Housing Finance in Indian Financial System

Script

1. Introduction

1. Meaning

- Housing is one of the basic and essential needs of human beings. A better house leads to better standard of living of the people, which in turns makes their life healthy and happy.
- Realizing the importance of housing in the national economy, institutional arrangements have been made during recent past for the provision of housing finance in India.

"Housing finance brings together complex and multi-sector issues that are driven by constantly changing local features, such as a country's legal environment or culture, economic makeup, regulatory environment, or political system"

(2009) Loïc Chiquier and Michael Lea, Housing Finance Policy in Emerging Markets, p. xxx.

Let us see in detail the structure of housing finance in India.

2. Rise of housing finance in India

- Life Insurance Corporation has traditionally been providing housing loans to its policy holders and housing finance companies have also been engaged in such financing.
- In the year 1977, housing development finance corporation (HDFC) was established with the main object to provide finance for acquiring house.
- And housing and urban development Corporation (HUDCO) in the public sector gave a boost to housing finance in India.
- During recent years commercial banks have been permitted to enter into this filed.
- The two insurance institutions have also set up their housing financing subsidiaries.

2. National Housing Bank

The establishment of National housing bank (NHB) in 1987 as the apex bank in this filed was significant step towards developing a sound and efficient housing finance system in India.

- It is a wholly owned subsidiary of the RBI.
- Its primary responsibility is to promote and develop specialized financial institution for

mobilization of resources and extending credit for housing.

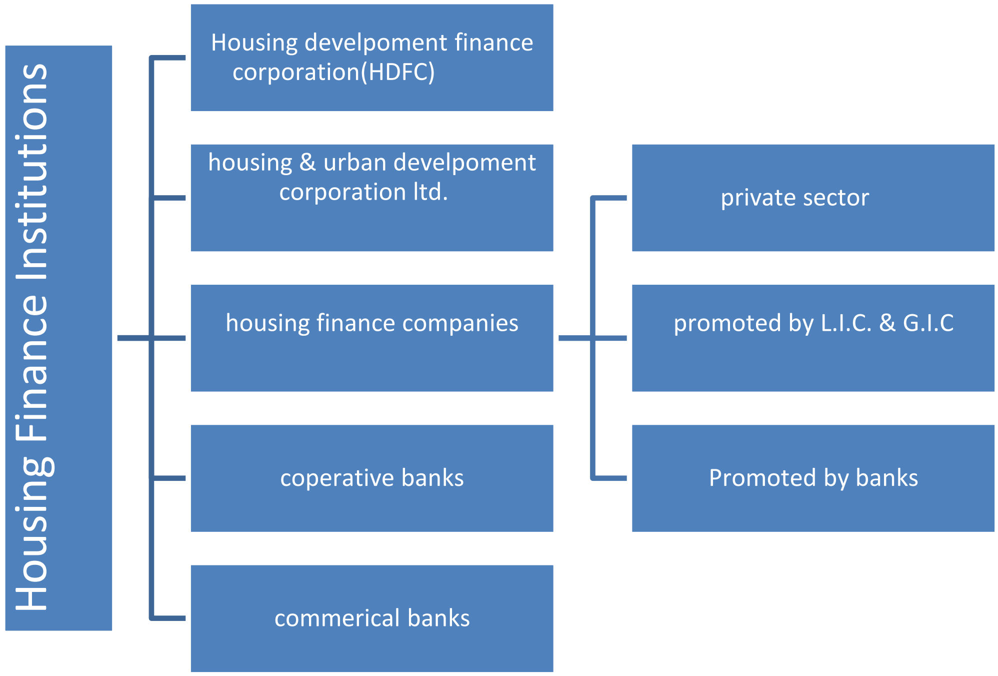
- Through these financing to help the economically weaker section of the society.
- It issue guidelines to the all the institutions and agencies connected with housing.
- It also empowered to borrow in foreign currency from banks or financial institutions in India and abroad.
- Various powers are being provided by the RBI to regulate the housing sector in India.

Role of NHB in housing finance:

1. To regulate and supervise housing finance companies/ institute
2. To promote housing financial companies/Institutes.
3. Housing project finance
4. Refinancing to housing financial institutions
5. Secondary mortgage market

- Housing finance institutions

  In India, a number of institutions have been setup to provide housing finance as shown in the following chart:



3. Fixing the amount of loan

There are certain factors which are essential for home loans:

(a) Factors affecting loan agreement:

- The estimated value of the property for which loan is required.
- Title deeds of the applicant of home loan must be clear.
- The time period for which the loan is required.
- Source of income and earning capacity.
- Any other unpaid loans at the time of application for home loans.

(b) Factors affecting interest burden :

In home loans, two types of interest can be charged. One is floating which means adjustable rate mortgage and second is fixed rate. However, under fixed rates home loan, a clause can be added which provides a right to the HFI to increase the interest rate after the agreed time. The rate of interest of housing or home loan is decided in the basis of the criteria:

- The time period for which the loans is required
- The amount of loan
- Borrowers repayment capacity
- Financier’s cost of providing fund

(c) Mode of repayment of housing loan:

- The most common way for repayment of loan is “equated monthly instalment” which means equal monthly instalments are to be paid by borrower.
- EMI is calculated considering the amount and rate of interest of loan as well as the time period for repayment.
- However, if the borrower is expecting to have reasonable increase in his future income, the instalment may be accordingly fixed.

(d) Other factors:

The HFC fixes the rate of interest for home loan which may be 2-3% lower than PLR which is based on banks cost of funds
The HFC charges an administrative fee of 1% of the loan amount and the procession fees ranging from 0.5% to 1% of the loan amount.

Re- pricing of a loan

Definition

Paying off an existing loan with the proceeds from a new loan, usually of the same size, and using the same property as collateral. In order to decide whether this is worthwhile, the savings in interest must be weighed against the fees associated with refinancing. The difficult part of this calculation is predicting how much the up-front money would be worth when the savings are received.

Other reasons to refinance include reducing the term of a longer mortgage, or switching between a fixed-rate and an adjustable-rate mortgage.

If there are prepayment fees attached to the existing mortgage, refinancing becomes less favourable because of the increased cost to the borrower at the time of the refinancing.

4. Types of interest rate

Fixed interest rate

Fixed interest rate means repayment of home loans in fixed equal instalments over the entire period of the loan. In this case, the interest rate doesn't change with market fluctuations. During the early part of the loan tenure the majority of monthly payments are used to service the interest and the principal is served in the later parts of the tenure.

Benefits

- Interest rate remains fixed irrespective of market conditions
- A fixed-rate home loan is excellent for those who are good at budgeting and want a fixed monthly repayment schedule, which is easy to budget and doesn't fluctuate
- It brings a sense of certainty and security

Drawbacks

- The major drawback with fixed interest rates is that they are usually 1-2.5 percentage points higher than the floating rate home loan.

Secondly, if for any reason the interest rate decreases, the fixed rate home loan doesn't get the benefit of reduced rates and the borrower has to repay the same amount every time. Another area of concern is whether the fixed rate home loan is fixed for the entire tenure or only for a few years. This has to be cross-checked with the bank while taking the home loan. A fixed home loan, which can be changed every few years, will definitely wipe out the very spirit of such a loan. Experts agree on the fact fixed rates are a better option if the economic scenario promises a rise in interest rates in the near future.

Floating interest rate

Floating interest rate by name implies that the rate of interest varies with market conditions. Home loans on floating interest rates are tied to a base rate plus a floating element thereof. So, if the base rate varies the floating interest rate also varies.

Benefits

- The biggest benefit with floating rate home loans is that they are cheaper than fixed interest rates. So, if you are getting a floating interest rate of 11.5 per cent while the fixed loan is being offered at 14 per cent, you still save money if the floating interest rate rises by up to 2.5 percentage points.

- Even if the floating rate goes over the fixed rate, it will be for some period of the loan and not the entire tenure. The interest rates will surely fall over a long period and, thus, the floating interest rate brings a lot of savings.

Drawbacks

the drawback with floating interest rates is the uneven nature of monthly installments. This makes it difficult to budget with floating interest rate home loans. As seen in recent times, due to the hike in floating home loan interest rates, the borrowers had to shell out thousands per month extra as their EMIs, throwing their entire budget out of order.

Conclusion

When it comes to choosing the interest rate, a majority of home loan borrowers go for floating rates.

Finally, it is up to the borrower to decide what suits him best. Before taking a decision, it is advisable for the borrower to compare home loans from different institutions in detail, including the various parameters set forth. If certainty and security are prime considerations, a fixed rate home loan will be the best. However, it won't come without the premium on interest rates.

5. Problems of housing finance

- Rapid population growth coupled with rapidly increasing urbanization and widespread poverty have created a serious shelter problem in India, contributing to the proliferation of slums, increased demand for urban infrastructure and services, and declining quality of life for low-income households.
- With the exception of government-sponsored housing programmes, formal housing finance institutions (HFIs) are reluctant to lend to low-income households because of factors such as the relatively high transaction and servicing costs, irregular and unsubstantiated income sources, and the absence of collateral in the form of title to property.

- The Role of Government
- The Government has adopted the role of a facilitator instead of a provider.
- One of the major obstacles facing the public initiative for housing is the unrestrained population explosion. Further, the constant migration of people from rural areas to cities in search of jobs puts housing and basic services in the urban areas under considerable strain.
- The facilitating role of the government and other financial institutions along with private intervention in facilitating finance to address the housing needs of the society is an indication of the significance of the sector in overall development of the economy

Objectives

You will be able to learn following by studying this lecture:

1. Meaning and rise of HF in India.
2. NHB and HFIs.
3. Fixing the amount of loans.
4. Re-pricing of loans.
5. Fixed v/s floating rate.

Summary

1. Housing finance is a finance which is available for housing in financial system.
2. In the year 1977, housing development finance corporation (HDFC) was established with the main object to provide finance for acquiring house.
3. The establishment of National housing bank (NHB) in 1987 as the apex bank in this filed was significant step towards developing a sound and efficient housing finance system in India.
4. The most common way for repayment of loan is "equated monthly instalment" which means equal monthly instalments are to be paid by borrower.
5. Fixed interest rate means repayment of home loans in fixed equal instalments over the entire period of the loan.
6. Floating interest rate by name implies that the rate of interest varies with market conditions.