise applicants on reducing the size and design of the house. In many cases, after a review of the family's total financial situation and potential income growth, loans that require more than 25 percent of income for repayment (HDFC's standard rule) are permitted.

The team's conclusion is that HDFC views lower income borrowers as an important part of its market and that this is reflected in both the marketing and processing of its individual loan program.

On the corporate side, HDFC appears largely to process the loan as applied for, letting the corporation determine the income ranges of workers who will live in corporate housing. There have, however, been some cases in which HDFC has successfully suggested that the corporation reach additional people by building more units at lower cost per unit.

New Approaches. HDFC has made a very few loans with 20 year terms, making an exception to its standard maximum 15 year term in the individual loan program. The firm is reluctant to expand this practice, not only because of the risk of interest rate mismatch between long term assets and short term liabilities, but also because of a concern that some of its current sources of funds could disappear all together through unpredictable changes in Government of India tax and credit allocation policies. HDFC has also experimented with a form of graduated payment mortgage (the Step-up Repayment Plan) but has been reluctant to expand this effort because of the increased default risk and the administrative costs of varying standard collection practices. Finally, HDFC has been gearing up for over three years to introduce a Home Savings Plan, modeled after the West German Bausparkassen program, in which an individual will contract to deposit a certain amount with HDFC over a two to seven year period, receiving a below market interest rate, and then will be permitted to borrow an additional amount at a below market rate. This innovation has been delayed because of limitations on staff time and is now planned to begin in May 1985. HDFC's goal is for a gradual build-up of Home Savings Plan account. The firm acknowledges that the pool of funds established under this program may not be adequate to permit draw-down of loans and may, therefore, require a subsidy from other HDFC resources.

Special Projects. The low income implementation plan prepared for AID emphasized a group of special projects designed to reach low income target groups. Since then other, similar projects have been identified by HDFC and AID as special low income initiatives. Indeed, the terms of the HG002 loan require that at least 15 percent of loan funds be used for such projects. Of the projects identified during the HG001 period, two have come to fruition. These have provided loans to rural population groups, in one case to upgrade traditional housing made of impermanent materials and in another to replace such housing with permanent structures. Two other projects in the original low income plan are still in the planning stages and HDFC's ultimate role is doubtful.

The team concludes that HDFC has made a good faith effort to implement the low income policy and plan agreed to with AID as a condition for releasing the second tranche of HG001. The policy and plan have increased HDFC's emphasis on reaching lower income people. However, it is the team's view that an excessive amount of HDFC staff energy has been spent on special projects and, as will be discussed further below, recommends that this area be deemphasized in favor of new approaches that will have a more systemic effect on HDFC's mainstream loan programs.

The Corporate Loan Program

HDFC's corporate housing program provides large benefits to the workers who occupy company-owned units on a rental basis. They typically live in housing substantially better than they could otherwise afford on the basis of a heavy subsidy from their employer. Rent charges are low -- ranging from no rent to 5 or 10 percent of salary. In a standard case rental payments cover only 15 percent of the 620 rupee average monthly cost of the housing unit to the corporation, and the subsidy represents a 50 percent increment in the employee's basic salary. The subsidy is viewed by both the company and its workers as part of the compensation package.

HDFC financing makes it possible for companies to provide housing for their workers by making loans that are easily available, unlike loans from governmental institutions, and available at more favorable rates than the principal non-governmental alternative source of funds, inter-corporate borrowing.

The structural quality and amenities of corporate-provided housing are basically the same as for units purchased by individual borrowers at income levels at or below 1200 Rs./mo.; and the number of occupants for the size of the unit is usually lower. Units visited by the team were structurally sound and well maintained.

While the occupants of rental worker housing must vacate their units when they leave the company's employment or retire, this does not appear to cause hardship. Most workers stay with a company until retirement and a somewhat common pattern is for a worker to begin buying his retirement house several years in advance, using a combination of withdrawal of provident funds, other savings, and, sometimes, homeownership loans from the company. The low cost of company rental housing may, in fact, contribute to the high savings rates that make homeownership possible for these workers.

In addition to providing low rent housing as part of workers' compensation, a number of companies build worker housing because their plant is located in an area remote from a population center with a skilled labor force. Housing must be provided for skilled workers because there is no acceptable local housing or no housing close enough to the factory. The availability of an HDFC loan makes possible, or at least advances the schedule, of industrial expansion in such areas. It thus supports the Government of India's program of dispersing industry away from major metropolitan areas.

Worker rental housing built with HDFC financing usually is part of a larger system of company provided housing assistance. There are at least three ways in which HDFC finances homeownership for industrial workers, and a company that owns worker rental housing usually is also involved in at least one of them. (1) An HDFC corporate loan, i.e., a loan the corporation is directly responsible for repaying, sometimes is used by the company to build housing that is sold to workers on an installment basis, with or without an interest subsidy, rather than rental housing. (2) HDFC has a program that provides a line of credit to the company, which screens individual homebuyers from among its employees and guarantees repayment to HDFC. (3) Many companies' employees take loans from HDFC on an individual basis, and, where permitted by law, the company agrees to deduct their monthly payment to HDFC from their salary. As noted above, HDFC sometimes links corporate deposits to commitments to make a certain volume of loans to the company's employees.

There are circumstances in which homeownership, even with a subsidy, is not possible. Where the plant is located in a remote area, the workers may not be willing to buy housing units, even if they can afford them, as they intend to return to their place of origin at retirement. In addition, the company may want to keep a stock of company-owned housing because it needs it for essential staff near the plant site. Such essential staff include, for example, skilled workmen who service machinery.

Where workers are willing to buy and alternative housing is available for future workers, some companies have been willing to provide a homeownership subsidy, rather than low rent housing, as part of the compensation package. Forms of subsidy include transfer of company-owned land and in-kind contributions to construction, as well as interest subsidies. The trade-off between subsidized homeownership and low rent company-owned housing is a matter of company policy and, sometimes, negotiation with the unions.

The corporate loan program is a money-maker for HDFC, carrying higher interest rates and shorter terms than individual loans. It thus indirectly helps HDFC reach lower income borrowers through the individual loan program without compromising the firm's financial integrity.

Prospects for growth in HDFC's corporate loan program appear good. The Government of India's Seventh Plan continues to emphasize incentives for plant location in officially-designated backward areas and, in a country with a severe housing shortage, workers are likely to continue to press for housing as part of their compensation.

If HG funds could not be used for HDFC corporate loans, this would not affect the volume of such loans. Rather, the effect would be to limit HDFC's overall growth rate, since HG funds would be drawn down more slowly. This might put some additional pressure on HDFC to reach lower income borrowers through its individual program. However, given the reasonable efforts HDFC is making to target its individual loan program to lower income borrowers, the team does not believe this consideration should be given much weight.

In sum, the team concludes that the corporate loan program is an appropriate use of HG funds. It provides substantial benefits to lower income workers by realizing companies' willingness to provide housing as compensation for workers, thereby adding to the housing stock in a country with a vast shortage of decent housing. And it supports the ability of HDFC to reach other low income households through cross subsidies. Moreover, in a highly unionized environment like India, the exploitative aspects of "company towns" are unlikely to exist; and the team saw no evidence of this at the projects visited. Finally, the availability of financing for company-owned housing has not acted as a barrier to homeownership opportunities for Indian workers.

Technical Assistance

The $100,000 in technical assistance funds provided during the HG001 period was used for what can be broadly defined as training activities. About two-thirds of these funds supported a management audit and general staff training exercise. The training concentrated on significant deficiencies in personnel matters and intra-firm communications documented in the audit report. It is the team's opinion that the audit was thoroughly done and the results effectively communicated to HDFC. In addition, the training conducted as a direct consequence of the audit was a very high priority to the firm. The audit and training taken together had significant impacts on HDFC. It provided the overall framework for the improvement of non-financial management procedures and personnel practices including recruitment, training, and compensation. It also achieved immediate gains in the form of improved working relationships within the firm, even down to the staff-manager level, as well as between central and branch offices.

The balance of the technical assistance funds supported executive training of two major types, both of which involved sending senior staff to conferences, seminars and similar events: meetings focused on low-income housing and urban development issues, and meetings on financial management and entrepreneurism. The gains here are much more difficult to measure, but the experience seems to have genuinely broadened the perspective of those involved, especially in regard to low income housing alternatives and ways of assisting lower income households. This in turn has made those participating more receptive to working on initiatives involving low income households.

Housing Quality

Questions have been raised about the quality of the housing financed by HFDC, not because of any indication of problems existing but rather as part of a general concern about sound business practices. From HFDC's perspective, loans on poorly constructed buildings could increase the likelihood of mortgage defaults and mar its reputation. From AID's perspective, association with deficient units -- through its lending to HFDC -- could be a source of embarrassment. To study this issue the team reviewed the procedures followed by HFDC in appraising and inspecting units on which it might make loans and an AID engineer inspected a sample of properties for which AID funds had been employed for the mortgage to determine if gross deficiencies were present.

The team's findings are:

(a) the procedures followed by HDFC regarding inspections of units during construction and appraisal are prudent and adequate;

(b) HDFC's exposure to loss is extremely limited due its highly conservative underwriting practices, which are designed to protect it from the necessity of foreclosure proceedings;

(c) inspections of 7 corporate projects and 21 units involving individual loans selected by the team from three branch offices uncovered no instances of deficiencies; construction quality as rated by the AID engineer ranged from satisfactory to excellent.

Based on these findings, the team concludes that there is no reason for AID to undertake inspections of HDFC-financed units.

Overall Conclusion and Recommendations

HDFC is a financially sound institution whose ability to sustain itself as such in the future is without question if current policies are followed. Moreover, the team believes that the Housing Guaranty loan -- both in its timing and magnitude -- importantly affected the ability of HDFC to achieve its present position. There is no question that HDFC is playing a key role in the development of a private housing finance system in India and it may have modest longer term effects on the efficiency of the financial sector in general by demonstrating the utility of private institutions and in accomplishing regulatory changes which will pave the way for the establishments of other firms. In this sense, the broad purposes of the Housing Guaranty loan have been achieved.

In addition to the general objectives, the HG had several specific goals regarding HDFC development. These quantitative goals, which were in the logical framework of the 1981 Project Paper, are listed in Table 1.1, along with the actual HDFC experience. At the time the initial Project Paper was written, it was anticipated that the HG funds would be dispersed over a two year period. Hence, two year goals and longer-range five year goals were developed. The actual disbursement period turned out to be three years. So, some interpolation is needed in comparing the goals with accomplishments.

The team's opinion is that HDFC substantially achieved the goals set for it. To appreciate the reasons for this judgment some comment on several of the goals is necessary.

- Regarding increased resource availability, HDFC was below the two year target at the end of two years but its growth accelerated in 1983- 1984. Moreover, it is important to note that HDFC has substantially exceeded the projections in this area which the International Finance Corporation made for it and is essentially in line with its own projections made in 1981.

- In terms of expanded operations, the number of branches opened fell short of the goal (2 vs. 6 over three years). On the other hand, HDFC has opened three branches since the end of the loan period. More loans have been processed than stated as the goal (on an annual basis).

- As to loans to corporations, the number of loans is almost exactly on target, if one uses the annual rate implied by the five year goal (133 loans actually made vs. a goal of 135). The number of units financed is below the goal by several thousand units. However, the goal was set on the basis of the HG funds being devoted to corporate loans, when in fact a large portion of HG funds have supported individual loans.

- HDFC has essentially met its target with respect to the share of beneficiaries (home owners plus workers living in corporate housing) who have incomes below the median household income figure employed in the project.

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TABLE 1.1

PROJECT PAPER GOALS AND HDFC ACCOMPLISHMENTS

activity	goal 5 year	goal 2 year	actual 3 yrs (1981-1984)
increased resource availability (mill.)	$400	$110	$140
expanded operations			
- new branches	2 per year		2 total
- loan applications processed (total)	78,000	32,000	56,506
increased corporate loans			
- number of loans	225	75	133
- number of units	22,000	13,500	11,839
low income beneficiaries	approximately one-third of loan recipients or beneficiaries		30%

Note: the number of loan applications included under the second activity are for individual loans only.

The ability of HDFC to pursue the development of a financially-sound housing finance system in India depends on the continued success of regulatory entrepreneurism. There are still a number of important legislative and regulatory requirements that tend to increase the cost and reduce the availability of funds for housing finance, particularly for low income borrowers. HDFC staff are continuing to hold discussions with GOI officials to effect these changes.

In this light, the second HG loan can be viewed as a sustaining housing investment similar to the first loan. However, it is even more an investment in establishing a rationalized housing finance system than the initial loan. If HDFC is successful in achieving the regulatory change it seeks, it will have established a set of ground rules for a new type of institution that is not only financially sound but also able to provide assistance to lower income households. As HDFC — and the housing finance system — matures, several adjustments to its activities, including those undertaken with HG funds, could be made which the team believes could place it on a better footing for the future.

These recommendations fall into three groups: (1) local resource mobilization; (2) low income policy; and, (3) the corporate loan program.

(1) Besides the direct effect of helping to provide adequate housing for lower income households, the primary accomplishment of HDFC has been the demonstration that funds can be effectively mobilized for this purpose by reliance on private sector initiatives. These initiatives are, however, constrained by Indian credit market policies

that limit explicit competition for funds. The firm has shown a good deal of creativeness in exploiting opportunities that are either created by or associated with existing credit market constraints. This activity should be encouraged because it is only through the development of a broad-based investor constituency that the firm's financial independence can be assured. Furthermore, it is through this type of competitive endeavor that the benefits of a formal financial system are made more apparent to an economy that channels less than 20 percent of its financial transactions through financial intermediaries.

Accordingly, the team recommends that HDFC strongly pursue its policy of expanding its base of individual deposits. Additionally we admonish AID to consider not simply the beneficiaries of HDFC loans in computing a measure of HDFC's assistance to the lower income sector. The long run gains to low income depositors — flowing from establishing a relationship with a formal financial institution — represents an important public policy improvement.

(2) Through its efficiency HDFC has reduced housing finance costs. However, these gains cannot be expected to offset the higher housing costs for many lower income households associated with other housing and credit market regulatory structures. While cross-subsidization of HDFC loan recipients beyond the limited scaling of interest rates already in place would help individual households, it would also have the perverse effect of relieving pressures to remove existing regulatory impediments.

With its small staff, HDFC's chief function is to provide efficient real estate finance services, and there is a very short supply of such services in the Indian economy. Accordingly, in implementing its low income policy the firm should focus more on systemic financial aspects of housing rather than the present, staff intensive emphasis on special housing projects that either may not be replicable or else do not, in fact, differ significantly from HDFC's standard corporate or line of credit programs.

In particular, the team recommends that attention be given to two pressing areas: increasing affordability through loan term modification; and expanding the supply of market rate mortgage credit. In the first area, we recommend the consideration be given to schemes that reduce mortgage payments without substantially increasing the firm's risk exposure. For example, a greater willingness to experiment with graduated payment schemes or with schemes that lengthen loan terms without a major increase in interest rate risk exposure would be in order. In addition, resources should be allocated to an analysis of how foreclosure laws might be amended so that the expected costs of default might be reduced. Such a reduction could help to lower the very high downpayment requirements currently in effect.

As for the supply of mortgage credit, HDFC can best leverage its resources and technical skills by providing these services to other financial institutions on either an equity participation or services contract basis, rather than pursuing projects of a non-financial nature.

(3) The corporate loan program provides substantial benefits to lower-income households. It is both directly pr`fitable for HDFC and linked in important ways to funds mobilization. In the team's view,

mortgages has been adequate to keep its risk of foreclosure for construction-quality related reasons to a minimum; and the impact on HDFC operations of the technical assistance resources provided to it by AID as part of the Housing Guaranty package.

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