India: Heading Toward a Liberalized and Integrated Housing Finance System

by Douglas B. Diamond and Ritu Nayyar-Stone

INTRODUCTION AND SUMMARY

Post-colonial India was traditionally a heavily planned and regulated economy with predominately directed investment flows. The financial sector was subject to a variety of allocation and interest rate regulations and only in the past decade has real progress been made in deregulation. Housing was not considered a priority sector and, in fact, was looked upon as a social good. Priority was given to the production sectors such as industry and trade. In this environment, investment in low- and moderate-income (LMI) housing was directed through the Housing and Urban Development Corporation (HUDCO), a government-owned entity. In addition, a number of self help nongovernmental organizations (NGOs) arose that, initially, operated at very modest levels of activities.

India's first private-sector, retail housing finance institution, the Housing Development Finance Corporation (HDFC), was formed in 1978. Until then, there was effectively no market-rate housing finance available. HDFC steadily grew into a major force in the sector, pioneering the businesses of private lending at market rates, and raising funds despite the controlled credit allocation structure in the country. Other private sector competitors to HDFC began to appear in 1983. In 1988, an apex institution, the National Housing Bank (NHB) was created.[1]

Douglas Diamond is an independent consultant. Ritu Nayyar-Stone is a Research Associate with the Urban Institute.

In the early 1990s, there were essentially three strands of financing flowing into LMI housing. The first and largest was the continuing flow from HUDCO to state and local housing boards to be used in developing large tracts of land to be allocated at below-market prices and accompanied by some financing facilities, also at below market rates. The major problem with this process was not just the nonsustainability of the pricing and rates, but the high degree of political intervention and default that was tolerated.

The second was a significant amount of lending to moderate-income households by housing finance companies (HFCs), which were required by NHB to cross subsidize small loans by charging higher rates on larger loans. Although there was evidence that many of these lower-rate, smaller loans were taken by relatively higher-income households, moderate-income borrowers did receive some benefit from this system. On the other hand, there was an incentive for HFCs to avoid such borrowers.

The third was a flow of funds and technical assistance to NGOs. These amounts remained small and most such institutions struggled under the burden of limited management capacity.

From 1993 onward, the pace of deregulation has picked up. There was a slowing of the growth of NHB refinance, which had supported the cross subsidization process by HFCs. A shift in fund raising efforts towards the attraction of fixed deposits at market rates from the public eliminated the capacity of private HFCs to continue cross subsidizing.[2] This shift took place within the context, and as a part, of a movement towards gradually deregulating and privatizing the financial sector. Interest rates of all kinds were allowed to be freely set and more and more lenders and borrowers accessed a free financial marketplace for funding, rather than a political marketplace of directed credit.

The housing finance sector has recently reached a major turning point, with deregulation proceeding to the point that new categories of market-rate lenders have appeared —banks, the Industrial Credit and Investment Corporation in India (ICICI), Industrial Development Bank of India (IDBI), even the state-owned mutual fund company, Unit Trust of India (UTI). Lending to higher-income groups has become very dynamic.

This is a first and very important step in a process of introducing real competition and eventually, greater pressure for going "downmarket" to LMI lending on a larger scale.

Meanwhile, there has been steady growth in the access to donor funds (USAID, KfW (Germany), and the ADB (Asian Development Bank)) for channeling through HFCs and NGOs for financing LMI households.[3] Even though most NGO activity has not been directly channeled at housing (rather it has been directed at income generation), they have been able to tap into external sources of funding and undertake some amount of innovative housing finance. This may expand as institutional capacity expands.

LMI LENDING MECHANISMS IN INDIA

Housing Finance Companies

The initial success of the HFC sector was due to opportunities left open to it by the restrictions imposed on the banking sector. Most of the 29 HFCs approved by NHB are sponsored by banks or insurance companies. These institutions chose to offer housing finance in a separate institutional structure because it avoided banking-sector restrictions (and also because the banks, due to these restrictions, did not pursue consumer credit of any kind).

However, the first and largest HFC, HDFC, was not related directly to any other financial institution. It was, thus, free of government control and pioneered a corporate culture and lending process that allowed it to grow steadily and challenge the limitations on the sector. It benefited from significant donor support, often with accompanying requirements of targeting funds toward LMI housing. From the beginning, it cross subsidized its lending by loan size, which was a policy that could be aggressively pursued while rates were regulated and competition limited.

HDFC remains the dominant provider of home mortgage loans in India with over half of the overall market. To survive and grow in a market dominated by directed credit, it had to develop a wide variety of funding sources, ranging from tapping directed credit available from the Life Insurance Company of India, banks and other institutions, to raising corporate, institutional and household deposits; marketing bonds to trusts; tapping donors of all kinds; and even offering a contract-savings plan, as well as going frequently to the growing stock market for equity infusions.

HDFC caters to individuals from all income levels who have reliable enough income to be able to confidently repay a loan over a reasonably long period of time (up to 15 years) out of their own future earnings. It has maintained a loan recovery rate of 99%, and operates on margins that are unusually thin for a developing country, about 1.5% to 2.0%.

As is the case in every country, this means that a majority of the housing finance borrowers in India are middle- and upper-income households. A study conducted in 1993 under USAID's housing finance program in India found that 16% of the total loan volume of Rs.14.5 billion was sanctioned to households with incomes below the median income of Rs.2800 per month in 1991-92.[4] Considering that this median income level was only about $100 per month, and, in many emerging economies, there is no market-rate housing finance at all or none received by below-median income households, this result was actually quite striking. However, even this lending was primarily in the context of employer sponsored and guaranteed lending programs.

HFC Lending to LMI Households via Donor Funds

As in most emerging economies, the general perception is that lower-income borrowers pose both greater credit risk and higher servicing costs to lenders, and thus Indian HFCs prefer to concentrate market-rate lending to middle-income groups. However, subsidized access to funding from donors, coupled with targeting requirements, has caused some channeling of funds to LMI households. The best example has been the channeling of funds by Kfw (Germany) through HDFC to NGOs specifically for low-income housing loans. The KfW line of credit to HDFC was available at 6% per annum and disbursed to beneficiaries at 7.25% per annum to be repaid over 22 years. The margin was smaller than normal for HDFC, but the NGOs were bearing most of the costs and risks and the low rate meant that the burden of repayment was lower.

USAID's housing finance program, which included a housing guarantee (HG) program comprised of a $125 million HG loan in the 1980s, was targeted 100% to median- and below-median-income households. There was no significant subsidy associated with these funds and it is not clear the extent to which the targeting of these funds were influenced by the program requirements.

The Asian Development Bank (ADB) decided to try to play a role in LMI housing lending and initiated a Housing Finance Project in India in 1997. One of its main objectives was to increase access to the housing finance system by truly low-income households through expanding linkages between HFCs and community-based finance institutions (CDFIs). In addition, it wanted to encourage innovative projects for low-income housing. The project was implemented through refinance facilities for each of three borrowers: NHB, HUDCO and HDFC.

It is interesting to note that both NHB and HDFC dropped their loan allocation to NGOs and toward slum improvement and low-income housing projects. Only HUDCO was able to allocate its funding as initially designated.

There were several reasons for this lack of follow-through. From the side of the intermediaries, the obstacles included:

1. The difficulty for the intermediaries to fully understand the financial and nonfinancial operations of the community-based financial institutions (CDFIs) and other NGOs, and thus assess their creditworthiness.

2. The difficulty of assessing the creditworthiness of the end users, the CBFI/NGO members, by the normal standards emphasizing collateral requirements, including land titles, and loan security versus the loan servicing capacity of the borrowers.

3. Conflicts over basic design issues, such as the appropriateness of long-term mortgage lending for finished housing versus the smaller, short-term loans for incremental housing usually desired by low-income families, as well as the continuing belief that lending to low-income households can only be done at below-market rates.

The CDFIs also had concerns. Due to the prevalence of grants and subsidized funds in the sector, many CDFIs believe that regular HFC lending is at rates that are unaffordable by their members. In addition, they perceive that HFCs are overly concerned with loan security and collateral requirements, that they charge too many fees, and that the loan approval and disbursement process is too lengthy. The net effect is there seems to remain a large knowledge and functional gap between HFCs and CDFIs regarding the requirements of HFCs for making such loans, and the operational necessities of the CDFIs to successfully borrow funds and lend to their members. It is not clear that this gap can be bridged.

HUDCO has made a substantial number of loans to CDFIs/NGOs. However, the scheme also faced similar problems. To resolve these problems, HUDCO established a Working Group in 1999 to review the existing system and make recommendations to streamline and expand the program. Their recommendations included:

- Separate application forms for CDFIs/NGOs.

- Separate appraisal forms.

- Single window clearance by community development specialists/regional chiefs in the field (for loans up to Rs.1 million) and by a multidisciplinary team at the home office for loans greater than Rs.1 million.

- Establishment of data bases and viable cost recovery systems by CDFIs/NGOs;

- Development of a special MIS software for CDFIs/NGOs to be made available free of cost.

- Annual conferences to share experiences and focus on the means to improve lending systems.

The ADB project was designed to also support investment in innovative and low-income housing and slum improvement projects, such as workshed-cum-housing and slum networking. However, there is only one loan for each type of project. Due to the complexity of these projects, they are necessarily slow moving and could not absorb large amounts of funds over the short time period envisioned for disbursements under the project.

HUDCO as a Wholesale LMI Funder

HUDCO is the only HFC with a special mandate to serve households below the median income. With its emphasis on the poor, HUDCO targets 55% of its housing finance to the low-income group and "weaker sections." It also cross subsidizes the interest rates to the low-income groups, and gives them a longer repayment period.

HUDCO is basically a wholesale funder of state and local housing boards, channeling approximately 98% of its loans and advances to these agencies. Unfortunately, according to the report of the "Working Group on Urban Housing for the Ninth Five-Year Plan," most of these agencies have serious problems.

- They often do not target their activities to lower-income groups.

- Due to poor demand assessment and project inefficiencies, large amounts of resources have ended up locked up in unsold property and housing units.

- The inefficiencies are aggravated by pervasive state controls on most aspects of functioning of housing agencies, and political directions on estate management and project implementation.

One result is that the loan portfolios of these agencies are full of defaults, and some of the loans to them from HUDCO are themselves nonperforming (but not classified as such because they are guaranteed by the state government). In other words, the central government does provide a large amount of funding through state and local government organs for LMI housing. However, the targeting and accountability for this funding is very poor. Despite this, the political usefulness of the status quo has prevented any serious reform of the process so far.

There are also some issues involving HUDCO's programs. Public agencies being funded by HUDCO have found it difficult to provide housing within the cost ceilings imposed by HUDCO. Another criticism leveled at HUDCO is that it does not pay adequate attention to developing a viable LMI finance system (Mehta, 1994). For example, the ADB-sponsored schemes to provide loan assistance to NGOs for housing projects was on a pilot basis only, and focused on specific projects and not on creating a steady flow of such lending.

CDFIs and NGOs Offering Housing Microfinance

Although there are a large number of NGOs working in the urban sector in India, most do not have any experience with housing and/or savings or credit operations. However, a few have attempted to provide housing finance to low-income families through innovative projects and CDFIs. They have devised flexible repayment schedules, used a variety of collateral or relied on peer group pressures for loan repayments. These activities, though, are generally confined to small communities within a particular city. Also, the housing activities have been quite limited in scale and scope, especially as compared with need.

Most such efforts have focused on what can be called microfinance for housing. As discussed in the introductory article, we have distinguished between micro lending for housing and LMI lending. While this distinction is somewhat arbitrary, there are real differences. First, microloans are generally smaller than LMI loans, partly because of the lower-income level of the borrowers, but also partly because of the short maturities and other terms of the loans. In addition, microloans are usually underwritten in somewhat different ways. They are frequently unsecured. If they are secured, it is (1) with savings deposits and valuables (such as gold jewelry in India) or (2) with group guarantees. Since the borrowers are generally informally employed, pension fund collateral (such as used in South Africa) or payroll deduction is not an option.

SEWA Bank in India is an excellent example of a decision made by an NGO to facilitate finance in a formal manner—both lending and deposit taking—as a crucial adjunct to the other activities carried out by SEWA and its other sister organizations. SEWA Bank is a registered bank, permitted to make loans, accept deposits, and perform all normal banking services. SEWA Bank was established in 1974 at the initiative of 4000 SEWA members who each contributed Rs.10 (about $1 at the time) as share capital.[5]

The bank has enjoyed steady growth, which has accelerated since the liberalization of financial policies beginning in the early 1990s. There are nearly 90,000 depositors, and the bank operates profitably. Unlike most NGOs, SEWA has never received a grant; its equity stems entirely from its members, all of whom are very low-income working women. Thus, SEWA is financially self-sustaining, and because of its large number of depositors, has not felt pressure to seek outside sources of finance.

SEWA offers the following loan products:

- Unsecured loans, using guarantors as "moral security," which is the most common type of loan.
- Secured loans, using savings deposits as collateral (the loan can equal up to 85% of fixed deposits or up to 65% of the value of gold jewelry).

Both secured and unsecured loans are for a maximum three-year term, a maximum amount of Rs. 25,000, have monthly repayments, and as of November 1998, had an interest rate of 17%. Housing features prominently in the loan portfolio. Because many microenterprises are based in the home, housing loans are considered key to business expansion. Many women have used the home repair loans to add electricity and indoor plumbing to their homes, features that can greatly enhance productivity. As of November 1998, SEWA had 12,548 housing loans outstanding, representing 46.6% of its portfolio.[6] Overdue payments are fairly common—about 40% of the portfolio has some outstanding overdue payments. However, long-term delinquency, and the resultant legal action, is rare; as of March 1998, SEWA had made no loan write-offs.

SEWA Bank's operations provide several indications for how to do such business:

- **Dedicated financial capacity.** SEWA Bank is an example of a financial institution formed to sustain and complement the activities of its NGO founder. Without a financial sister institution or partner, NGOs have generally found it difficult to lend at scale on a sustainable basis.
- **Financial partner to NGO goals.** Many NGOs do not wish to leave their spiritual foundations as project developers, community organizers, lobbyists for the poor, labor union partners, and so forth. In these cases, it is crucial to form a separate financial arm, if financing at scale on a sustainable basis in important to further the goals.
- **Savings as crucial input to both equity and loan collateral.** SEWA's financial success is dependent on its emphasis—original and continuing—on savings accounts. Its savings operations exceed its loans by a ratio of 10:1 in both number and value. Deposits plus shares contribute 83% of the bank's capital, and excess savings are invested in financial instruments.
- **Financially self-sustaining.** Many similar microlending institutions require grants to cover costs. As noted, SEWA has never received a grant; some cross subsidization exists as SEWA union leaders help mobilize savers and screen prospective borrowers.

- **Women-based development.** Women as both savers and borrowers have proven themselves to be valuable customers and NGO members.

Another approach has been taken by SPARC (Society for the Promotion of Area Resource Centers). SPARC has in recent years become one of the best known NGOs working on housing issues for the poorest of the poor—pavement dwellers and slum dwellers in India. Its path has differed from that of SEWA and SEWA Bank in that it did not initially create a sister financial institution but rather has sought credit and savings facilities in a wide variety of approaches, beginning with small savings groups. SPARC works within an association of NGOs and CBOs, and it has pioneered philosophies regarding communities as stakeholders, the core importance of savings groups, women as borrowers, and group lending and guarantees.

Initially, in order to expand the finance for its housing development activities, SPARC obtained lines of credit from HUDCO and HDFC. Although there is still a line of credit from HUDCO, this has not offered either the desired scale or flexibility. Instead, SPARC has focused on moving beyond a project-by-project focus and is reaching out for more innovative means of attaining "scale" in funding.[7] These new efforts are described below, following an overview of SPARC's goals and lending activities.

As an NGO, SPARC's main focus has been on building and strengthening a community's own organizing potential, especially with women's participation. To this end, SPARC also recognized the need to develop linkages with other community-based organizations. SPARC collaborates actively with the National Slum Dwellers' Federation (NSDF), and has also formed a federation of women's collectives, called Mahila Milan (whose main activity is the Crisis Credit Scheme). The three-way alliance of SPARC, NSDF and Mahila Milan presents possibilities for useful linkages between community-based organizations and professionally staffed NGOs. Their main focus has been: (1) access to land and regularization of slum areas and (2) evolving a community-based financial system that enables women to be free of the moneylenders' trap for crisis credit.

SPARC bases its housing development projects on the joint involvement of three additional parties: (1) the central or state government must provide the land, (2) the municipal government provides the infrastructure and (3) the people build their houses using their savings and housing loans.

Savings schemes are at the core of the operations of SPARC and its affiliates. The first scheme was the crisis credit approach of the women's collectives, which belong to Mahila Milan, in which very small amounts are saved by poor women. While this cannot meet the need for capital for housing, on a group lending basis, it provides for cash requirements. SPARC now promotes savings schemes for housing, which in turn, may provide the collateral for a housing loan.

SPARC's housing finance activities focus on two kinds of housing development loans:

- **Group loans to community-based cooperatives.** Group loans to cooperatives for construction of new housing. Community-based group loans, rather than individual loans, are the logical extension of both SPARC's philosophy and community-based organization.

- **Individual loans for incremental development of existing houses.** These would be offered to members of the collectives under similar terms as the business loans; amounts up to Rs.7000 are available.

As documented in Sheela Patel's report, however, financing arrangements with HUDCO were problematic, often due to excessive regulations, and thus SPARC has continued to seek alternative lines of credit. One important lesson learned, however, has to do with the flexibility required in repayments. SPARC found that in any given month, 20% to 39% of households could not meet repayments. However, the communities generally manage to find ways to solve this problem, including a repayment swap arrangement among households. In the end, however, a fairly high level of credit risk must be accepted as part of lending to the very poor and its funding incorporated into the savings and lending schemes. As noted below, SPARC is now considering establishing a more formal institutional arrangement that will manage savings and credit.[8]

SPARC has recently forged a new financing structure, involving grant funds and a guarantee fund from Homeless International, and a currently local "loan" from Citibank, India. Homeless International, which has assisted SPARC with grant funding in the past, is a United Kingdom-based NGO association, with over 30 members in Asia, Africa, and Latin America.

- First, SPARC has joined the numerous savings groups that work with the NGO partners into a Federation of Savings Groups, which is thereby able to leverage much greater credit. The origination, underwriting, savings and servicing functions are handled by systems developed by the Federation. However, SPARC'S leaders have agonized over what type of "formal," legal institutional structure a financing institution might take—whether a financial institution or some other type under Indian law, a foreign bank in India and an international NGO fund. As a bank, capital requirements would be onerous to keeping costs low. As a non-profit in India, the institution could not take deposits. This institutional dilemma is still under consideration and is a problem faced by NGOs in many countries.

- Second, Citibank, India has provided a loan to SPARC at the prime rate. Clearly, this rate is too low to cover the necessary risks and costs; SPARC and Citibank note that it is partially philanthropic.

- Third, SPARC has a guarantee fund from Homeless International. Homeless International thereby takes the top slice of the risk on Citibank's loan—20%.

- Fourth, until such time as a deposit-taking financial institution is chartered, SPARC invests the members' savings in mutual funds in India.

- Fifth, SPARC is also seeking ways to access off-shore credits.

SEWA Bank, SPARC, and other NGO-linked intermediaries have the following operational profile with respect to credit operations:

- **Short-term loans and savings:** The shorter terms are considered essential for reducing credit risk, due to the likelihood of a disruption in income or expenditure situations over longer terms. In most cases, there is also some attempt to assess the credit worthiness by previous savings and repayment records, though only some of the agencies require a minimum savings period of six to 12 months. Some CDFIs also require a minimum savings balance, ranging from 10% to 33.3% of the loan amount. This assesses the past savings behavior and provides a hedge against default.

- **Loans for different purposes:** Low-income groups require credit for a variety of purposes, ranging from family crises, consumption and income generating activities, to housing and infrastructure services. Of the different CDFIs in India, only SEWA (50%) and the Baroda Citizens Council (66%) show a major proportion of the lending for housing, largely for repairs and upgrade purposes. In some other cases, though, housing loans from other financial institutions have been routed through them. The thrift and credit associations under the Federation of Thrift and Credit Associations (FTCA) have been providing housing loans up to Rs.40,000 for construction.

- **Cost of credit:** Interest rates have ranged from 12% to 36% (when market rates have been 13% to 15%), and are generally tied to the prevailing "market rates." This is in direct contrast to the usual misconceptions about subsidized interest rates on the grounds of affordability.

- **Security for the loan:** A large proportion of the loans are unsecured and based on the direct knowledge of the borrower. In some cases, the personal guarantees of one or two other members are required, especially for larger amounts. In the case of registered financial institutions, like the cooperative societies or banks, the value of unsecured loans cannot exceed Rs.20,000 (about $500). For secured loans, the security is largely in the form of gold or other movable property. Mortgages are not utilized, except when an external financing institution has used the NGO to facilitate lending to the households directly or to their housing cooperative.

- **Default and delinquency:** Cost recovery and default rates vary in NGO-linked CDFIs. The FTCA reports high recovery rates for the primary thrift and credit cooperatives in the range of 95% to 100%, though some had recovery rates of only 75%. However, these rates include non-housing loans as well.

The Urban Cooperative Finance Systems

In addition to the NGO-related CDFIs, there are "cooperative" financial institutions in the urban areas. There are two primary urban cooperative financial institutions:

- Primary cooperative banks, also known as urban cooperative banks (UCBs).

- Primary non-agricultural cooperative credit societies, also referred to as urban credit cooperative societies (UCCSs).

The UCBs play a significant role in both mobilizing household deposits and especially in lending to the household sector. The UCBs target group is largely families below the median income, and they are required to lend 60% of their funds for "priority sectors." For housing, loans of less than Rs.25,000 are considered as a part of the priority sector. Given the price levels for housing, this limit makes the price-to-loan ratio very unattractive for potential borrowers.

The UCCSs have fewer problems regarding overdues and bad debt relative to rural credit cooperative societies. Their main function is to mobilize savings and enable their members to have access to credit. Therefore, most societies have a compulsory thrift system, where an amount decided at the formation of the cooperative society is to be saved by each member every month. The amount ranges from Rs.10 to Rs.100 and more, and the interest paid on savings ranges from as low as 6% to 14%.

Loans are available for any purpose, but are largely used to meet social obligations, health-related expenses and also for housing upgrade or construction. The size of the loan is generally linked to the savings and is four to five times this amount. The loans advanced by the credit cooperative societies are unsecured and largely based on personal surety/guarantee of other members.

The real effective security in cooperative society lending thus is group and peer pressure. The rapport of the executive committee with the members and a quick follow-up are critical in this approach. Further, the high priority given to the past repayment records and regularity in thrift for credit sanctions also acts as an incentive for regular payments. The total default amounts ranged from 3.8% to 14.6% of the total outstanding loans for the UCCS.

Mehta (1994) suggests two possible linkages between credit cooperative societies and HFCs:

- The cooperative may essentially act as an intermediary, as an originating and servicing agency of loans for which they have received bulk credit from an HFC on certain terms and conditions. This may be done with the employer and/or the District Cooperative Registrar facilitating the process of identifying the specific cooperative societies. In this arrangement, strict financial appraisal of the cooperative society would be necessary.
- The role of the cooperative may be to assist the HFC in loan origination and servicing. However, the actual loan agreement could be made directly between the HFC and the borrower. The cooperative may receive a service charge for its assistance. This arrangement would be preferable for larger loans and in cases where the cooperatives do not have any direct experience. Over time, with successful performance, the linkage may mature into a bulk loan arrangement.

POTENTIAL BENEFITS FROM THE ENTRY OF MAJOR NEW PLAYERS

Until recently, banks were restricted on the rates they could charge on consumer lending, including housing. Those limitations have been relaxed, except for smaller loans. As a result, there are indications that bank lending for housing is rising rapidly. This is true both among banks that already have sponsored HFCs and those previously not involved in housing.

At the same time that banks are targeting housing lending, additional significant competition to HFCs has arisen from wholly new sectors. As noted, HUDCO, industrial development finance institutions such as ICICI and IDBI, mutual funds such as UTI, and nonhousing consumer finance institutions have all declared an avid interest in making retail housing loans, as part of a strategy of building integrated financial institutions in the wake of liberalization.

Although HUDCO's focus has been on the housing sector, HUDCO did not have extensive experience with retail lending. However, its extensive branch network, extensive name recognition, and perceived government guarantee has allowed it, in just two years, to marshal much in the way of deposits, and make as many retail housing loans as had the second largest private HFC.

ICICI is a financial conglomerate that was originally sponsored by the government to serve as an intermediary between institutional and retail investors and corporate borrowers, specializing in project finance, infrastructure finance and corporate working capital. It dwarfs any other "private" financial institution in India with over Rs.700 billion in assets (vs. Rs.130 billion in HDFC), the bulk of which are lent out to Indian corporations, both private and government-owned. It has traditionally been the predominate nongovernmental issuer of bonds and is, in fact, owned primarily by private investors in India and abroad.

IDBI is actually a larger version of ICICI, but with greater government ownership and control. As a consequence, it has been less aggressive in formulating and pursuing a post-liberalization strategy. Despite this, it has established a bank and is also planning to enter into housing finance with the same substantial advantages of ICICI with respect to name recognition in the financial markets (but less in the retail market).

Once one perceives the larger forces shaping the sector, a variety of other shifts are understandable. While ICICI and IDBI are constructing HFCs and retail and investment banking arms to attach to their corporate finance activities, HDFC is building a corporate and retail banking arm to attach to its HFC. SBI and the other banks are building up their retail banking and creating investment banking arms to attach to their branch networks. Many are adding mutual fund arms. All of the above are seeking to enter into the insurance business, to add another important financial product to their rosters.

For similar reasons, the nonbank consumer finance companies that previously did not lend for housing are also diversifying into housing. In particular, the big players in nonhousing consumer finance, such as Sundaram and Tata, are implementing major housing lending efforts.

Is there something particularly attractive about housing lending that is motivating these moves? At first glance, the attractions are not evident. The gross spread on loans by HFCs appear to be hemmed in by competition to about 1.5% to 2.0%, as low or lower than in most developed countries. However, the sector is perceived to have extraordinary growth prospects, due to a convergence of factors that will boost the size of the market-rate mortgage market (this leaves aside the traditional subsidized finance provided to special low-income housing projects). The following are major factors:

- First, the middle class is finding its size and wealth boosted by the economic reform process. This shift is reflected in the rapid expansion in the auto market (and auto loan market), and it is not surprising that the other major consumer durable, housing, is in line for expansion also. At the same time, the growth of the middle class can be expected to be accompanied by a growing tendency to embrace mortgage borrowing at a much higher rate than in the past, as younger households shift away from the deeply held attitudes against debt.

- Second, fiscal incentives being given housing loans are hastening this shift in thinking. Under current fiscal incentives to borrowers, it is irrational for any middle-class household (with enough tax liability) not to borrow at least Rs.100,000 at the time of buying or expanding a house rather than use cash. This is because the net effective rate on the loan is lower than the tax-exempt returns on this amount of deposits.

- Third, in 2000 the Parliament enacted an effective foreclosure process (applicable only to lenders registered with NHB). The private lending sector has not suffered high default losses so far, so it would seem that this step is not significant. But it means that finally the home itself can be (possibly) looked to as a true collateral. This means that people with less overt evidence of reliability (lacking guarantors or as much evidence of regular income) can be lent to and, possibly, larger loans can be made. It also means that the lender does not need to rely as much on the staff to develop the "knack" for managing delinquencies with the meager current enforcement tools.

- Fourth, nominal lending rates seem to be headed to record low levels. This automatically increases the size of loan that can be serviced by borrowers.

- Fifth, there are a growing number of financial services, which can be sold to the households who can afford a formal-sector house and qualify for a mortgage. These include all forms of insurance, investing activities (mutual funds, brooking), other consumer finance and, of course, conventional banking services. All players targeting this market need to have a mortgage lending window as well.

- Finally, a potentially important factor is the relaxation of the notorious Urban Land Ceiling Act. It has been repealed at the national level and awaits repeal in one more state before private housing development can resume in urban areas without passing through a process of government "purchase" and allocation of the land. Partly due to this, as well as to the end of distorted negative real interest rates in the financial sector, the real prices of housing have fallen dramatically since 1990 and housing affordability has improved substantially.

All of these trends may have a profound impact on the availability of housing finance to the "middle" portion of the low- and middle-income housing market. They will generate pressures for the private sector to push downmarket in new ways, especially since the organizational and technological basis for making profits on small margins requires significant scale of operations.

A larger middle-class housing finance sector need not immediately improve access to loans by the truly lower-income groups. They will still operate under key handicaps, including an inability to afford a formal sector house with clear land title, irregular income flows, the absence of a credit record with which to assess creditworthiness, and continuing barriers to integration and cooperation between CBS and regular banks and HFCs.

However, assuming that the government refrains from undermining the potential for private sector entry, there will be increased incentive to seek to innovate in the area of the interface between formal sector middle-income workers and the rest of the population. India may soon provide one of the best case studies of the potential for private market-rate housing finance to penetrate down the income distribution without interference from government-subsidized competition or other distortions. In the process, there are new modes of interfacing between institutions with advantages in delivering finance to lower-income groups and major financial institutions.

NOTES

[1] In terms of comparable U.S. institutions, the NHB has been assigned the functions of several diverse agencies. It has the regulatory responsibility of the Office of Thrift Supervision and the industry promotion tasks of the Federal Home Loan Banks. It also has some of the funds mobilization-through-secondary-market-operations of Fannie Mae and Freddie Mac. See Vora (1999) for more detail.

[2] Cross-subsidization can not long survive a competitive free market, since those who are able to minimize their lending to small borrowers will be able to avoid the implicit tax and offer lower rates to their larger borrowers.

[3] In India, community development finance institutions (CDFIs) have been successful in targeting some LMI households for housing finance. CDFIs are developed either through NGOs like the Self-Employed Women's Association (SEWA) Bank or urban cooperative systems such as Urban Cooperative Credit Societies (UCCS) and Employees Credit Cooperative Societies (ECCSs).

[4] See JSP Associates, 1993.

[5] See Martha Alter Chen and Donald Snodgrass.

[6] See Martha Alter Chen, op. cit., page 10.

[7] The recent information on SPARC was obtained from conversations by Sally Merrill with Sheela Patel, its founder, and a recent case study by Ruth McLeod, January 2000.

[8] See Ruth McLeod, 2000.

REFERENCES

Chen, Martha Alter and Donald Snodgrass, "An Assessment of the Impact of SEWA Bank in India: Baseline Findings," Harvard Institute for International Development, Harvard University, August 1999.

JSP Associates Management Consultants, New Delhi, "Baseline Financial Profiles of Housing Finance Companies in India," Prepared for Indo-US Housing Finance Expansion Program (USAID), New Delhi, India: Abt Associates Inc., 1993.

McLeod, Ruth, "Bridging the Finance Gap in Housing and Infrastructure, India: SPARC—A Case Study", *Homeless International,* January 2000.

Mehta, Meera, "Analysis: Down Marketing Housing Finance Through Community Based Financial Systems." Prepared for Indo-US Housing Finance Expansion Program (USAID), New Delhi, India: Abt Associates Inc., 1994.

Vora, P.P. "The Indian Housing Finance System." *Housing Finance International.* December 1999, Vol. XIV. No. 2.