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Options for Licensing, Regulation, Supervision and Closure of Housing Finance Companies in India

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CONTENTS

CONTENTS (continued)

TABLES

ABBREVIATIONS

(In Order of Appearance in the Report)

United States Agency for International Development	USAID
National Housing Bank	NHB
Housing Finance Company	HFC
Reserve Bank of India	RBI
Housing Finance Institution	HFI
Department of Finance Companies of the Reserve Bank	DFC
Loan-to-Cost	LTC
Loan-to-Value	LTV

EXECUTIVE SUMMARY

The National Housing Bank (NHB) of India has a multiple set of responsibilities. It is assigned the tasks of being a promoter, a regulator/supervisor, and a lender to the Housing Finance Industry. It must strike a delicate balance between these three potentially conflicting roles.

Its current emphasis is on its promotional and lending roles. However, stronger regulatory authority can also be consistent with its promotional role. Public knowledge that Housing Finance Companies (HFC's) are being closely monitored and regulated will increase public confidence in these institutions, thereby promoting the mobilization of funds for housing.

Overall, the housing finance industry is in its infancy. Currently, regulatory provisions, though limited, are adequate for the few companies operating as HFC's.

This report presents several options and recommendations for changes in legislation, directions/regulations, and guidelines the NHB should consider as the HFC industry matures and become harder to manage on the personalized basis used today. These options and recommendations are outlined briefly below. They are more fully developed in the body of the report.

Levels of Licensure and Approval

Housing Finance Companies in India can progress through three levels of licensure or approval. First, an HFC must become registered with the Registrar of Companies. This is a routine step which involves a minimum review and little regulation or oversight of operations in the form that is typical for financial institutions in most developed economies.

Second, an HFC can apply to the National Housing Bank to become formally classified as a Housing Finance Company (this function was formerly handled by the Reserve Bank of India's Department of Financial Companies). HFC's which meet certain criteria and receive this formal classification are eligible for substantial tax benefits. They also become subject to on-site inspections and to regulations, or Directions, of the NHB. The Directions primarily address the deposit-taking activities of HFC's. Since the tax benefits are crucial to the long-term economic viability of HFC's, these companies have a strong incentive to apply for classification and to accept the accompanying regulation.

Finally, the National Housing Bank offers an attractive loan refinancing program to qualified institutions. In order to become NHB-qualified, an HFC must make application and meet additional eligibility guidelines. The NHB has increased abilities for controlling the activities of NHB-qualified Housing Finance Companies through its operation and oversight of this program.

The overall legislative authority for the NHB to license, classify, and qualify HFC's is both broad and adequate. However, some changes, which are presented later, could clarify and strengthen the NHB's overall regulatory position.

Legislative Focus and Power

The legislation which established the National Housing Bank is strongly biased toward NHB's role in protecting depositors from unethical deposit solicitation practices. It also emphasizes the role of NHB in promoting the growth and health of companies classified as HFC's.

There are broad, general authorities of the NHB which can be interpreted as giving it the power to regulate the investment of depositor funds (the asset side of an HFC's balance sheet). But these are somewhat vague. Troubled financial institutions often get into their difficulty over the quality of their investment portfolios. Therefore, the NHB should have clear and specific legislative authority to regulate the investment activities of all HFC's.

The powers of the NHB to monitor and inspect HFC's are broad and adequate. However, the regulators have a limited set of options open to enforce their recommended changes when they find institutions out of compliance with their directions or guidelines. They have too few options between moral suasion and simply prohibiting a company to cease taking deposits.

This limited set of enforcement tools is not as critical for the small HFC industry which exists today, but it will become a problem when the number of Housing Finance Companies grows. The NHB should begin now to seek legislative authority to apply remedies against institutions engaged in unsafe and unsound practices in escalating levels of severity--up to and including conservatorship. In addition, the legislative authority for NHB to prohibit deposit taking on the basis of unsafe and unsound operations at an HFC should be made more clear.

When the NHB is faced with a company which cannot survive, its options are also somewhat limited. If the NHB is to meet its responsibility to promote public confidence in HFC's, it must have the ability to effectuate a timely and efficient winding up process.

Therefore, NHB should seek legislative authority to facilitate mergers of weaker institutions with stronger ones. It should also have the power to establish receiverships on the basis of clear evidence of danger to depositors' funds.

There is no government-sponsored deposit insurance open to HFC's. Since this type of insurance is an important source of depositor confidence and since its implementation implies serious government commitments to the depositing public, the NHB should take the lead in developing a thoroughly-thought-out position on the offering of deposit insurance and present it to Parliament.

Finally, the refinancing program currently offered by the NHB is a valuable mechanism for efficiently utilizing the funds of HFC's to provide residential loans. In the long term, a formal secondary mortgage market should be developed to strengthen this process. Since the NHB is a logical home for a secondary mortgage market agency, it should begin now to seek legislative authorization to set up such a operation at a time when market forces justify the need.

Regulatory Focus

The clearest statements of the National Housing Bank's regulatory expectations are contained in its Directions (which apply to all institutions classified as HFC's) and in its Guidelines (which apply to institutions qualified to engage in business with the NHB). Those regulatory requirements are based on sound financial principles. However, there are some changes which should be considered to clarify and strengthen the NHB's position as the promoter/regulator/lender of HFC's.

For instance, the NHB should consider requiring one or two years of operating experience at an HFC before it can become NHB-qualified. Qualified companies should be allowed to advertise their NHB-qualified status (with a disclaimer that NHB does not guarantee deposit repayment). These changes would give greater value to the "NHB-qualified" designation and provide the depositing public with an objective designation of quality for institutions to which they entrust their savings.

The NHB should examine provisions in its current Directions and Guidelines in order to ensure that <u>credit risk of portfolios</u> at HFC's is controlled. For instance, NHB-qualified institutions are allowed to have up to 25% of their portfolios in nonhousing loans. Poor investments in this part of the portfolio can cause serious losses for an HFC. Therefore, NHB should establish guidelines for approved investment in that 25% of the portfolio which is currently unrestricted. It should also consider portfolio diversification rules (such as limiting loans to one borrower or loans to a single housing project) for all HFC's.

The refinancing program which NHB operates is attractive for the way it allows HFC's to leverage more funds into the residential loan market. The loans from NHB which are used in the refinancing scheme are not used in determining an institution's capital leverage for regulatory purposes. There should be a limit on the amount of refinancing an HFC can have outstanding at one time.

The NHB can also reduce the <u>credit risks</u> taken by HFC's by promoting safe underwriting <u>on an individual loan basis.</u> There are numerous borrower and collateral conditions which combine to determine a residential loan's quality. There is also a rather wide range of these conditions which qualify a loan as "safe" or "high quality". The NHB should consider promoting high quality lending through allowing HFC's to leverage their capital more highly if their loans comply with the most conservative underwriting and loan documentation standards. It should also examine the feasibility of offering better refinancing terms on loans which meet the highest standards of quality and documentation.

The interest rate risk at HFC's is currently controlled through NHB Directions which restrict these institutions' deposit maturities to a range of 24 to 84 months. This has the effect of substantially limiting the attractiveness of depositing funds in an HFC. The NHB should begin now to modify the reports it receives from all HFC's to allow measurement of interest rate risk exposure. If it later considers allowing deposits of less than 24 month maturity, it should designate a reasonable percentage of these short-term deposits as stable, "core" deposits for interest rate risk measurement purposes. Then it should develop explicit rules governing exposure to interest rate risk.

The table at the end of this section presents a summary of recommended changes classified by type of action needed (legislation, direction/regulation, or guidelines) and a rough timetable for implementing these changes (immediate, intermediate, and long-term). These recommendations are listed in their order of appearance in the text.

As the HFC industry develops, it is likely to require constant monitoring and adaption of NHB's regulatory posture. The current NHB regulatory staff is small but have many years of experience with the Reserve Bank of India and the commercial banking field. While mortgage finance requires some skills different from those in commercial banking, these people appear to have a detailed understanding of regulated financial services in India and backgrounds which should be sufficient for their current assigned tasks.

Summary of Recommendations

Recommended Changes	Type of Action	Timing
Require one or two years of operating history before an institution becomes NHB-qualified.	G	Imm
Allow HFC's to advertise their NHB-qualified status (with a disclaimer about any NHB guarantee of repayment).	G	Imm
Seek authority to issue both general and specific directions concerning loan and investment activities for HFC's.	L	(Begin) Imm
Establish guidelines for investment in nonhousing loans for 25% of portfolio.	G	Imm
Develop portfolio diversification rules.	D	Int
Establish limits for the amount of refinancing an HFC can have outstanding.	G	Int
Allow HFC's to leverage capital more highly if their loans comply with the most conservative underwriting and documentation standards.	D	L-T
Propose legislation to establish a secondary mortgage market.	L	L-T
Study feasibility of offering better loan refinancing terms on the most conservatively underwritten loans with standard documents.	G	Int
Develop underwriting criteria to use as equity trade-offs (only after Parliament approves legislation allowing rapid fore-closure and sale and after these new provisions have been tested).	D	L-T
Modify reports to NHB to allow measurement of interest rate risk exposure.	D	Imm
Develop rules for limiting interest rate risk exposure.	D	Int

Recommended Changes	Type of Action	Timing
Seek authority to apply remedies against institutions engaged in unsafe and unsound practices--up to and including conservatorship.	L	Int
Obtain authority to prohibit deposit taking for unsafe and unsound operations at an HFC.	L	Int
Seek authority for NHB to:		
• Encourage mergers of weak with strong institutions.	L	Int
• Establish receivership at an HFC's insolvency.	L	Int
• Establish receivership prior to insolvency.	L	L-T
Develop a position on the feasibility of deposit insurance for HFC's and present it to Parliament.	L	Int

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Legend:			
	G = Guidelines	D = Directives	L = Legislative
	Imm = Immediate (next year)	Int = Intermediate (1 to 3 years)	L-T = Long Term (3 to 5 years)

CHAPTER 1
INTRODUCTION

The government of India is in the process of establishing incentives and a more formal regulatory structure to deal with the shortage of housing finance in the country. Less then twenty percent of housing finance is currently conducted through formal channels.

This Study in Relation to Others

The purpose of this study is to examine the need for additional or alternative regulations, laws or incentives required to develop a justified confidence on the part of the depositing public in the safety and soundness of the Indian Housing Finance Institutions (HFI's) and to advise the National Housing Bank (NHB) on its options.

Other reports dealing with various aspects of housing finance in India have been prepared over the past two to three years. These reports include:

- Wilson, Karen J., "The National Housing Bank: Regulatory Options and Assessment Factors," January 1988;
- Diamond, Douglas B., "Expanding Market Oriented Housing Finance in India," February 1990; and
- Madway, David M., "Revision of India's Foreclosure Laws," February 1989.

Wilson discussed several overall principals and issues associated with regulation of financial institutions and made several general recommendations concerning how NHB should approach its regulatory functions. The NHB is now more fully operational in its regulatory task than it was when Wilson performed her study. The principals covered in that excellent report have, for the most part, been implemented. This study, therefore, concentrates on several specific issues and options which have arisen as the NHB has proceeded to carry out its responsibilities.

The work of Diamond focused on the viability of Housing Finance Companies and did not deal directly with options for licensing, regulation, supervision and closure of such companies. However, his analyses suggest that the financial programs of the National Housing Bank are important to the survival of HFC's in the long run. Thus NHB's regulatory oversight role is enhanced by the fact that these companies need its services in order to be profitable. This dependence on NHB should make the implementation of the specific recommendations contained in this report more feasible. In addition, part of the NHB's control of Housing Finance Companies can be exercised through its credit-granting functions.

Madway noted that the granting of credit on a traditional property-equity basis is complicated, and perhaps even impossible in India, due to the problems associated with foreclosure laws. These problems have a significant impact on the issues of regulating and closing Housing Finance Companies. Some of the recommendations in this report cannot be implemented until the changes recommended by Madway are accomplished. Those instances are noted as appropriate.

General Background

Depository companies and institutions are a familiar part of the business landscape of India. However, in recent years a number of highly visible and disreputable companies have engaged in the business of gathering deposits at attractively high interest rates; some have subsequently failed to return either principal or interest to the depositors. In addition, until recently there have been few regulations or constraints on operations of the small number of Housing Finance Companies in the country.

That situation has been remedied with the National Housing Bank Act of 1987, which established the National Housing Bank for the purpose of promoting, regulating, and financing the fledgling housing finance system. The NHB is currently in the process of taking over both the licensing function (which was formerly performed by the Reserve Bank of India (RBI)) and the regulatory/supervisory function.

CHAPTER 2

LEGISLATIVE BACKGROUND AND RECENT HISTORY OF THE CURRENT REGULATORY SYSTEM

Authority to License Companies

In the past two to three years the regulation and supervision of Housing Finance Companies have received new attention. All HFC's have always been licensed by the Registrar of Companies under the 1956 Companies Act. (The terms "licensed" and "registered" are used synonymously in the this report, although "licensed" is used most often.)

Authority to Classify Companies as HFC's

It has been the function of the Reserve Bank to classify registered companies as HFC's. The RBI has chosen to make this classification on a case-by-case basis one to two years after an HFC begins operation. The rationale for waiting up to two years has been that the classification as an HFC can then be done on the basis of an inspection of actual business rather than on the basis of projected business.

In April of 1989, the RBI promulgated its latest version of "Directions" to all classified HFC's. The Directions govern the deposit-taking activities of these companies. After the National Housing Bank was organized and operating, it assumed the regulatory function of the RBI with respect to HFC's and reissued those Directions on June 26, 1989. The RBI simultaneously canceled their directives. The process of classifying companies as HFC's is still being transferred to NHB.

One change is envisioned in this process. NHB will classify institutions on the basis of their projected business and statements of purpose (indicated in their memorandum of incorporation). Since companies which are classified as Housing Finance Companies are required to comply with the deposit-taking Directions, the effect of this change is to establish some oversight and discipline to the deposit-taking activities of these institutions at an earlier date.

Regulation of Housing Finance Companies

The focus of the regulatory powers granted to the NHB by the National Housing Bank Act of 1987 is on oversight of deposit-taking activities. The powers of the NHB to regulate these activities fall into five broad categories:

- Establishing restrictions on deposit rates and maturities.
- Limiting the deposit solicitation activities of HFC's to assure the full and fair representation of information to depositors.
- Monitoring compliance of HFC's with the Act and with NHB Directions through periodic reports and on-site inspections.
- Conducting a broad range of business with HFC's, including provision of financial services or direct investments in the institutions.
- Imposing conditions to protect the business interests of NHB in its dealings with HFC's.

These authorities are primarily aimed at regulating deposit solicitation activities and at empowering NHB in its capacity as a creditor to these institutions.

The National Housing Bank Act does not directly recognize NHB's regulatory and supervisory role in the list entitled "Business of the National Housing Bank," which is presented in Chapter IV of the Act. Table 1 presents an abbreviated form of that list, which consists primarily of activities which are promotional and supportive of HFC's.

The only powers in this list which appear to be regulatory or supervisory in nature (as opposed to promotional) are the powers to provide "guidelines to ensure growth on sound lines," which is a somewhat weak form of regulation; and "doing all other things incidental to...the exercise of its powers...under the Act," which is rather broad and somewhat vague.

Certain other powers within the Act appear to be focused on specific functions of NHB rather than on the general regulatory and supervisory powers a traditional financial institution regulator might have. For instance, the power to inspect institutions (Section 24) appears in a context of the NHB as a creditor rather than as a regulator. Its powers to gather information from HFC's and issue directions (Section 31) are granted only "in respect of any matters relating to, or connected with, the receipt of deposits...".

Table 1
Business of the National Housing Bank
(Chapter IV, National Housing Bank Act, 1987)

- Promoting and establishing of Housing Finance Institutions (HFI's).
- Making loans and advances to HFI's.
- Purchasing securities issued by these institutions.
- Guaranteeing and underwriting securities of HFI's.
- Trading in the securities of Housing Finance Institutions.
- Conducting surveys or research in human settlement and housing issues.
- Formulating programs for the mobilization of resources for housing.
- Establishing programs for economically weaker sectors of the economy which can be subsidized by the Central or State governments.
- Sponsoring training programs in housing-related matters.
- Providing guidelines to HFI's to ensure their growth on sound lines.
- Providing technical assistance to HFI's.
- Working with other major financial institutions of India to coordinate housing finance functions.
- Exercising all powers in performance of duties entrusted to NHB under the Act, as modified from time to time.
- Acting as an agent of the State on Central Government or the RBI, as authorized.
- Doing all other things incidental to or consequential upon the exercise of its powers or discharge of its duties under the Act.

Thus the powers of the National Housing Bank are focused primarily on the liability side of the HFC industry's balance sheet and can be summarized as follows:

- Depositors are protected from unfair solicitation methods,
- Financial interests of the NHB are protected, and
- While the Act does not specifically cite NHB responsibility to regulate an HFC's investment activities, it assigns NHB the task of ensuring sound growth and unspecified incidental powers.

Adequacy of General Legislative Authority

It appears that **the authority of the National Housing Bank to monitor and inspect HFC's with regard to its credit and depositor-protection functions is both broad and adequate.** The authority also appears adequate to cover the necessary monitoring required of a supervisor giving attention to the overall health and operation of Housing Finance Companies as they exist in India today.

To date, NHB has been very consistent with the letter and spirit of the legislation. The Directions which it has issued to all HFC's deal almost exclusively with deposit-gathering issues and are designed primarily to protect the depositing public. The credit facility NHB is providing will be discussed more fully later. However, this facility has been designed to provide significant benefit and assistance to HFC's as well as to promote lending to lower and middle income groups (loans eligible for this program must be for houses under forty square meters in size or under Rs 1.50 lakhs in cost).

In order to do business with the NHB and enjoy the benefits of many NHB services mentioned in Table 1, HFC's must go through a process of qualifying to do business with NHB. This process involves an NHB inspection and compliance with a series of guidelines, issued by NHB most recently on January 1, 1990. More details concerning achievement of this NHB-qualified status are presented in the next chapter.

Several summary points concerning the current legislative background and current regulatory and supervisory system are worth keeping in mind. They are the following:

1. The NHB, an institution established in part to perform the regulatory and supervisory function, is very new. Some of the responsibilities it is assuming are still in the process of being transferred from the Reserve Bank of India.

2. The legislation establishing the National Housing Bank is strongly biased toward NHB's role in protecting depositors from unethical deposit solicitation practices and toward promoting the growth and health of companies classified as HFC's.

3. Some of NHB's strongest powers are based on its role as a creditor to NHB-qualified HFC's and its need to protect its interests as a creditor.

Subsequent chapters of this report deal with issues of licensing, regulation/supervision and closure of HFC's, and discuss options open to the National Housing Banks in addressing these issues.

CHAPTER 3

LICENSING, CLASSIFICATION AND QUALIFICATION OF HFC'S

An HFC can be identified as having one or more of three levels of approval for operation: licensed, classified, and qualified. Each of these is discussed below.

Licensing of an HFC

Prior to beginning operation, all companies of India are required to be licensed by the Registrar of Companies under the Companies Act of 1956. The licensing process is not particularly rigorous. A licensed company may collect deposits subject to the Acceptance of Deposit Rule of 1975.

Classification as an HFC

Companies which are engaged in the housing finance business as a major part of their operations can apply to be classified as HFC's. In order to be eligible for this classification, over 50% of a company's assets and income must be in housing finance.

In the past, the classification process was performed by the Reserve Bank of India's Department of Financial Companies (DFC), on the basis of a company's first one or two years of operation. The DFC classification function is now being transferred to the National Housing Bank. It is the intent of the NHB to make the classification of a company as an HFC on the basis of information contained in its memorandum of incorporation. This is an important change, since institutions classified as HFC's immediately come under an obligation to abide by the Directions of the NHB concerning the manner in which deposits can be solicited, and they enjoy certain tax benefits.

The general restrictions[1] on companies classified as HFC's are the following:

- Deposit rates are capped at 14%.
- Deposits must have terms between 24 and 84 months. No demand deposits can be accepted.
- Liquidity must be maintained at 10% of deposits.
- Advertisements for funds must be approved by NHB.
- Leverage is restricted:
  - To 10 times capital for HFC's with less than 10 crores capital,
  - To 12.5 times capital which is in the 10 to 20 crores range, and
  - To 15 capital which exceeds 20 crores.
- Certain reports must be submitted to NHB, and NHB is authorized to perform on-site inspections.

Benefits of Being Classified as an HFC

As long as any classified HFC follows the restrictions in the previous section and the others listed in the Directions of June, 1989, it can operate as an HFC. This classification function is not a chartering function wherein the NHB can deny a company its right to operate without NHB's formal and affirmative approval. That is, a licensed company may engage in housing finance without NHB approval. However, its long-term economic viability would be in question without the tax benefits which are available to a company classified as an HFC, its investors/depositors, and its borrowers.

These tax benefits are substantial and provide a strong incentive for companies engaged primarily in housing finance to apply to the NHB for classification as an HFC. They include the following:

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[1] Certain categories of deposits are exempted from the Directions. These include deposits received from foreign governments, the Central Government, State and local governments, or sources which have repayment guaranteed by the Central or a State government; deposits received from banking companies, the State Bank of India, regional rural banks, and co-operative banks; loans received from NHB and several other special-purpose financial institutions established under various legislative actions or owned by the Central Government or a State Government; funds received from other domestic companies, directors or shareholders; security deposits; and funds raised by the issuance of certain bonds or debentures.

- An HFC may create a special tax deductible reserve of up to 40% of total income.

- Income from property held in charitable or religious trusts is not taxable if the income is deposited in HFC's or invested in their bonds.

- Investments in shares of approved companies engaged in long-term residential finance enjoy a 50% tax deduction up to a cap of Rs. 20,000 invested.

- Individuals and certain associations of individuals may deduct up to Rs. 10,000 in interest or dividends received from HFC's.

- Up to Rs. 10,000 in repayments of amounts borrowed from an HFC is eligible for deduction.

- Up to Rs. 5 lakhs can be deducted from the total assessable wealth of a person if that wealth is in the form of deposits with a public company providing long-term housing finance.

In addition, all house owners receive tax benefits which promote house purchasing and, therefore, promote the housing finance done by HFC's. Those benefits are summarized in Appendix II of this report.

Qualification for NHB Programs

Finally, a company can be qualified to do financial transactions with the National Housing Bank. In order to achieve such qualification, an HFC must be licensed and classified and, additionally, must be inspected by the NHB and found to comply with a set of "Guidelines for Housing Finance Companies," which were most recently issued in January, 1990. The Guidelines expand on the June, 1989, Directions in several major areas:

- The HFC must be engaged only in financial activities and put at least 75% of its loans into housing.

- A minimum capital requirement is established as Rs. one crore, at least 30% of which must come from the company's promoters and 20% from an organization acceptable to the NHB. When an HFC cannot secure 20% of its capital from a financial institution acceptable to the NHB, promoters must supply at least 50% of the capital.

- At least two directors from the outside institutional investor group will sit on the board.

- The Chief Executive Officer will be approved by NHB.

- Maximum allowable lending rates on housing loans are specified in the schedule established by the RBI for commercial banks:

Loan Amount	Annual Interest Rate	Maximum Loan-to-Cost Ratio
To RS. 20,000	12.5%	80%
20,001 to 50,000	13.5%	75%
50,001 to 100,000	14.0%	70%
Over 100,000	14.5 to 16.0%	65%

- Front-end fees (excluding stamp taxes and government-imposed charges) are restricted to 2% of advanced funds, and no loan prepayment charges are allowed.

- NHB exercises approval authority over appointment of the HFC's auditors.

An important effect of the Guidelines should be noted. They employ an inverse loan-to-cost ratio. That is, loans with higher balances have lower LTC ratios. While it appears to be a matter of public policy to consciously incorporate a cross subsidy on the rates of lower balance loans, there is really a quadruple cross subsidy effect. The first effect is on default. Virtually every U.S. study of default rates shows that loans with low LTC or loan-to-value (LTV) ratios have far lower default rates than those with higher FM ratios. In fact, this single factor is the one most highly correlated to residential loan defaults. Second, the origination costs of small loans and large loans are very similar. Charging of lower rates on small-balance loans does not recognize the fact that the origination of many small loans imposes more cost on an HFC than the origination of fewer high-balance loans. Third, there are loan servicing costs which are unrelated to the size of the loan. An HFC with more low-balance loans will have higher loan servicing costs than will an HFC with a similar size portfolio composed of fewer high-balance loans. But the first institution receives a lower return on that high volume of low-balance loans. The fourth cross subsidy is the one on mortgage rates which is obvious from the rate/balance schedule. To the extent this quadruple cross subsidy is desirable from a social point of view, policy makers and regulators should recognize that this economic subsidy works in four dimensions rather than just one.

Benefits of Being NHB-Qualified

Housing Finance Companies which comply with the Guidelines are eligible to engage in the NHB's financial programs. The most valuable program is the refinancing scheme wherein the NHB will extend a loan to a qualified HFC for 100% of any loan made to homeowners in amounts up to Rs. 100,000 for residences not exceeding 40 square meters in size or Rs. 150,000 in cost. Home improvement and repair loans up to Rs. 30,000 are also eligible for the refinancing scheme. The NHB loans are advanced at 1% to 2% below the rates on the loans which are refinanced, giving the HFC a guaranteed positive spread. This is an important source of financing which allows HFC's to recycle their loans in a fashion similar to that provided by the secondary mortgage markets which have developed in other countries.

Finally, the National Housing Bank is authorized to act as the lender of last resort for qualified HFC's. To date, it has exercised this authority on one occasion. Appendix I contains a complete copy of the Guidelines, which include both company requirements to achieve qualification to do business with NHB and the outline of the general benefits of the refinancing scheme and tax provisions.

Distribution of HFC's by Category

There are currently limited numbers of companies licensed, classified, and qualified. As of August, 1990, there was some question as to how many companies are appropriately assigned to each category. However, there is general agreement that between 60 and 80 companies are registered as HFC's. Many of these are inactive, and others are very small. There are approximately 20 companies formally classified as HFC's. This classification was done by the DFC within the Reserve Bank. Between 7 and 9 companies are qualified to do business with the NHB and three of those have not yet been classified formally as HFC's.

Table 2 summarizes the breakdown of the (roughly) 70 companies in the HFC sector as of August, 1990.

The obvious conclusion presented by these figures and by Table 2 is that the Housing Finance Company industry is currently quite small relative to the size of India's population. With so few companies in operation and the generally small asset bases of the operating companies, it is little wonder that HFC's play a relatively modest role in the formal housing finance sector of India.

Table 2
Categories of Housing Finance Companies

	Licensed as HFC		
HFC / NHB	Classified as HFC	Not Classified as HFC	Total
NHB-Qualified	5	3	8*
Not NHB-Qualified	15	47	62
Total	20	50	70*

* Numbers are mid-points based on estimates of 60 to 80 total HFC's and 7 to 9 NHB-Qualified HFC's.

CHAPTER 4

ISSUES AND OPTIONS FOR LICENSING, CLASSIFICATION AND QUALIFICATION

There are several issues raised by an examination of the current licensing, classification and qualification processes for HFC's. There are also options for dealing with these issues. The issues and options are discussed below.

The fact that a consideration in these processes (such as the background of the individuals proposing to obtain a license) is not discussed in this section should not be taken to mean that the factor is unimportant. It is merely meant to imply that the current way in which such factors are being addressed seems to be well-thought-out and performed. Thus they are no longer matters which should be considered "issues."

Issue 1. Should NHB have a national chartering function for HFC's whereby it is the organization solely authorized to register these companies prior to their beginning operation as providers of housing finance?

The Reserve Bank of India has the authority to charter commercial banks. Since NHB is a subsidiary of RBI, the NHB could conceivably be given chartering/registration/licensing authority over Housing Finance Companies which is now vested in the Registrar of Companies. However, to answer the question of where chartering authority should lie, one must address the benefits derived from making a change in the current system.

There are substantial economic advantages available to institutions classified as HFC's (tax benefits) and designated as NHB-qualified (refinancing program). In fact, the long run growth and viability of HFC's may require these benefits, as suggested by Diamond (1990). Since NHB controls these designations, it already has two levels of approval which can be used to effectively restrict the operation and growth of companies in the housing finance sector to those which meet its standards. **Transfer of the added chartering/registration/licensing authority, as it now exists with the Registrar of Companies, would likely provide little added public benefit at this time.**

Issue 2. At what point in time should NHB classify a company as an HFC and thus bring it under the Directions?

Delaying the classification one to two years to base the assigned designation on actual, rather than projected business has the advantage that it assures greater classification accuracy than a classification based on prospective business or on plans. On the other hand, there is little risk associated with an early classification based on projected business. The classified company may be required to operate under the Directions for a period of time; however, those restrictions are certainly not onerous. If a misclassification has been made, a company could appeal that classification based on its actual operations.

Early/immediate classification of a company as an HFC based on its proposed business plans has the advantage that companies are quickly brought under the Directions. This increases the likelihood they will engage in responsible deposit-gathering behavior. It also eliminates the need to phase-in companies which operate as HFC's for a year or two, later become classified as HFC's, and then need a period of time to come into compliance with the Directions.

On the whole, the current approach of making an immediate classification as an HFC is preferable to the alternative.

Issue 3. At what point in time should NHB consider an HFC for possible qualification to do business with NHB?

If companies can become licensed, are classified immediately as an HFC, and then qualify for NHB's refinance program in very short order, that would bring immediate benefits to those institutions in the form of NHB programs and assistance.

On the other hand, a delay of one or two years before an organization can become NHB-qualified would enhance the NHB-qualified status and make it an "earned" designation based on performance, not speculation about future business. Such delayed approval would form a basis for greater, more justified depositor confidence. Alternatively, NHB may wish to extend the qualified status at the time of a company's classification as an HFC in order to foster HFC growth and development and meet NHB's mandate to promote HFC's. However, if this decision is made, NHB should consider introducing a partial qualification status which allows companies to participate in the refinancing program (perhaps up to certain limits) but withholds other benefits of NHB qualification until an operating history of a safe and sound nature has been established. Withheld benefits may include NHB's purchase, guaranteeing and underwriting an HFC's securities.

The advantages of delayed or partial approval as an NHB-qualified company outweigh the disadvantages, despite the fact that withholding full NHB-qualified status is not totally consistent with NHB's role to promote the operation of HFC's, in the short run.

Issue 4. Should HFC's be allowed to advertise openly that they are qualified to do business with the National Housing Bank?

Allowing such advertising would create a marginal level of confidence on the part of the depositing public. Also, such an action would be costless in terms of personnel or out-of-pocket funds.

However, such advertising might lead to confusion in the minds of depositors and suggest that there is some sort of government guarantee behind their deposits.

The best solution to this issue would be to **allow NHB-qualified institutions to advertise and list on their letterheads a statement to the effect that the institution is "Inspected and reviewed by NHB" or "Qualified to do business with the NHB."** Such a statement should only be used in conjunction with a disclaimer that "Repayment of deposits is not guaranteed by NHB." This combination of statements, or a similar combination, should have the effect of creating the confidence which promotes funds mobilization while not misleading depositors to assume more safety for their deposits than is justified.

Issue 5. Should there be a minimum size/capitalization level before an HFC can become NHB-qualified? That is, should the one crore capital limit be retained for NHB qualification?

From the perspective of NHB's promotional responsibilities toward HFC's, one could argue that there should be no minimum capital requirement to qualify institutions to do business with NHB. In fact, the best criterion, were there are an easy measure for it, would be the "quality" of an institution.

However, the efficiency of the approval process must be considered. The review of applications and the approval process for the HFC's which apply for use of the refinance scheme are somewhat independent of an institution's size. HFC's with one crore of capital take approximately as long to review as those with one lakh and consume approximately as much attention and as many NHB resources. In addition, the business of housing finance is one of thin margins and high volume. Size is critical to success, and housing finance is not a business to dabble in.

Given that NHB has a full agenda of start-up responsibilities, it is prudent to set limits on the size of institutions it must review. This helps assure that its resources are concentrated on the institutions large enough to make an impact in the housing finance markets.

Further, since one crore is Rs. 10 million and the average loan size is approximately Rs. 85 thousand, one crore of capital will support only 120 loans. (If an HFC obtains the maximum allowable borrowing of ten times its capital, it could support about one thousand two hundred loans.) It is prudent for NHB to have somewhere between 300 and one thousand loans from which to choose its sample in its first inspection to determine if an HFC originates loans at a quality level high enough to justify qualification as an HFC borrower.

Overall, the one crore capital limitation should be retained. If, at a later date, NHB personnel gain experience and install systems which allow increased efficiency in the review process, this limit might be reduced without an attendant burden on NHB's limited resources.

CHAPTER 5

REGULATION AND SUPERVISION - CURRENT STATUS

Legislation, Directions and Guidelines

The legislative authority of the National Housing Bank to regulate and supervise all HFC's has been discussed previously. In addition, NHB's somewhat stricter rules for institutions it qualifies to borrow from it have also been summarized. The conditions which apply to NHB-qualified borrowers are contained in its Guidelines (presented in Appendix I) and take a form similar to creditor covenants. Also, these Guidelines are advisory in nature and negotiable with the NHB.

The powers which NHB has implemented in its legislatively authorized Directions, applicable to all HFC's, are summarized in Table 3. The provisions of the Guidelines with which NHB-qualified institutions must comply are presented in Table 4 and are divided into restrictions on Assets, Liabilities, Management, and Operations.

In addition to the restrictions and guidelines summarized in Tables 3 and 4, the NHB has the option of including whatever restrictions on assets, liabilities, management, and operations it can negotiate into its refinancing or direct loan agreements with its client HFC's.

Importantly, the NHB has the power to perform periodic on-site inspections as authorized in Chapter IV of The National Housing Bank Act, 1987. It also has personnel and programs from the RBI to perform these inspections to assess compliance with the directions, the guidelines or any specific directives it may issue.

Current Remedies

The NHB's means of dealing with institutions which fail to comply with the June 26, 1989, Directions or with its Guidelines are quite limited. HFC's which violate the Directions can be prohibited from accepting deposits (Section 31(4) of the National Housing Bank Act, 1987). There does not seem to unanimity of opinion as to whether this prohibition on deposits requires the return of currently-held deposits or simply applies to the acceptance of new deposits. The prohibition of deposits, however it is interpreted, can be invoked for a

Table 3
National Housing Bank Powers Over All HFC's
Contained in Directions[2] Issued June 26, 1989

Specification of maximum deposit rates --- currently 14%.

Limitation on deposit maturities --- currently 24 to 84 months.

Prohibition on demand deposits.

Maximum capital leverage ratios --- currently:
10.0 times capital which is 10 crores or under,
12.5 times capital between 10 and 20 crores, and
15.0 times capital which exceeds 20 crores.

Limitations on deposit brokerage fees: currently to a one-time fee which is 2% of the funds advanced.

Requirements for certain reports to the HFC's Board of Directors.

Requirements for certain reports to the NHB.

Requirements as to form of registers to record deposits.

Limitations on advertising.

Audit requirement.

[2] Certain categories of deposits are exempted form these Directions

Table 4
Summary of Guidelines for Housing Finance Companies[3]
(Provisions in Addition to Directions of June 26, 1989)

Asset Guidelines:

- The primary purpose of the HFC should be to engaged in long-term housing finance. At least 75% of its assets should be in housing loans.
- Lending should be focused toward individuals.
- Limits are established on loan rates and loan-to-cost ratios. The current limits are:

Loan Amount	Annual Interest Rate	Maximum Loan-to-Cost Ratio
To RS. 20,000	12.5%	80%
20,001 to 50,000	13.5%	75%
50,001 to 100,000	14.0%	70%
Over 100,000	14.5 to 16.0%	65%

Liability Guidelines:

- Minimum paid up capital --- currently one crore.
- Capital mix encourages ownership participation by other public financial institutions, which may include the NHB.
- Encouragement to use deposits as the primary source of funding.

Management Guidelines:

- Restrictions on ownership or control by construction companies.
- Board of Directors representation must include as least two members from a public financial institution (which may include the NHB).
- The Chief Executive Officer must be approved by NHB.

[3] As of January 1, 1990.

Table 4 (continued)

Operating Guidelines:

- Restrictions on front-end charges --- currently 2% of amount borrowed.
- Target for administrative costs --- currently 1.5% of outstanding loan balances.
- Prohibition of prepayment charges on loans.
- Requirement that NHB approve a change in auditors.

violation of the general Directions which cover all HFC's, or for a violation of specific directive issued to any specific company under the NHB's powers in Section 31(3).

However, this power to prohibit deposit-taking is somewhat draconian in nature. It would likely be invoked only in the case where numerous meetings had been held between NHB regulatory personnel and management or the HFC's board of directors seeking voluntary compliance with the Directions.

There is currently no specific power for the NHB to issue general directions concerning the safe and sound investment of depositor funds. In serious cases, NHB is empowered to issue specific directives prohibiting unnecessarily risky investments in situations where NHB can justify the directives on the basis that the potential losses threaten the ability of the HFC to repay depositors.

In egregious cases where HFC-classified institutions undertake false filings, fail to file required reports with NHB, or engage in unscrupulous deposit-gathering activities, the HFC employees responsible can be fined or imprisoned (Sections 49-52 of the National Housing Bank Act, 1987).

In cases of HFC's which are qualified to do business with the NHB, the NHB has the power to monitor, inspect, and apply all remedies available to deal with other HFC's plus the ability to withdraw approval of the HFC to engage in the NHB refinancing scheme. The withdrawal of the NHB qualification may also jeopardize an HFC's qualification for beneficial tax treatment at the hands of the CBDT.

Adequacy of Current Remedies

Given the current size of the active, classified industry (fewer than two dozen institutions) and the small number of NHB-qualified companies (fewer than ten), regulation and supervision to date has been (and can continue for some time to be) handled on a case-by-case basis. Regular face-to-face contact is taking place in quarterly meetings between the NHB Chairman and senior executive officers of the NHB-qualified companies. These are the companies doing the dominant share of lending in the formal private and joint sector housing finance market today.

In such a personalized environment, **the limited enforcement powers and remedies are likely to be sufficient. NHB's present strategy appears appropriate.** That is, making NHB qualification very attractive, and even essential for long-term survival, through access to the refinancing facility and eligibility for tax benefits
is a strong motivator for institutions to maintain the good will of NHB.

<u>Future Trends</u>

As the Housing Finance Company industry grows, three things are likely to happen. First, the close familiarity between the regulatory and supervisory personnel at the NHB and the various active HFC's will diminish. With this reduction in close and frequent contact there will be a parallel reduction in the NHB staff's knowledge of what various companies are doing.

Second, in this larger, less closely knit industry many institutions will wish to know the bounds within which they can operate without incurring NHB's displeasure. It is also possible that courts of law could rule the NHB must give adequate prior published notice before imposing sanctions against practices it considers unsafe and unsound.

Third, a limited number of institutions will get into serious financial trouble and push the limits of prudent management, exceeding the limits of their operating authority in an effort to recover from prior mistakes and poor investments.

In an industry of 100 institutions, and potentially several hundred companies, regulatory and supervisory options beyond those currently available must be open. Personalized oversight will not be possible in this future environment. However, now is the time the National Housing Bank should consider its future options for establishing guidelines and regulations relating to the four classic areas of risk in financial institutions: credit risk, liquidity risk, interest rate risk, and management risk.

CHAPTER 6

ISSUES AND OPTIONS FOR DEALING WITH RISK

Credit risk is the risk which institutions face when they make loans and face the prospect that the borrower will be unwilling or unable to repay the principal and interest on the loan when due. Additionally, there is risk that the value of the loan's collateral will not be sufficient or available to cover the amount due the lender.

Issue 1. Should the National Housing Bank seek specific powers to issue general directions covering the prudent investment of depositors' funds? That is, should NHB seek authority to issue general regulations covering the asset side of HFC's balance sheets?

It has been the experience of other countries, particularly that of the U.S., that a major risk exposure of institutions is in their assets. Substantial defaults and reductions in real estate values, coupled with the inability of lenders to gain possession of those assets have created great losses for U.S. financial institutions specializing in real estate lending.

There is currently a distinct lack of concern at the NHB and in the lending community over this possibility. The economic forces now at work in India are certainly different from those in western countries. There is a rapidly growing population in India--increasing at rates well above those in western countries. There is a high demand for housing which is currently unmet. The unmet demand can be traced to a shortage of building capacity and limited formal housing finance mechanisms.

These forces indicate pressure exists that will keep real estate values stable or higher for the foreseeable future. But there is still reason for caution. These forces can be diminished over time through the satisfaction of demand in local pockets and through changes in demographic characteristics of certain geographical areas. This has been the experience in the U.S. as real estate values dropped successively in the Midwest, the Southwest, the Northeast, and now California. It would be in the best interests of the financial system to assure that the mechanisms are in place to deal with the risks attendant to similar regional or local changes within India.

Also, the present approach to establishing standards primarily governing institutions' deposit-gathering functions (and then reviewing their investment policies and actions to determine if those actions threaten the repayment of deposits) puts a burden on NHB for analysis of each unique set of investment activities. A more efficient approach which should be considered is to establish general asset investment principles and then let individual HFC's apply for specific waivers from those directives. In addition, knowledge on the part of the public that HFC's must comply with safety and soundness directives for the investment of deposits is likely to increase the depositing public's confidence in these institutions. Finally, the two HFC managers interviewed for this study agreed that NHB should have the power to issue directives concerning the prudent investment of depositor funds.

One might argue that the existence of NHB power to regulate the investment of deposits could discourage the establishment of new HFC's and frustrate NHB's promotional responsibilities. However, it is not the existence of regulatory powers that catches the attention of a regulated industry. It is how the regulator uses those powers. Responsible exercise of the asset regulatory authority is unlikely to deter responsible investors in HFC's. Perhaps those who are discouraged from investing in HFC's once they learn of NHB's regulatory powers and see their responsible use, are those who <u>should</u> be discouraged from investing in enterprises which manage other people's money.

It is a strong recommendation of this report that NHB begin now to seek explicit authority to issue both general and specific directions to all HFC's concerning the prudent investment of depositors' funds. The authority secured at an early date can remain dormant until the industry grows and the need to exercise such authority is more apparent.

One of the first areas which NHB should address in its examination of asset investment powers is the 25% of portfolio which does not have to be invested in housing loans at NHB-qualified companies. Since the 75% of portfolio which must be devoted to housing loans typically earns a narrow margin, any significant losses on imprudent investments of the 25% could quickly wipe out the earnings on the residential loans. **Guidelines covering acceptable investments for the leeway 25% should be considered soon.**

Some U.S. Savings and Loans experienced significant losses through investment of depositor funds in risky ventures outside the housing market. Some of these losses occurred in areas such as junk bonds. However, some state charted companies were allowed to invest in almost any type of loan or business. A wide range of returns on these investments followed.

The width of this range indicates the range of risks involved with such direct investments and the need for regulators to establish reasonable limits on the amounts which might be invested directly in business ventures, in stocks (traded and untraded), speculative financial instruments (similar to futures and options in the U.S. market) and any other asset on HFC might put funds into and where the value has wide fluctuations over relatively short periods of time.

The NHB should also consider adopting diversification rules and guidelines. These rules would address such matters as limits on loans to a single borrower. U.S. regulators consider it risky for a company to have more than a quarter of its capital loaned to any one borrower; some prefer an even lower limit. Also, prudent diversification dictates that institutions should limit loans to owners of structures in a single project.

Another limit which should be considered is the amount of refinancing an NHB-qualified institution can undertake. At present, NHB loans are exempted from the leverage ratio limitations imposed on capital. However, after the refinance scheme has matured and has been in use for an extended period, there will be a necessity for NHB to establish limits as to how much refinancing an HFC can have outstanding at any one time. With no limitations in place, a company could theoretically leverage its capital by an infinite amount.

Capital limitations which specify allowable leverage of between 10 and 15 times capital (depending on the size of the capital base) appear to be adequate and conservative at this time. However, **a basis other than amount of capital should be considered to determine where in that 10 to 15 times capital range a particular HFC should be allowed to operate.** One option would be to allow greater leverage for higher quality loans originated using the most conservative underwriting standards and meeting standard documentation requirements.

There is a rather wide envelope within which prudent residential lending can take place. For instance, a loan for 70% of a property's cost to an individual whose monthly expenditure to service that loan is 20% of his/her income is generally considered to be a prudently underwritten loan. However, a loan with a 50% loan-to-cost (LTC) ratio and a 15% debt-service-to-income figure is even more conservatively underwritten, assuming these ratios are verified with reliable, standard documentation. If an HFC could leverage capital more highly for its investment in the most prudent loans, this encourages the mobilization of funds into the housing finance sector; it lowers the risk of default to the institution; and it encourages standardization of underwriting practices and documentations.

Standardization, of course, is a prerequisite to the development of a fully operating secondary mortgage market. This is an area where NHB has had little time to devote its energies to date. It is also a possible first step which NHB may wish to consider toward the introduction of variable capital requirements. That is, **institutions should, at a future date, be required to put aside more capital if they make loans that are near the edge of the envelope of prudent underwriting than if they make loans which are more conservatively underwritten and documented.**

NHB has the potential to provide strong incentives right now for the use of the most prudent underwriting and documentation standards. One option it should consider is variable lending rates on loans refinanced in the refinancing scheme. It is possible to provide more favorable loan rates or margins for those loans which meet standardization, safest underwriting and complete documentation requirements.

Current underwriting in India is based almost solely on an assessment of the borrower's willingness and ability to repay the indebtedness. There is little or no equity-based lending wherein lenders agree to forego compliance with standard limitations on borrower debt, etc. in those cases where the loan-to-cost ratio of the property is low. In a number of western nations, an equity-based underwriting is common due to the fact that lenders feel well-protected in low LTC defaults. They can foreclose on the collateral property and sell it with a strong likelihood that sufficient funds will be recovered to pay off the borrower's debt.

Since India does not have an efficient and straight-forward foreclosure and sale procedure (see USAID report by David Madway "Revision of India's Foreclosure Laws," February, 1989), reasonable tradeoffs (within the prudent underwriting envelope) between underwriting criteria to measure willingness/ability to repay and an equity base are not now relevant. However, **if legislation pending before the Indian Parliament is passed and a realistic mortgage foreclosure mechanism is established, NHB should consider establishing guidelines which allow lower LTC loans to be refinanced with slightly more liberal limits for such traditional factors as debt coverage ratios or the presence of substantial guarantors.**

The NHB should also seek specific legislative authority to establish underwriting and servicing requirements on individual mortgage loans. Such authority should be applicable to all HFC's (in the form of Directions) or to specific instances of companies which engage in unsafe and unsound underwriting practices. **Even prior to receiving the legislated authority, the NHB should consider writing these standards into individual loan agreements with NHB-qualified institutions.**

Such standard should address the traditional mortgage loan underwriting criteria such as appropriate LTC ratios (loans with LTC's over 80% should be seriously discouraged). Other factors such as acceptable debt-service ratios should also be spelled out.

These actions would serve as a basis for safe and sound mortgage lending and protect NHB funds. However, they will also serve as the first steps in setting underwriting standards which are necessary for the functioning of a secondary mortgage market (see Raymond J. Struyk's USAID report "A Secondary Mortgage Market for India," June, 1990).

The lenders interviewed in connection with this report and those interviewed by Wilson (1989) used conservative LTC values in underwriting their loans (all under 80% and most under 70%). However, the debt-service ratios (as high as 50%) were quite risky by U.S. standards. It is possible that cultural differences in the two countries (attitudes toward debt and bankruptcy, etc.) make such high ratios less risky.

However, a combination of these liberal debt service ratios and the problems with foreclosure on properties means that debt collection actions should be both timely and vigorous. **Thus NHB should consider as part of its promotional and educational responsibility the conduct of seminars for HFC managers covering sound loan servicing and debt collection techniques.** Wilson (1988) found significant differences among some of the institutions she visited in debt collection effectiveness.

<u>Issue 2.</u> What added measures are need to control liquidity risk?

The June 26, 1989, Directions require all HFC's to maintain a liquidity ratio of 10%. This is a conservative figure given that these institutions have no demand deposits and deposit maturities range from 24 to 84 months.

Also, the National Housing Bank has the authority to act as lender of last resort for HFC's. This lending role has been used on at least one occasion to date. In addition, the refinancing scheme provided by the NHB is a valuable tool for assuring a NHB-qualified HFC's liquidity. (As noted at an early point in this report, there will soon be a need to establish a limit on the amount of refinancing any one HFC can have outstanding at any one time.)

The NHB is a logical home for a secondary market facility. Such a market can provide substantial liquidity to mortgage lenders. The feasibility of a secondary market has been discussed by Raymond J. Struyk (1990). The underwriting and documentation standardization recommendations covered earlier in this August, 1990 report would go a long way toward encouraging and preparing the HFC industry to originate the high quality mortgages and standard documents an active secondary market requires.

One option to increase the liquidity tools available to HFC's is to expand the parameters on loans eligible for the refinancing scheme. Some loosening of restrictions on that program has already taken place.

This report does not recommend implementation of liquidity options beyond those currently being considered or a change in the 10% liquidity requirement.

Issue 3. To what extent should interest rate risk be monitored and controlled?

The NHB has the legislative authority to require whatever reports it deems appropriate for it to monitor any aspect of HFC operations. Thus the question of monitoring interest rate risk is really one of how closely the NHB chooses to track and direct HFC's in risk mitigation strategies.

Now the NHB collects information on rates and maturities of deposits in its periodic reports. However, there is no matching with the maturities of its loans. Thus there is no way of computing or estimating interest rate gap or portfolio duration, the two most common interest rate risk measures.

Interest rates in the Indian economy are regulated and have been stable over a period of several years. The same conditions existed in the United States during the 1960's and early 1970's. A change in policy on the part of the U.S. Federal Reserve Board in the late 1970's completely altered the way in which interest rates were determined. Housing finance institutions which held long-term assets were badly damaged as short-term rates rose and long-term asset yields became inadequate to cover liability costs. The point is this: policies of interest-rate-setting bodies can change. The prudent course is to monitor and control interest rate risk--even in the most stable rate environments.

The requirement that Housing Finance Companies in India offer deposits with terms between 24 and 84 months has been justified by regulators, in part, on the basis of keeping the maturities of liabilities long. This requirement does help reduce some of the interest rate risk of HFC's.

However, it imposes a heavy cost. Substantial numbers of short-term accounts cannot be accepted. The "core" portions of short-term accounts are the balances that tend to be stable regardless of the fluctuations of interest rates over a rather wide range. Mortgage loans can be made with this core portion of short-term deposits without incurring serious interest rate risk.

It should be noted that nondeposit borrowings of HFC's can be in short maturity instruments. Care should be taken on the part of asset/liability managers to keep these liabilities relatively long term to match maturities of their housing loan assets.

Mortgages in India have maturities of seven to 20 years. However, the average length of life of a mortgage is somewhat less than its maturity due to the fact that many borrowers prepay their loans--not because they sell their homes, but because there is a strong ethic to pay off these loans. Homes tend to stay in the same family unit for years, and many homes are merely upgraded and modified as more members of the extended families move in with the original home owners. (See Struyk, Kenney and Friedman's "Mortgage Prepayment in India," 1988.)

Thus HFC's are exposed to a potentially high level of interest rate risk, which is not being measured. Also, there is no financial hedging facility to provide synthetic protection against interest rate moves.

At a minimum, **regular reports to the NHB should be altered to show the distributions of maturities on both assets and liabilities so that simple interest rate gap measures can be calculated.** Many institutions may not be sophisticated enough to understand more complex measures like duration. But requiring all institutions to submit gap reports gives the NHB as basis for dialogue with HFC's on the subject of interest rate risk.

By asking for this maturity distribution of assets and liabilities early in the life of the HFC industry, the National Housing Bank will encourage the industry to establish systems to track this risk at its inception. One of the greatest delays and hindrances to setting up interest rate risk monitoring in U.S. financial institutions was the complaint from S&L's that they did not have the information or the systems to generate this information on their large, already-existing portfolios. The NHB can avoid this problem by requiring interest rate risk information early on.

<u>Issue 4.</u> Does NHB have adequate powers and ability to control the risk that unscrupulous or incompetent individuals will obtain control over deposit-taking institutions? That is, can NHB appropriately control management risk?

There are four points at which inappropriate parties might possibly be screened out of involvement in the ownership or management of HFC's. They are:

- At the time of registration with the Registrar of Companies.
- When an institution is classified as an HFC by the National Housing Bank.
- At the point when an HFC becomes NHB-qualified.
- During the operation of an HFC at any point in the monitoring or inspection of a company where findings indicate the need for action against management.

Obviously, the best place to screen out inappropriate parties is at the initial stages of approval. Unfortunately, the inappropriate parties are not obviously unscrupulous or incompetent at the application stage.

It is primarily at the third and fourth points listed above that NHB has an opportunity to review management risk--especially in the case of NHB-qualified institutions where the NHB has the power to disapprove the institutions's CEO. While some evidence of incompetence or unscrupulous behavior may be discovered in early reviews, **this report does not recommend moving the initial review of management up to the registration or classification points.** Those two designations do not carry significant distinction at this time to justify altering the present approval policies. But the NHB-qualified designation especially if institutions are allowed to advertise such a designation--implies a much closer inspection by

NHB, which is both possible and planned. Thus initial management review at the time an HFC applies to do business with NHB is adequate.

As the HFC industry grows, it will become more important for the NHB to have power to halt unsafe and unsound activities on the part of HFC managements--even those that have been previously qualified for business with NHB. Such power should be independent of court actions, which may become protracted and time consuming. Much mischief can occur in the time it takes courts to resolve issues, and great losses can accrue to depositors.

Therefore, **at a future date, the NHB should be authorized to take firm and rapid actions against officers and/or directors of HFC's who are abusing their positions.** Such actions should be scaled in escalating stages and could include:

- Reprimands--cumulative numbers of these reprimands could be tracked and result in eventual dismissal or debarment from the industry.
- Removal of the offending party from involvement in certain phases of an HFC's activities.
- Removal of a party from his/her post as an officer or director of an HFC.
- Conservatorship of the entire institution.

The NHB should begin immediately to seek authorization to invoke these types of sanctions and to define the conditions under which each would be used.

Issue 5. Should construction companies own HFC's? Provision 5 of the Guidelines requires that construction companies be barred from ownership or management of HFC's approved to do business with NHB.

This is a prudent and conservative provision and should not be changed. The most egregious cases of abuse of fiduciary responsibility in operations of savings and loans in the U.S. occurred in situations where real estate developers achieved control of depository institutions. This appears to have resulted from three conditions:

1) There is a temptation for such controlling parties to finance construction projects owned by their other companies. The financial institution tends to become the lender of last resort for troubled projects.

2) Owners and managers of construction/development companies tend to have entrepreneurial, risk-taking business attitudes which are consistent with

investment of capital from sophisticated investors but inconsistent with the fiduciary responsibilities which financial institutions owe to small depositors.

3) The construction/development business seems to be one in which many survivors operate continuously at the margins of rules, regulations and codes. Managers from this environment have difficulty adjusting the operations in a more strict regulatory setting.

It is possible that these three conditions do not exist in the Indian construction/development sector. However, interviews with Indian businessmen suggest that they do.

Provision 5 of the NHB guidelines indicates that an equity interest on the part of a scheduled bank may cause NHB to relax the restriction on construction company participation. An additional option might be to allow construction company ownership and participation if there are strict limitations on the investment of funds in:

1. Projects or developments in which the construction company has more than a 10% interest.

2. Construction projects of all types, i.e. limits below the 25% leeway currently allowed. For instance, investments in any one project may be limited to one-quarter to one-third of an HFC's capital.

3. Projects in which related parties own more than a 10% interest.

Even such limitations as these might not protect against two or more friendly developers' cooperating in: a) having their controlled HFC's lend to the others projects, and b) "look the other way" and ignore adequate independent underwriting on these projects.

CHAPTER 7
CLOSURE AND DEPOSIT INSURANCE

<u>Closure and Winding Up</u>

Under present authorities, NHB has no powers of closure. Institutions to be closed are dealt with like any other company which is forced into receivership or winding up proceedings. NHB does have the power to prohibit the taking of deposits. Depending on whether the prohibition on deposit taking relates to just new deposits or to all deposits on hand, that power may be the equivalent of closing down an HFC.

There should be some clarification of this power. Also, the power to prohibit deposit taking is applicable at present to cases where an HFC violates deposit-taking directions. This power should be extended to unsafe and unsound operations of all types, including risky investment practices.

If NHB's regulatory and supervisory role is to protect the depositor's interest, it needs power beyond the slow-moving winding up procedures of the courts. When a financial institution begins to lose money, there is a tendency for its management to try to earn back its prior loses through investment in higher yielding transactions. These deals, of course, involve greater credit risk and often lead to even greater loss. This cycle of desperation needs to be broken at an early point. A great deal of damage can be done to an institution and its depositors if the managers who created the initial losses are allowed to maintain control during an extended winding up period.

NHB should consider two options in addition to those listed in the previous section. **It should seek authority to facilitate mergers of weak institutions with strong ones**--including providing financial incentives or access to special refinancing provisions to the acquirer. In addition, **NHB should seek authority to appoint a receiver for HFC's in cases of insolvency.** Such receivers would conduct the winding up functions.

It should be noted that most institutions are actually economically insolvent well before their books and records show insolvency. This is due to the failure of traditional accounting techniques to record the real economic substance of transactions involving interest sensitive assets and liabilities. It is also due to the fact that many managers of institutions approaching insolvency are not diligent in recording their losses. When independent parties finally take over the company, they typically find serious losses have not been recognized and that writedowns are necessary. Thus it would be economically more effective if NHB could obtain authority to establish receiverships at institutions prior to their actual reporting of insolvency.

Deposit Insurance

The establishment of a deposit insurance fund should certainly be considered for HFC's. The existence of such a fund would go a long way toward creating depositor confidence and increasing the mobilization of funds for housing.

Complete guarantee of depositors' funds has proven costly in the U.S. experience. Various schemes are now being reviewed to limit the government's obligations under new deposit insurance rules. Some options the government of India might consider could include:

- Limiting the insurance of accounts at any one institution to the amount of deposit insurance premiums that institution has paid into the insurance fund.
- Limiting the insurance to the total of funds collected, allocating insurance funds on a first come, first served basis to the institutions which fail.
- Establishing an assessment mechanism whereby surviving institutions would be billed for the cost of closing and disposing of one of their insolvent competitors.

Other possibilities are, of course, available. However, this broad subject is worthy of a substantial feasibility study in and of itself.

Appendix I

Guidelines for Housing Finance Companies

January 1, 1990

Guidelines for Housing Finance Companies

The National Housing Bank (NHB) has been established from July 9, 1988 under the National Housing Bank Act, 1987 as a principal agency to promote housing finance institutions and to provide financial and other support to them. The NHB is keen that not only more housing finance institutions should come up but also that they should be sound, healthy, viable and cost effective. Accordingly, the NHB has evolved the following guidelines for promotion of *housing finance companies*(HFCs) in the private and joint sectors. Only those HFCs which conform to these guidelines would be eligible for financial support from the NHB.

Organisation and main activity

2. HFC should be a public limited company formed with the main object of carrying on the business of providing long-term finance for construction or purchase of houses in India for residential purposes. It should be engaged <u>only</u> in financial activity. 75% of its lending should be by way of loans for housing.

Minimum paid-up capital requirements

3. HFC should have minimum paid-up capital of Rs.one crore to be subscribed in the following proportions and maintained at all times:

		not less than
i.	Promoters' contribution	30%
ii.	Scheduled banks/public financial institutions/ Government/HFCs approved by the NHB	20%

Note : *a.* If HFC is unable to secure equity participation as stipulated at (ii), promoters' contribution should not be less than 50 per cent of the paid-up capital.

b. Participation by the scheduled banks is subject to directives issued by RBI.

c. Prior approval of the NHB should be obtained before one HFC contributes to the equity of another HFC.

4. On merits of each case, the NHB will consider participating in equity of HFC to the extent of 20 per cent of its paid-up capital.

5. i. HFC's name should not bear any resemblance to the name of any construction company with which promoters of the HFC may be associated.

ii. HFC should not be a subsidiary of a construction company.

iii. HFC should not have or promote, as its subsidiary, a construction company.

iv. Chairman, Managing Director or any whole-time Director of an HFC should not hold any of these offices in a construction company with which HFC's promoters may be associated or vice versa.

NHB may relax, at its discretion, the conditions stipulated in this paragraph in the case of HFCs which have equity participation by scheduled banks etc. mentioned in para **3 (ii)** above.

Board of Directors

6. Normally, the bank/financial institution/HFC/Government having equity participation will have its nominees on the Board of HFC. If for any reason, such Directors are less than two in number, the NHB will have the right to nominate two Directors on the HFC's Board. In the case of HFC which is unable to secure equity participation as stipulated at para **3(ii)**, NHB will have the right to nominate two Directors on HFC's board. The appointment of HFC's Chief

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Executive will also be subject to NHB's prior approval. HFC's Memorandum and Articles of Association should contain a provision to this effect.

Borrowings

7. HFC's total external borrowings whether by way of deposits, issue of debentures/bonds, loans and advances from banks or from financial and other institutions but excluding NHB's refinance, should not exceed **10 to 15 times** their net owned funds i.e. paid-up capital and free reserves less deferred revenue expenditure and intangible assets. The limits will be as below:

Net owned funds	*Total borrowings*
upto Rs. 10 crores	10.0 times
above Rs. 10 crores and upto Rs. 20 crores	12.5 times
above Rs. 20 crores	15.0 times

Credit rating

8. HFC should satisfy such criteria as may be prescribed by the NHB.

Acceptance of deposits

9. HFC should mobilise resources mainly by way of deposits from households with minimal reliance on borrowings from institutions. Since housing loans are for relatively long periods, it is also necessary that there is no undue mismatch between the duration of deposits and the lending portfolio. Under the Housing Finance Companies (NHB) Directions, 1989, issued on June 26, 1989 HFCs can accept a deposit of money from the public repayable after a period of more than twenty four months but not later than eighty four months from the date of acceptance or renewal of such deposit at interest rate not exceeding 14 per cent per annum.

Loans

10. The main objective of promoting HFC's is to make access to institutional finance for home-seekers easier. The bulk of HFC's lending should, therefore, be directly to individuals or groups of individuals. Their motto should be to render quality service to individual households.

Lending rates and margins

11. HFC's interest rates on housing loans and the scale of financing should be as prescribed by the Reserve Bank of India for scheduled commercial banks, which are presently as follows:

Housing loan per individual (in Rupees)	*Rate of Interest p.a.*	*Loan as % of estimated cost* (including cost of land)
upto 20,000	12.5%	80%
20,001 to 50,000	13.5%	75%
50,001 to 1,00,000	14.0%	70%
above 1,00,000	14.5 to 16.0%	65%

Front-end charges

12. Front-end charges including application or registration fee, processing fee, administrative fee, out-of-pocket expenses in connection with technical inspection and any other fee, charge or expense, under whatsoever name, should not exceed 2% of the loan. There should be no minimum amount prescribed under any head. Document registration charges, stamp duty, etc. are not included in the front-end charges.

Administrative cost

13. HFC should aim at keeping its administrative cost as low as possible. In any case, such cost in the long run should not exceed 1.5% of the outstanding loans.

Prepayment charges

14. Normally, no prepayment charges should be levied except in cases where prepayment of loan is on account of sale of the housing unit financed or there is reason to believe that the prepayment is made to secure some undue advantage.

Auditors

15. HFCs, barring Government companies, should obtain prior approval of the NHB before appointing, re-appointing or removing any Auditor or Auditors.

Security for depositors

16. Every HFC should maintain in the form of liquid assets (with a scheduled bank and/or in unencumbered approved securities) at least 10% of its outstanding deposits, on a day to day basis.

Advertisement rules

17. Issue of advertisements soliciting deposits of money from the public is governed by the Non-Banking Financial Companies and Miscellaneous Non-Banking Companies (Advt.) Rules, 1977 made by the Government of India in consultation with the Reserve Bank of India under section 58 A of the Companies Act 1956 (1 of 1956).

Financial assistance from the NHB

18. The NHB extends to eligible HFCs refinance facilities under schemes announced from time to time. At present, the NHB provides 100% refinance in respect of housing loans upto Rs 100,000 for built-up accommodation upto 40 sq. mtrs. 100% refinance is also provided for housing loans upto Rs.30,000 for upgradation and major repairs. Further, the NHB has powers to grant ad-hoc financial assistance to HFCs to meet short-term gaps in resources.

Tax concessions

19. Subject to the approval of the Central Government in each case, a housing finance company is eligible for the following tax concessions:

a. A public company formed and registered in India with the main object of carrying on the business of providing long-term finance for construction or purchase of houses in India for residential purposes, can create a special reserve within an amount not exceeding 40% of the total income and, such a reserve is admissible as a deduction in computing income chargeable to income tax under the head Profits & Gains of Business or Profession vide Section 36-(i)(viii) of the Income Tax Act.

b. Investments in the new equity shares of such companies are an eligible deduction up to 50% of the cost of such shares under Section 80-CC of the Income Tax Act.

c. Deposits with or investments in any bonds issued by such companies from income derived from property held under trust wholly for charitable or religious purposes, qualifies as an eligible mode of investment under Section 11(5) of the Income Tax Act.

d. Interest on deposits with such companies qualifies for deduction under Section 80-L of the Income Tax Act.

e. Repayment of the amount borrowed from any such company for housing purposes is eligible for deduction under Section 80-C of the Income Tax Act up to the limit of Rs. 10,000.

f. Deposits made with such companies are exempt from Wealth Tax under Section 5(1)(xxvii) of the Wealth Tax Act.

20. Further information and clarification, if any, may be had from the General Manager, National Housing Bank, Bombay Life Building, 45 - VeerNariman Road, Bombay - 400 023.

Dated 1st January 1990

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40

APPENDIX II

TAX BENEFITS TO INDIAN HOUSE OWNERS

The Tax benefits to house owners were taken from a section of "Tax Concessions available to HFC's/Individuals" published by the National Housing Bank.

- **Income Tax Act, 1961**

  -- A concession of Rs. 3600 is allowed for the newly constructed houses for a period of five years from the date of completion of such construction, if the property is let out and used for residential purposes.

  -- Where the residential house property is acquired, constructed or renewed, etc. from out of the borrowed funds, the amount of interest accrued on such borrowings is eligible for deduction as under: 1) In the case the house so acquired etc., is used for self residential purposes a maximum of Rs. 5000 2) In case the house so acquired etc., is let out, the actual amount payable.

- **Long Term Capital Gain**

  -- The long term capital gain arising on a residential house property where the tax payer owns only one such house is fully exempt from income tax u/s 53 if the sale consideration does not exceed Rs. 2.0 lakhs. The long term capital gains are fully exempt from income tax u/s 54 if they are fully invested in another residential house within one year before or two years after the sale in the purchase of a new house or within three years after the sale in the construction of such house. If a taxpayer does not own a residential house and has a long term capital gain from any capital assets and invest the net sales proceeds in the purchase or construction of one residential house, then the entire long term capital gains would be exempt from income tax u/s 54F. Long term capital gain arising out of the sale of residential house property also qualifies for deduction under section 48(2) as under:

  (i) first Rs. 10,000 in full, and

  (ii) the balance @50%.

  -- Repayment of the amount borrowed by an assessee from a housing finance company, his employer, NHB, etc. qualifies for deduction up to Rs. 10,000.

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Other

Additional materials used in the preparation of this report included:

The National Housing Bank Act, 1987

National Housing Bank General Regulations, 1988

Housing Finance Company (NHB) Directions, 1989

Guidelines for Housing Finance Companies, January 1990

Other materials included memoranda, policies, underwriting guides and manuals which would be considered proprietary by those supplying them. Thus these items are not listed here.