Block

3

FUND BASED SERVICES

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BLOCK 3: FUND BASED SERVICES

This is the third block on financial services that introduces the topic of fund based financial services. The financial services sector has registered a growth of over 15% YoY and the growth is sustaining over the past few years. A major portion of the growth is also attributed to growth in fund based services especially banks and financial institutions. Fund based services is the backbone of Indian economy.

Fund based services is a financing method that is based on the assets of companies which can be debtors, inventories, receivables, fixed assets such as plant and machinery etc. The block covers various concepts of consumer credit, bills discounting, housing finance, mortgages, real asset finance and securitization. This block contains seven units from Unit 13 to Unit 19.

Unit 13: This unit provides an introduction to *Consumer Credit* which is a very important segment of fund-based finance. This portfolio which has been witnessing a healthy growth of over 17% is a fast-growing segment and a major source of employment for finance and marketing students. Consumer credit is extended to individuals to buy goods or services. Consumer credit encompasses all asset-based financing plans that are offered primarily to individuals for acquiring consumer durables. The unit covers the features of a consumer credit transaction, and assessment of consumer credit by financial institutions. It is also devoted on the legal framework of the subject in the unit as well.

Unit 14: This unit deals with *Bill Discounting:* A boon to MSMEs, this facility is gaining prominence in banks and financial institutions especially discount houses. A collateral free finance, the portfolio has a promising future and is a very important segment of fund-based facility that students must learn. Bill discounting is an easy way of getting finance for the seller and is a self-liquidating debt. This unit discusses various aspects of bill discounting in India which includes the process of bill discounting, financial and accounting, aspects of bills discounting and legal aspects of bill discounting. A unit is also devoted to the learners on comparison between bills discounting and factoring. The unit concludes with a bird`s eye view on bills business in India.

Unit 15: This unit deals with the concepts of *Factoring and Forfaiting* **–** As foreign trade is increasing, the opportunities for the factoring industry are growing at a similar pace. In the FY 2019 foreign trade stood at US $ 2.88 trillion and is expected to grow in 2021-22 at an accelerated pace. Factoring has helped businesses become more competitive in complex world markets. Factoring volume in India increased by 12% in 2019 and has an excellent growth prospect. Many financial institutions have set up a separate subsidiary to handle factoring services such as SBI global factor, can factors, etc. which is another important segment in fund based financial services that students must lean. Factoring is a type of inland receivable finance coupled with management of receivables and credit risks handled by the factor thereby reducing the burden on the seller. Similarly, Forfaiting is for export receivables. The unit covers various aspects of both the topics from concepts, functions, benefits, operating procedure and cost involved in these transactions. A comparison between factoring and normal receivable finance, factoring and forfaiting which is covered in detail should make the learner well versed with the subject.

Unit 16: This unit covers broad frame work of *Housing Finance in India.* The Indian home loan market is anticipated to grow at a CAGR of around 22% during 2021-2026 on account of increasing urbanization and affordable mortgage rates. Most of the banks and standalone housing financial institutions have witnessed good growth in both top and bottom line. This is a sector that has a great future and is a huge potential segment for employment. Housing for all by 2022, the policy initiative by the government of India has given impetus to budgeted houses in India and is the fastest growing sector in the housing. The unit covers various aspects of housing finance such as the role of Apex financing intuition NHB, schemes offered by other financial institutions, the regulatory role in this sector, various concessions offered by the government, legal and tax aspects of the housing sector.

Unit 17: This unit covers broad frame work of *Mortgages and Mortgage Instruments*. Loans against mortgage or mortgage as security for loans, are important activities in fund based loans. Hence the legal issues in mortgages and various instrument in mortgage market provide important knowledge base in the fields of financial management. Mortgage is creating a charge over immovable property to secure a debt payment or obligation. It is a legal agreement against which a bank or any financial institution provides the money for the purchase of the house property. The unit covers the basic concepts such as meaning, essentials and types of mortgages and mortgage instruments. The unit also dedicated to the mortgage finance in India.

Unit 18: This unit discusses the topic *Real Estate Financing* **-** *Risk and Returns* – NBFCs account for 61 per cent of commercial real estate borrowings in the country. With an increase in population, there has been a rising demand for the need of infrastructure such as office and commercial spaces which can create good demand for marketing and finance students. This unit deliberates on classification of real estates, real estate financing, real estate transactions, the risk and returns associated with such activity, the features of real estate financing in major mortgage markets, various innovative financing strategies and of instruments. Some of the salient features of RERA, the real estate regulator and the investor protection is well covered in the unit.

Unit 19: This unit covers broad frame work of *Securitization.* Retail transaction of securitization has witnessed steady growth and experts are of the view that the growth story will continue for years to come. It is another growing portfolio which should be learnt by the students. Securitization refers to the conversion of illiquid assets to liquid assets by converting longer duration cash flows into shorter ones. The unit covers various aspects on the subject such as process of securitization, risk management in the portfolio, and India's landscape on securitization.

Unit 13

Consumer Credit

Structure

"Price is what you pay. Value is what you get."

- Warren Buffett

13.1 Introduction

Consumers expect value for the price they pay. Price includes the rate of interest they need to pay for acquiring the goods.

In the previous unit we discussed a financial services activity called hire purchase. It discussed about the meaning and various aspects of hire purchase like tax, legal, accounting, etc. The framework of financial evaluation concerning hire purchase is also discussed. The present unit discusses about another financial service activity called consumer credit.

The term 'consumer credit' encompasses all asset-based financing plans that are offered primarily to individuals for acquiring consumer durables. The typical form of a consumer credit transaction is one where the individual pays a fraction of the cash purchase price on taking delivery of the asset and agrees to pay the balance with interest over a specified period.

In India, the practice of offering consumer credit has been in vogue for a very long time, but it remained fragmented and individualized until the late eighties. The credit for educating the 500 million strong Indian middle class about the advantages of the 'Buy Now; Pay Later' culture must go to Citibank, which went in for aggressive marketing of consumer finance through a wide array of schemes

– the Citi mobile finance scheme for financing purchase of new cars, the 'Wheels' scheme for financing purchase of two-wheelers and the 'Easy Buys' scheme for financing purchase of consumer durables like VCRs, VCPs, TVs, refrigerators, washing machines and home appliances.

Following the lead taken by Citibank, the other multinational banks, the State Bank of India, ICICI Bank and several finance companies, which were on the lookout for concentric diversification opportunities jumped into the fray. Of course, the factors which motivated these financial intermediaries to enter the consumer credit industry was the growing strength of the upwardly mobile Indian middle class, the rapid increase in the disposable income of this class and the boom in the consumer durables and automobile industries during the latter half of the eighties.

Consumer credit includes student loans, auto loans, credit cards and all other types of credit extended by commercial banks to households with an exception of housing loans.

In this unit, we will look at some of the salient aspects of consumer finance, the legislative framework governing these transactions in the developed countries and the considerations in building a sound consumer credit portfolio.

13.2 Objectives

After going through this unit, you should be able to:

- Appreciate the various features of consumer credit
- State various components of consumer credit
- Discuss the legal aspects in consumer credit
- Discuss and evaluate the credit requirement of the customer

13.3 Features of Consumer Credit Transactions

Consumer credit is a way for people to pay for the products later while enjoying the benefits of the goods acquired upfront. The salient features of consumer credit transactions are as follows:

Number of Parties to the Transaction

The transaction can be either a bipartite one involving the dealer-cum-financier and the borrower/customer or a tripartite one where the dealer and the financier are two distinct entities. The tripartite transaction can be of the sales-aid type where the dealer arranges for finance and does the necessary paper work on behalf of the borrower. Under such transactions, the credit granting decision lies with the dealer, of course, subject to the eligibility criteria stipulated by the finance company. Such transactions are structured with recourse to the dealer. On the other hand, a tripartite transaction can be of the conventional type where the customer approaches the finance company to avail of the credit facility.

Structure of the Transaction

A consumer credit transaction can be structured in the form of hire purchase, or credit sale or conditional sale transaction. As we have discussed earlier, a hire purchase is a contract of hire with the option to purchase. The customer, while having the option to purchase, need not do so. He or she can terminate the agreement and return the goods at any time, subject to the terms and conditions of the agreement. In a conditional sale contract, the ownership is not transferred to the customer until the total purchase price (including the charge for credit) is paid. Besides, the customer cannot terminate the agreement before the purchase price is paid. In a credit sale contract, the ownership is transferred to the buyer on payment of the first installment. The customer, however, cannot cancel the agreement before the total purchase price is paid. Most of the tripartite consumer finance transactions are of the hire purchase type.

Down Payment

Consumer finance schemes can be broadly classified under two categories: Down payment schemes and deposit linked schemes. Since we have already drawn the distinction between the two types of schemes, we are not going over the same ground here. The down payment varies between 20% and 25% of the value of the consumer durable. Likewise, the security deposit under the deposit linked scheme varies between 15-25 percent of the amount financed (which is equal to the investment outlay). The deposit is of cumulative nature carrying interest at a prescribed rate (which at the time of writing cannot exceed 15% interest compounded monthly). Some finance companies also offer zero deposit scheme under which the equated monthly installment (EMI) is higher than the EMI under the 15% and 25% deposit schemes.

RBI had issued a circular making the concept of zero cost EMIs non-existent. This has however not stopped the retailers and e-commerce giants like Amazon and Flipkart from not offering these schemes.

The zero percent (0%) EMI scheme is a short-term repayment scheme. It consists of a shorter tenure and hidden costs. The catch in these kinds of schemes is that the lender receives more than the regular interest rate. Further, the overall expense of the loan is higher than what is initially perceived. Some of the issues associated with offering these schemes are:

- Hidden Cost: Other charges compensate for the 0% interest component. Banks are not allowed to offer loans below the stipulated base rate.
- Creation of Artificial Demand: High sales on a 0% interest scheme creates artificial inflation of demand leading to a high rate of inflation.
- Disparity in Pricing: Customers who pay upfront cash to purchase the product receive a discount that is not available if they purchase on 0% EMI. Further, the retailers charge a transaction fee on prepayment through debit/ credit card leading to disparity in pricing.

- Higher Debt Crisis: Due to 0% EMI, customers spend more and enter into a higher debt crisis.

Repayment Period and Rate of Interest

The repayment schedule is drawn based on monthly installments over a period varying between 12 months and 60 months. The borrower is permitted to choose the most convenient repayment period from the given range of options. While the rate of interest is typically expressed as a flat rate, some financial intermediaries like ICICI Bank disclose the effective rate of interest. In recent times, many finance companies have dispensed with the practice of disclosing the rate of interest. Instead, they disclose the equated monthly installments associated with the different repayment periods (see Illustration 13.1) and require the borrower to figure out the effective rate of interest for himself.

The repayment is required to be made through post-dated cheques. In respect of institutional consumer credit schemes where the finance is routed through the organization, which employs the borrower, the organization concerned is required to deduct EMI at source and transmit the payments to the finance company. Most of the schemes provide for early repayment of the loan, subject to certain conditions. They also provide for either a rebate for prompt payment (prompt payment bonus) or a charge for delayed payment.

Security

The consumer credit is secured through a first charge on the asset concerned and the borrower is prohibited from hypothecating or pledging or selling the asset during the credit period.

Product Range

Consumer credit is made available for a wide range of durables like passenger cars, two-wheelers, TVs, VCRs, personal computers, washing machines, cooking ranges, food processors and mini-generators.

Borrower Profile and Eligibility Criteria

The types of borrowers covered by the consumer finance schemes are individuals, partnership firms and private or public limited companies.

The eligibility criteria for individual borrowers include a minimum level of annual emoluments, the minimum number of years in the present employment and minimum take-home salary. For partnership firms and companies, the criteria include a profitable track-record, minimum levels of sales and net worth.

The eligibility criteria mentioned above are a broad outline and need not be the same for all institutions. There can be different criteria for different institutions based on their policy guidelines. There has been a steady growth in the retail loans portfolio of which consumer loans form a major component.

Consumer credit remains to be the key driver of an Indian economy. This is on the back of the robust growth in unsecured lending types like personal loans, credit cards and consumer durable loans.

Secured lending categories such as loans against property (LAP), home loans and auto loans, experienced moderate total balance growth. The healthy growth levels showcases that credit demand by Indian consumers remains robust. The lenders have continued to make credit available to borrowers to meet that demand.

Further, the rate of overall consumer lending growth in India is still remarkably greater than that of the other major economies in the world, as per the TransUnion CIBIL.

Indian lenders continue to increase in size and complexity. This showcases that they intend to expand the consumer universe, so that they can reasonably extend credit to the extent of their underwriting capacity and sophistication, accordingly with new data sources and analytic tools. The continued evolution in capabilities is gaining more and more significance in maintaining the retail-lending growth. This is because of the external factors like funding availability and the global economic outlook, and the present potential headwinds.

All major consumer-lending products experienced double-digit percentage (%) growth in the total number of accounts.

Example: Features of Axis Bank Consumer Loan

With Work-From-Home (WFH) becoming a norm, various furniture and appliances are required at home to make it a pleasurable and comfortable business. Axis Bank provides loans on easy terms to acquire various consumer goods. Some of the features of the consumer finance are,

- Axis Bank takes credit score, employment history, repayment capacity of the applicant into consideration and sanctions loan almost instantly.
- Loan can be applied online.
- There is no requirement of collateral security.
- Minimum documentation required.
- Repayment tenure can be tailored to suit the needs of the applicant.

Source: Get Instant Personal Loan to Buy Home Appliances (Consumer Durable Loan) Online (axisbank.com) dated 17th June, 2021, Accessed on 11.07.2022

13.4 Components of Consumer Credit

This section deals with important components of consumer credit.

(1) Effective rate of interest

(2) Rebate in the event of early repayment

(3) Effective rate of interest on the completed transactions.

As we have gone over this ground in the earlier unit, we will only go through a few numerical illustrations to recapitulate the mechanics involved.

Illustration 13.1

The Equated Monthly Installments for a consumer loan of ₹ 20,000 under three repayment options are as follows:

Repayment Period (in months)	EMI (₹)
12	1,900
24	1,070
36	799

Calculate the flat and the effective rates of interest for each option.

Solution

i.	Repayment period	= 12 months
	Total charge for credit	= (₹ 1,900 x 12) – ₹ 20,000 = ₹ 2,800
	Flat rate of interest	$= \frac{₹\ 2,800}{₹\ 20,000} \times 100 = 14\%$
	Effective rate of interest	$= \frac{n}{n+1} \times 2F = \frac{12}{13} \times 28 = 25.85\%$
ii.	Repayment period	= 24 months
	Total charge for credit	= (₹ 1,070 x 24) – ₹ 20,000 = ₹ 5,680
	Annual charge	= ₹ 2,840
	Flat rate of interest	$= \frac{₹\ 2,840}{₹\ 20,000} \times 100 = 14.2\%$
	Effective rate of interest	$= \frac{24}{25} \times 28.4 = 27.26\%$

The reader can verify that for the 36 months repayment option, the flat and the effective rates of interest are 14.61% and 28.43% respectively.

Illustration 13.2

Alpha Finance Company offers the following types of Deposit Linked Schemes for acquiring cars.

Deposit Scheme	Zero Deposit	25% Deposit
Amount (₹)	1,00,000	1,00,000
Repayment Period (in months)	36	36
Equated Monthly Installment (₹)	3,700	3,560
Bullet Installment at the end (₹)	9,000	
Accumulated Interest on Deposit (after 36 months)	Nil	12,777

The company levies a front-ended documentation and service fee of ₹ 2,000, besides offering a prompt payment bonus of ₹ 10 per ₹ 10,000 per month on expiry of the repayment period. The EMI is payable at the end of every month.

a. Calculate the effective rates of interest implied by the two schemes.

b. After 24 months, one of the borrowers under the 25% Deposit Scheme opts for an early settlement. The company levies a service charge of 2% on the principal outstanding on the date of settlement and allows a prompt payment bonus in respect of the installments paid. The company also offers an interest rebate calculated in accordance with the Rule of 78 Method. Calculate the effective rate of interest on the completed transaction.

Solution

a. The effective rate of interest implied by the deposit schemes will be that rate of interest, which equates the present value of the following cash flow stream to zero. i.e.

Loan Amount – PV (Installments paid) – Service Fee + PV (Accumulated Value of Deposit) + PV (Prompt Payment Bonus) = 0

Before we calculate the present values, let us figure out some of the elements in the equation.

i. Accumulated Value of 25% Deposit = ₹ 25,000 + ₹ 12,777 (received after 36 months) = ₹ 37,777

The reader can verify from the equation ₹ 25000 x FVIF (i,3) = ₹ 37,777 that (i) is about 14.75% p.a. or 14% p.a. compounded quarterly.

ii. Prompt Payment Bonus under Zero Deposit Plan

$$= \frac{₹\ 3{,}700}{₹\ 1{,}000} \times 10 \times 36 = ₹\ 1{,}332$$

Prompt Payment Bonus under 25% Deposit Plan

$$= \frac{₹\ 3{,}560}{₹\ 1{,}000} \times 10 \times 36 = ₹\ 1{,}281.60$$

We will define i_1 and i_2 as the effective rates of interest implied by the Zero Deposit Scheme, and the 25% Deposit Scheme respectively.

The value of i_1 can be obtained from the equation:

At

₹ 1,00,000 – ₹ 2,000 – ₹ 3,700 x 12 x i/i^{12} $PVIFA_{m(i_1 3)}$

– ₹ 9,000 x $PVIF_{(i_1 3)}$ + 1,332 x $PVIF_{(i_1 3)}$ = 0

i_1 = 0.26, LHS of the equation = (–) 1,548.06

i_1 = 0.28, LHS of the equation = 629.81

Interpolating in the range we get i_1 = 0.2742 or 27.42%
The value of i_2 can be obtained from the equation:

₹ 75,000 – ₹ 2,000 – [₹ 3,560 x 12 x $PVIFA_{m(i_2 3)}$ + ₹ 37,777 x $PVIF_{(i_2 3)}$

+ [1,281.6 x $PVIF_{(i_2 3)}$] = 0

At

i_2 = 0.24, LHS of the equation = (–)736.62

i_2 = 0.26, LHS of the equation = 436.86

Interpolating in the range, we get i_2 = 0.2526 or 25.26%

Therefore, the effective rates of interest implied by the Zero Deposit and the 25% Deposit Schemes are 27.42 and 25.26% respectively.

b. Total charge for credit = (3,560 x 12 x 3) – 1,00,000 = ₹ 28,160

Interest rebate as per 'Rule of 78' = $\frac{12 \text{ x } 13}{36 \text{ x } 37}$ x 28,160 = ₹ 3,298

Capital content of the installments outstanding on payment of the 24th installment

= ₹ (3,560 x 12) – 3,298 = ₹ 39,422

Service charge levied on the amount of principal outstanding

= ₹ 39,422 x 0.02 = ₹ 788

Rebate for prompt payment = $\frac{3,560}{1,000}$ x 10 x 24 = ₹ 85

Amount payable on early settlement = (42,720 + 788 – 3,298 – 85) = ₹ 40,125

Accumulated value of the deposit received after two years

= ₹ 25,000 $\left(1+\frac{0.14}{4}\right)^8$ = ₹ 25,000 $(1.035)^8$ = ₹ 32,920

We will define i_3 as the effective rate of interest on the completed transaction. i_3 can be obtained from the equation.

$$₹\ 75{,}000 - ₹\ 2{,}000 - [₹\ 3{,}560 \times 12 \times \text{PVIFA}_{m(i_3 2)}]$$

$$- [₹\ 40{,}125 \times \text{PVIF}_{m(i_3 2)}] + [₹\ 32{,}920 \times \text{PVIF}_{m(i_3 2)}\}] = 0$$

At i = 0.24, RHS of the equation = (–) ₹ 524.05

i = 0.26, RHS of the equation = ₹ 692.58

Interpolating in the range we get i_3 = 0.2486 or 24.86%

The effective rate of interest on the completed transaction is lower than the effective rate of interest implied by the original transaction.

Example: Impact of RBI's Repo Rate hike on Consumer Loans
On 8th June 2022 Reserve Bank of India (RBI) raised interest rate by 50 basis points to a two-year high of 4.9%. This is to tame inflation which is a cause of concern. Increase in repo rate by RBI generally followed by banks resulting in hiking interest rates on vehicle, home and consumer loans. Therefore, EMIs in these loans will surge impacting borrowers.

Source: RBI repo rate hiked: How will it impact FDs, EMIs, loan interests - Business News (indiatoday.in) dated 8th June, 2022, Accessed on 12th July, 2022

<u>Check Your Progress - 1</u>

1. Which of the following encompasses all asset-based financing plans that are offered primarily to individuals for acquiring assets such as TV, fridge, etc.?
   a. Home loans
   b. Educational loans
   c. Consumer loans
   d. Business loans
   e. Miscellaneous loans
2. Which one of the following assets does not come under the gamut of consumer credit?
   a. Purchase of passenger cars & two-wheelers
   b. Purchase of TVs, VCRs, personal computers
   c. Purchase of washing machines, cooking ranges, food processors
   d. Purchase of mini-generators
   e. Purchase of flats

3. Which one of the following is not the component of eligibility criteria for securing consumer loans from financial institutions?
   a. To be employed in an organization
   b. Minimum emoluments
   c. Should be a public-sector employee
   d. Minimum years of service in present employment
   e. Minimum take-home salary
4. What is the flat rate of interest charged on a loan of ₹ 25,000 for 12 months if the EMI is ₹ 2,400?
   a. 15.10%
   b. 15.20%
   c. 14.80%
   d. 14.85%
   e. 15.00%
5. What is the effective rate of interest charged on a loan of ₹ 25,000 for 12 months if the EMI is ₹ 2,400?
   a. 25.00%
   b. 27.08%
   c. 28.06%
   d. 27.65%
   e. 29.00%

Activity 13.1

You are working as a credit apprising officer at ABC Finance Ltd. Mr. XYZ approaches you for a consumer loan of ₹ 1,00,000 to purchase an LED TV worth ₹ 1,30,000. What are the various steps that you will take for considering the loan?

Answer:

13.5 Legal Framework

Consumer credit is popular across many countries. Let us have some glimpse of consumer credit in other parts of the world also.

In countries like the UK where consumer credit has been in popular use for long, it is subject to a comprehensive legislative framework. The legislation seeks to:

(a) Make the customer more aware of the true interest rates implicit in the various lending schemes

(b) Protect the customer against the unscrupulous, once the agreement is made.

To have a better understanding of the scope of such legislations, we will touch upon the salient features of the legal framework for Consumer Credit in UK.

13.5.1 Consumer Credit Act in UK

The Consumer Credit Act, 1974 of the UK is an almost 50-year-old act which regulates all credit card purchases and personal loans in UK. It is aimed at protecting the borrower in credit agreements, loans, and mortgages. The Act requires full written details of the true interest rate (i.e., annual percentage rate) to be quoted, a cooling-off period to be given, during which borrowers may change their minds and cancel agreements, and all agreements to be in writing. The Act does not cover overdrafts.

The Act was amended in 2000 and brought under the legal framework contained in the Financial Services and Markets Act 2000 (FSMA). Subsequent changes to the Act were done in 2003, 2006, 2007, 2009, 2013 and 2014.

A proposal to modernize consumer credit laws to reduce costs for businesses and simplify rules for consumers has been announced by the UK government in June, 2022. The UK government also proposes to move the Act from being a statute to bringing it into the purview of Financial Conduit Authority, thereby enabling quicker regulatory responses to changes in consumer credit market.[1]

13.5.2 UK Consumer Rights Act 2015

The Consumer Rights Act, which came into force on 1st October 2015 in the United Kingdom, is a legislation that replaced the old legislations namely the Sale of Goods Act, Unfair Terms in Consumer Contracts Regulations and the Supply of Goods and Services Act. This act applies to items bought after the Act came into force. Majority of the rights and protection for UK consumers can be found in this Act.

On 20th April, 2022, the UK Government announced plans to introduce many of the proposed reforms, including the enhanced powers for the CMA to investigate and sanction infringements of consumer law.

[1] https://www.gov.uk/government/news/uk-commits-to-reform-of-the-consumer-credit-act; dated June 16th, 2022

13.5.3 Consumer Credit in USA[2]

Consumer credit is an important element of the United States economy. A consumer's ability to borrow money easily allows a well-managed economy to function more efficiently and stimulates economic growth. The Federal Trade Commission (FTC) is one of many U.S. federal agencies which regulates the consumer credit system and enforces the laws related to it. One of the FTC's primary responsibilities involves protecting consumers from companies that engage in unfair or deceptive business practices, and this responsibility extends to the consumer credit market.

Federal Reserve Consumer Credit-G.19 report releases the outstanding US consumer credit as on that date. Accordingly, the total outstanding in December 2022 was USD 4,775.9 billion. Consumer credit in US includes non-revolving credit and revolving credit. Non-revolving credit includes auto, student, and personal loans. Revolving credit includes credit cards, home equity lines of credit (HELOC), and personal and small business loans.

13.5.4 Consumer Protection Law in India

The industrial revolution and the development in international trade and commerce led to the vast expansion of business and trade. It resulted in a variety of consumer goods in the market to cater to the needs of the consumers. A host of services like insurance, transport, electricity, housing, entertainment, finance, and banking as well has been made available to the consumers. A well-organized sector of manufacturers and traders with better knowledge of markets came into existence, thereby affecting the relationship between the traders and the consumers, making the principle of consumer sovereignty almost inapplicable. The advertisements for goods and services on television, in newspapers, and in magazines influence the demand for the same by the consumers. However, there may be manufacturing defects or imperfections or shortcomings in the quality, quantity and purity of the goods or there may be a deficiency in the services rendered. With all these, the production of the same item by many firms led the consumers, who have little time to make a selection, to think before they can purchase the best. For the welfare of the public, the glut of adulterated and sub-standard articles in the market must be checked.

Very little could be achieved in the field of consumer protection, in spite of various provisions providing protection to the consumer, and providing for stringent action against adulterated and sub-standard articles in the different enactments like; the Indian Penal Code, 1860; the Indian Contract Act, 1872; Code of Civil Procedure, 1908; the Sale of Goods Act, 1930; the Standards of Weights and Measures Act, 1976; and the Motor Vehicles Act, 1988.

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[2] U.S. Federal Trade Commission
https://www.federalreserve.gov/releases/g19/current/

Though the Monopolies and Restrictive Trade Practices Act, 1969 and the Prevention of Food Adulteration Act, 1954 had provided relief to the consumers, yet it became necessary to protect the consumers from exploitation and save them from adulterated and sub-standard goods and services to safeguard their interests. In order to provide for better protection of the consumer interests, the Consumer Protection Act was enacted in 1986

The Act was later amended in 2002 through the Consumer Protection Amendment Act, 2002.

The objectives of the Consumer Protection Act are-

1. To provide for better protection of the consumers' interests, and for the purpose, make provision for the establishment of consumer councils and other authorities for the settlement of consumer disputes and for matters connected therewith.
2. It seeks, *inter alia*, to promote and protect the rights of consumers such as (a) the right to be protected against marketing of goods which are hazardous to life and property; (b) the right to be informed about the quality, quantity, potency, purity, standard and price of goods to protect the consumer against unfair trade practices; (c) the right to be assured, and wherever possible, have access to an authority of goods at competitive prices; (d) the right to be heard and to be assured that consumers' interests will receive due consideration at appropriate forums; (e) the right to seek redressal against unfair trade practices or unscrupulous exploitation of consumers; (f) the right to consumer education.
3. These objectives are sought to be promoted and protected by the Consumer Protection Council that is to be established at the central and state levels.
4. To provide a speedy and simple remedy to consumer disputes, quasi-judicial machinery is sought to be set up at the district, state and central levels. These quasi-judicial bodies will observe the principles of natural justice and they were empowered to give relief of a specific nature, and to award, wherever appropriate, compensation to consumers. Penalties for non-compliance with the orders given by the quasi-judicial bodies were also provided.

Consumer Protection Act, 2019

The Consumer Protection 2019 replaced the Consumer Protection Act, 1986. The main objective of the new Act is to protect the interests of the consumers and to establish a stable and strong mechanism for the settlement of consumer disputes. Under this Act, the National CDRC (Consumer Disputes Redressal Commission) is enabled to hear protests worth more than ₹ 10 crores and the State CDRC was given purview for the worth of more than ₹ 1 crore however not as much as ₹ 10 crore. This enabled the District CDRC to engage grumblings where the worth of merchandise or administration is up to ₹ 1 crore. The other new features brought in by the Act are:

1. E-filing of grievances
2. Inclusion of the definition of unfair trade practices
3. Alteration in the procedure for appeals
4. Inclusion of e-commerce transactions under the purview of the Act
5. Redefinition of consumer rights and distinction between the consumer of goods from that of consumer of services.

Example: RERA Act does not Prohibit Remedies under the Consumer Protection Act

On 2nd November 2020, a two-judge bench of the apex Court, held that there was nothing in the Real Estate (Regulation and Development) Act, 2016 (RERA) barring commencement of proceedings under the Consumer Protection Act.

Statutory provisions of the RERA have been analysed by the apex court. It is to consider whether the solution provided under the RERA Act to an allottee was the only modality to raise a grievance. The apex court gone into the details of whether the provisions of the RERA Act prohibit consideration of the grievance of an allottee by any other fora.

Source: Remedies Under The Consumer Protection Act Not Barred By The RERA Act - Dodd-Frank, Consumer Protection Act - India (mondaq.com) dated 22nd April 2021, Accessed on 11th July 2022

13.6 Consumer Credit Portfolio Management: Some Aspects

As often said, building a large consumer credit portfolio is not a difficult task when compared to managing one. This is so because 'managing' calls for evaluating, monitoring and controlling a large number of individual accounts. Therefore, a consumer credit institution must primarily focus on streamlining the credit management function.

For Banks and other financial institutions with large portfolios of credit, Credit Portfolio Management (CPM) is a key function. CPM looks across the entire credit book instead of individual credit. The important role of CPM is to understand the credit risk that the institution faces, manage the same and improve returns on those risks by trading loans in the secondary market, besides hedging, identifying and managing concentrations of risk.[3]

[3] http://www.mckinsey.com/business-functions/risk/our-insights/the-evolving-role-of-credit-portfolio-management

13.6.1 Credit Evaluation

The first step in the streamlining process is to define and articulate a clear-cut procedure for evaluating customers. This is an onerous and difficult task - onerous because the number of customers to be credit-rated is quite large; - difficult because there are no hard data on the past payment record or on the financial position of the borrower (like the audited financial statements) to judge the willingness and the ability to repay.

In some countries, credit reference bureaus provide a large part of the information required for evaluating the credit applicant. The typical data stored on the individual file includes:

- Records of all registered county court judgments and decrees, in the last six years.
- Information supplied by other traders regarding bad debts, slow-paying accounts and repossessions.
- Records of bankruptcies and administration orders.
- Voters roll information.

Some credit bureaus also file details of all satisfactory credit transactions reported to them by other users. A good credit score can ensure loans from banks and financial institutions. All one needs to do is log on to the website and provide a few personal details for authentication including PAN number and he will receive the credit score on payment of a fee.

For the credit evaluation of an individual borrower, the finance company calls for a copy of the salary certificate and the name and address of the employer. For the credit evaluation of business entities like sole proprietorships and partnerships, the finance company looks for the financial statements of the entity for the last two years, duly certified by a chartered accountant and the addresses of the bankers with whom the business entity has credit facility. Thus, checking with the employer and the banker seems to be the only way of obtaining independent reference information in India.

13.6.2 Methods of Pre-screening Borrowers

Since a finance company, engaged in offering consumer credit, must assess the creditworthiness of a large number of individual borrowers, it is good to use a mechanical scoring system for preliminary evaluation of the credit applicants. The following example helps us to understand the process.

ABC Bank develops a questionnaire that is used for screening borrowers. This questionnaire is presented in the table below. The reader can find a number within parentheses appended to each question. This indicates the percentage of borrowers in that category who subsequently defaulted.

A perusal of the questionnaire reveals that what we are trying to obtain is an overall risk index for the loan applicant. The way to do it is to add up all the relevant probabilities of default in different categories. In the given example, the borrower who gave the most unfavorable response to each question will have a risk index of 28 and the (smart) borrower who furnished all favorable responses will have a risk index of 3. To discriminate between the good and the bad risks, the finance company will have to define its own acceptable risk index. For instance, it may decide that all loan applicants with a credit-risk index of more than 10 will be rejected.

Sample Questionnaire for Evaluation of Loan Applicants with Default Rates

1.	Do you have a telephone at home?	
	Yes	(0.7)
	No	(1.0)
2.	Do you:	
	Own Your Home?	(0.7)
	Rent a House?	(2.4)
	Rent a Room?	(6.5)
3.	How long have you been in your present job?	
	Less than 6 months	(8.4)
	7 to 24 months	(3.2)
	More than 24 months	(0.2)
4.	What is your take-home monthly pay?	
	Less than ₹ 50,000	(8.8)
	Between ₹ 50,000 – ₹ 1,00,000	(3.3)
	Above ₹ 1,00,000	(0.4)
5.	How many members are there in your family?	
	One to Two	(0.2)
	Three to Five	(0.7)
	More than Five	(2.0)
6.	For how long do you require the loan?	
	12 months or less	(1.3)
	More than 12 months	(0.8)

Source: ICFAI Research Center

The reader must have observed that the method employed for separating the sheep from the goats is conceptually weak because adding up the probabilities the way it is done ignores the interactions between the different factors. As an alternative, the information provided by the questionnaire can be used to identify the factors relevant for credit rating and combine them using the statistical technique of

Multiple Discriminant Analysis. Suppose only two such factors are considered, then the graphical approach can be used. For example, if the take-home pay and the number of months spent on the present job are regarded as two relevant factors then the credit index can be defined as follows:

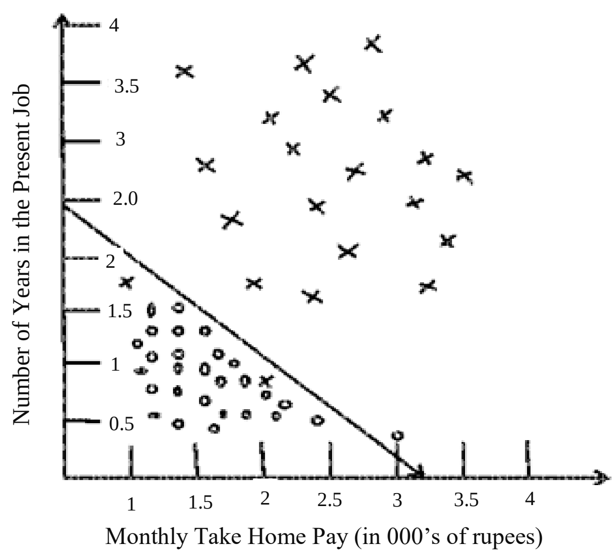
$Z = aX_1 + bX_2$

Where,

Z	=	index of creditworthiness
X_1	=	take-home monthly income (in rupees)
X_2	=	number of years spent on the present job.

Based on a sample drawn from the past data (consisting of both defaulters and non-defaulters) a scatter diagram can be drawn as shown in Figure 13.1.

Figure 13.1: Scatter Diagram



Source: ICFAI Research Center

In this diagram, Os represent (within the triangle) the customers who have defaulted and Xs (out of the triangle) denote the customers who have paid on time. A visual inspection of the scatter of points reveals that a discriminating line can be drawn intercepting the X_1 axis at 3.2 and X_2 axis at 2.4 such that the two groups – the defaulters and non-defaulters - are kept as far apart as possible. Therefore, the equation is

$Z = 3X_1 + 4X_2$ or

Index = 3 (Take-home monthly pay in 000's of rupees)

+ 4 (No. of months spent on the current job expressed as a fraction of year)

Credit applicants with an index[4] of 10.6 or more will be accepted and applicants with an index of less than 10.6 will be rejected.

13.6.3 Bookkeeping and Collection

Managing a consumer credit portfolio effectively requires: (a) an accurate system of book-keeping, and (b) a collection program that is consistent and persistent. Collection efforts are bound to deteriorate if the slow-paying accounts cannot be followed up with authority, because the information is not up to date.[5]

As far as enhancing the effectiveness of the collection program is concerned, the following guidelines have been offered by a credit manager:[6]

- A good collection practice is to ask for payment when the customer is most likely to pay. The whole point of a collection letter is to induce payment. It must be timed to arrive as near to payday as possible.
- For accounts that miss the first instalment – the first payment – failure, a personal call must be made immediately. This will at least confirm that the customer still lives at the same address and establish the real reason why the account has not been paid properly.
- The person following up an account should not threaten any action unless his office intends to take that action when the account is not paid. The customer may not take the credit department seriously if it does not mean what it says.

Slow paying accounts with small balances do not justify legal action on economic grounds. In such cases, the collection of balances can be achieved by getting the customer to sign a declaration to pay by, say, weekly installments. Of course, the last resort in recovering large accounts is legal action.

13.6.4 Credit Information Companies[7]

Credit Information Companies ("CICs") are companies formed under the Companies Act which are governed and regulated by the RBI and granted a certificate of registration under the CICR Act to undertake the business of a CIC. According to the Credit Information Companies Regulation Act 2006, only the members of the CICs can have access to the credit scores and credit information of individuals and only 'Specified Users' are permitted to become members of a CIC.

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4 Note that the equation of the line is $X_1/3.2 + X_2/2.4 = 1$ or $3X_1 + 4X_2 = 9.6$.

5 Readers interested in knowing about the input requirements for a computerized consumer credit accounting system can refer to, Credit Management Handbook (Second Edition) Edited by H. Edwards (A Gower Handbook) pp. 356-358.

6 Mudge G.L., "Retail Credit Management", Credit Management Handbook.

7 https://www.mondaq.com/india/corporate-and-company-law/1234332/access-to-credit-information

https://www.creditmantri.com/article-rbi-guidelines-on-credit-information-report/#: ~:text = The%20RBI% 20reinforced% 20that%20such,the%20letter%20from%20the%20RBI.

The RBI in November 2021 introduced an amendment to the Credit Information Companies Regulation, 2006 through a gazette notification. The amendment modified Regulation 3 to add a list of specified users. A specified user is an entity engaged in the processing of information, for the support or benefit of credit institutions, and satisfying the criteria laid down by the Reserve Bank from time to time.

The above amendment allowed third parties who satisfy the criteria laid down by the RBI to legitimately source credit information directly from CICs. The amendment will benefit various players across the Fintech sector in the digital lending process. The amendment will facilitate access to formal credit data even by unregulated entities in a regulated manner, thereby enforcing the implementation of data protection and security protocols.

India has 4 credit information bureaus - TransUnion CIBIL™, Equifax, Experian, and CRIF High Mark. These credit information bureaus are directly regulated by the RBI's Department of Banking Operations and Development. Under the 2005 Credit Information Companies (Regulations) Act (CICRA), banks and NBFCs are required to report every retail loan taken by a consumer to all four credit information bureaus.

[8]CIBIL Score - Effective Prediction of Potential Borrowers

Credit Investigation Bureau of India Ltd CIBIL is India's first credit-scoring model that provides predictive insight into consumer risk behavior to enable the lenders to make lending decisions. The CIBIL score provides information on whether a potential borrower is likely to default within a period of 12 months.

CIBIL score considers all the borrower's trades, secured and unsecured borrowings, which will enable the lender to manage risk effectively by minimizing the losses and increase profitability. The comprehensive report of CIBIL provides extensive data on the credit histories of potential and existing borrowers. This information is updated based on the information received from various institutions comprising banks, financial institutions, state financial corporations, non-banking financial companies, housing finance companies and credit card companies.

Example: Proposed acquisition of Citibank's consumer businesses in India by Axis Bank

Citibank and Axis Bank announced that their respective Boards had approved the acquisition by Axis Bank, the consumer businesses of Citibank India. This acquisition was subject to getting regulatory approvals and customary closing conditions.

Contd…

[8] https://www.transunioncibil.com/product/cibil-consumer-report (2017)

Consumer businesses of Citibank India comprises of credit cards, retail banking, consumer loans and wealth management. Consumer businesses of Citi's NBFC Citicorp Finance (India) Ltd. are also part of the deal. They include construction equipment, commercial vehicle loans and personal loans portfolio.

Axis Bank considers this acquisition a strategic fit.

Source: Axis Banks proposed acquisition of Citibank's consumer businesses in India strongly positions it for accelerated premium market share growth dated 30th *March, 2022, Accessed on 11th July, 2022*

13.6.5 Consumer Credit in India

[9]Outstanding consumer credit in India was ₹ 20367.33 billion (billion INR is ₹ 100 crores) as on December 2022. The consumer lending market in India grew 10.2% in 2020 to reach a value of $377.7bn (INR 28.1tn), according to Global Data's Global Retail Banking Analytics database. This was lower than the five-year (2016-2020) CAGR of 14.8% for the market.

The overall consumer lending market in India was led by home loans. It was followed by personal loans (including auto loans), which was the second largest category and credit card loans.

Total consumer loan balances outstanding registered a CAGR of 14.8% over the five years (2016-2020) due to particularly low growth of 15% in 2019 and 10.2% in 2020. Global data is forecasting a CAGR of 12.5% for total consumer loan balances outstanding over the period 2021-2025.

The following table provides a glimpse of consumer credit in Indian financial system.

Table 13.1: Deployment of Personal Loans in Banking System

₹ In Crores	31st Dec 2021	25th March 2022	30th Dec 2022
Personal Loans	3274532	3381699	3935144
Consumer Durables	25102	27628	36640
Housing (Incl. Priority Sector)	1634687	1684424	1898411
Advances against FDRs	80026	78730	109937
Advances to Individuals against share, bonds, etc.	5968	6161	6806
Credit Card Outstanding	141751	147789	180090
Education	81933	82723	92754
Vehicle Loans	388737	402689	484747
Loans against gold jewellery	75761	73942	84256
Other Personal Loans	840568	877613	1041502

Source: RBI Press Release Sectoral Deployment of Bank Credit

9 https://www.retailbankerinternational.com/marketdata/india-consumer-lending-market-cagr-2020-2025-2/ https://www.theglobaleconomy.com/rankings/consumer_credit/

Check Your Progress - 2

6. Which one of the following information does Credit Information Bureau India Ltd **(**CIBIL) score provide to a lender?
   a. Whether a potential borrower is likely to default after 3 years
   b. Whether a potential borrower is likely to default within a period of 1 to 2 years
   c. Whether a potential borrower is eligible for the loan that he has sought
   d. Whether a potential borrower is likely to repay within a period of 12 months
   e. Whether a potential borrower is likely to default within a year
7. Which of the following deals with the establishment of Consumer Councils and other authorities for the settlement of consumer disputes?
   a. The Sale of Goods Act, 1930
   b. The Indian Penal Code, 1860
   c. The Standards of Weights and Measures Act, 1976
   d. Monopolies and Restrictive Trade Practices Act, 1969
   e. The Consumer Protection Bill, 1986
8. Which of the following entity provides a large part of the information required for evaluating the credit applicant?
   a. The applicant
   b. The banker
   c. Credit rating agencies
   d. Credit Reference Bureau
   e. The local government
9. Which of the following factors will be used by the finance company to discriminate between the good and the bad risks?
   a. Create credit rating parameters
   b. Define its own acceptable risk index
   c. Work out the credit score based on CIBIL
   d. Obtain adequate collateral so the applicant will pay
   e. Obtain guarantees from two peoples acceptable to the bank
10. Which of the following act of the supplier/service provider is regarded as unfair as per the Consumer Protection Bill 2015?
    a. Maintaining an appropriate amount of security deposits
    b. Proportionate penalty for a breach
    c. Termination of the contract without a cause
    d. The clause that puts the consumer at an advantage position
    e. Termination of the contract with a cause

Activity 13.2 You are posted as manager "Credit Management Department" of Best Finance Ltd, a fast-growing financial institution specializing in consumer credit portfolio in their corporate office. What are the various steps you will initiate to manage the credit portfolio? **Answer:**

13.7 Summary

- Consumer credit encompasses all asset-based financing plans that are offered to individuals for acquiring consumer durables.
- Under the 2005 Credit Information Companies (Regulations) Act (CICRA), banks and NBFCs are required to report every retail loan taken by a consumer to all four credit information bureaus.
- Consumer credit includes student loans, vehicle loans, auto loans, credit cards and all other kinds of credit extended by commercial banks to households, with the exception of housing loans.
- The consumer credit transaction can be either a bipartite involving the dealer-cum-financier and the borrower/customer or the tripartite transaction where the dealer arranges for finance and does the necessary paper work on behalf of the borrower.
- A consumer credit transaction can be structured in the form of hire purchase, credit sale or conditional sale transaction.
- Consumer Finance Schemes can be broadly classified under two categories: Down-Payment Schemes and Deposit-Linked Schemes.
- Consumer credit includes non-revolving credit and revolving credit.
- The types of borrowers covered by the consumer finance schemes are individuals, partnership firms, private and public limited companies.
- Under the 2005 Credit Information Companies (Regulations) Act (CICRA), banks and NBFCs are required to report every retail loan taken by a consumer to all four credit information bureaus.
- To protect the consumer from unethical practices by the dealer or financier, the Consumer Protection bill 2015 was enacted in Parliament, replacing the earlier one enacted in 1986. This is intended to provide for adequate protection of the interests of consumers and for the prevention of unfair trade practices.

- Consumer credit is an important element of the developed economies like USA and UK.
- The overall consumer lending market in India was led by home loans. It was followed by personal loans (including auto loans), which was the second largest category and credit card loans.
- Credit Information Companies ("CICs") are companies formed under the Companies Act which are governed and regulated by the RBI.
- The amendment CICR 2006 in the year 2021 allowed third parties who satisfy the criteria laid down by the RBI to legitimately source credit information directly from CICs.

13.8 Glossary

Consumer: A consumer is an individual or organization who purchases products or services for his personal use and not for manufacturing or resale.

Consumer Credit: Consumer credit is the loan advanced by the shops, banks and other financial institutions to consumers so that they can buy goods.

Consumer Durables: Consumer durables are mass-market heavy goods (such as washing machines, refrigerators, furniture) intended to last three or more years.

Credit Evaluation: Credit evaluation is the process undertaken by the financing institution on a business or on an individual to check their eligibility for considering the credit.

Credit Score: It is a three-digit numeric credit information report derived from the credit history of an individual or an entity.

Credit Information Report: It is the credit payment history of an individual or entity across loan types and credit institutions over a period of time.

Effective Rate of Interest: The effective interest rate is the interest rate that is paid on loan by the customer due to the result of compounding over a given time period.

Flat Rate of Interest: Flat interest rate is the interest rate that is calculated on the full amount of the loan throughout its tenure without considering the monthly repayments.

Hire Purchase Transaction: Hire purchase transaction is an arrangement whereby a customer acquires an asset by paying an initial amount as stipulated by the company and repays the balance over 12 to 36 months as per the terms of the agreement/contract.

Personal Loans: Personal loans are the loans that are given to individuals for personal purposes such as marriage, traveling abroad, loans for covering hospital expenses, etc.

Pre-screening of Borrower: It is the process of evaluating a borrower through a series of questions from a questionnaire, through which a credit score is determined.

Retail Loans: Retail loans are those loans that are given by the banks/financial institutions to individuals to meet their personal needs including acquiring assets.

13.9 Self-Assessment Test

1. Discuss the various features of consumer credit.
2. Nowadays, many NBFCs are offering zero % interest on consumer loans. What is the mechanism of this type of offerings by the institutions?
3. Calculate the flat rate and effective rate of interest on a loan of ₹ 50,000 repayable in 24 monthly instalments with an EMI of ₹ 3,000/- per month.
4. Discuss the importance of the Consumer Protection Act 1986.
5. Discuss the various aspects of consumer credit portfolio management.
6. What is a conditional sale contract? How is it different from a credit sale contract?

13.10 Suggested Readings/Reference Material

1. Anthony Saunders, Marcia Millon Cornett, Anshul Jain (2021), Financial Markets and Institutions, 7th edition, Tata McGraw-Hill Education
2. Prasanna Chandra (2020), Fundamentals of Financial M, 7th edition, Tata McGraw-Hill Education.
3. Devie Mohan (2020), The Financial Services Guide to Fintech, 1st edition, Kogan Page Limited.
4. Siddhartha Sankar Saha (2021). Indian Financial System. 2nd edition, Tata McGraw-Hill Education
5. DR. R. Shanmugham (2020). Financial Services. 2nd edition. Wiley India

13.11 Answers to Check Your Progress Questions

1. (c) Consumer Loans

Consumer credit encompasses all asset-based financing plans that are offered primarily to individuals for acquiring consumer durables.

2. (e) Purchase of Flats

Consumer credit is made available for a wide range of durables like passenger cars, two-wheelers, TVs, VCRs, personal computers, washing machines, cooking ranges, food processors and mini-generators. Purchasing of flats does not come under the consumer credit product.

3. (c) **Should be a public-sector employee**

The eligibility criteria for individual borrowers include a minimum level of annual emoluments, a minimum number of years in the present employment and minimum take-home salary.

4. (b) **15.20%**

The flat rate is calculated by the formula (Total charge to the credit/ Initial credit) = (2,400 X 12) - 25,000/ 25,000= 28,800 / 25,000 = 15.2%.

5. (c) **28.06%**

The effective rate of interest must be worked in two steps. First step is to calculate flat rate which is calculated by the formula (Total charge to the credit / Initial credit) = (2,400 X 12) - 25,000 / 25,000= 28,800/ 25,000 = 15.2%. The second step is effective rate which is given by the formula = $\frac{n}{n+1}$ X 2 F, where n= no of installments and F is flat rate= $\frac{12}{13}$ X (2 X 15.2) = 28.06%.

6. (e) **Whether a potential borrower is likely to default within a year**

CIBIL is India's credit information company for individuals and provides credit score as a value-added service. This credit score provides predictive insight into consumer risk behavior to enable the lenders to make lending decisions. The CIBIL score provides information on whether a potential borrower is likely to default within a period of 12 months.

7. (e) **The Consumer Protection Bill, 1986**

The Consumer Protection Bill, 1986 seeks to provide for better protection of the interests of consumers through the establishment of consumer councils.

8. (d) **Credit Reference Bureau**

In some countries, credit reference bureaus do provide a large part of the information required for evaluating the credit applicant.

9. (b) **Define its own acceptable risk Index**

To discriminate between the good and the bad risks, the finance company will have to define its own acceptable risk index.

10. (c) **Termination of the contract without a cause**

Termination of the contract without a cause is considered unfair, as the consumer will not be able to recover the cost that has already been spent and will be subjected to heavy loss.

Unit 14

Bill Discounting

Structure

"Markets are constantly in a state of uncertainty and flux and money is made by discounting the obvious and betting on the unexpected."

- George Soros

14.1 Introduction

One of the factors prompting discounting of bills is to remove the uncertainty apart from improving the cash flow.

In the previous unit we discussed about consumer credit which includes credit cards, auto loans, student loans and all other types of credit extended by commercial banks to households with the exception of housing loans. Without going into the product details, we discussed about the features of a consumer credit transaction, computation of interest component in consumer credit and the legal framework and some RBI guidelines for consumer credit.

The buyers and sellers of trading in goods have conflicting expectations. The seller wishes to get paid immediately and the buyer wants a longer credit period. Bill discounting is the solution to the problem which places them in a win-win situation. The seller gets his major part of money immediately by discounting with his banker and is able to satisfy its customers by giving credit period. Thus, the bill discounting is an easy way of getting finance for the seller.

This unit discusses bill discounting in India and some operational issues on bill discounting.

14.2 Objectives

After going through this unit, you should be able to:

- Discuss the concepts and definitions and characteristics of bill discounting
- Illustrate on the various types of bills of exchange
- Explain the conceptual issues on accounting of bills transactions
- Tell the legal aspects of bill discounting in India
- Distinguish bill discounting from factoring transactions
- Demonstrate the market trends of the bill market in India

14.3 Concept and Definitions

Trade involves buying and selling of goods and services for money or its worth. There is an exchange of goods and services. In goods, the trade takes place from manufacturer to wholesaler/retailer and ultimately to the consumer. At every stage, there involves buying / selling of the goods/ services for exchange of cash.

The trade transaction can be in cash or credit mode. In cash transaction, there is an exchange of goods / services with cash. The price of the deal is confirmed by the invoice and bill of exchange.

In case of credit transaction, the credit period is decided by the parties involved and the bill of exchange/ promissory note is accepted by the purchaser and payment is made on the due date.

The seller submits the accepted bill of exchange along with invoice to the financial intermediary/ bank for negotiation which can involve purchasing or discounting the bills at predetermined rate and the intermediary in turn collects the payment from the purchaser on due date.

The terms bills purchase or discount or bill for collection is used by for different types of transactions. In case of purchase, the entire amount of bill is parted to the client after maintaining a percentage of the bill amount towards margin. Interest is collected on realization of the proceeds of the bill on due date. In case of discount, the interest is collected up front for the usance (credit) period and the balance amount is parted to the client. In case of bill for collection, the intermediary/ bank only handles the bill as an agent, gets the amount collected and credits it into the client’s account. However, in certain cases, banks provide a certain percentage of the bill sent on collection as advance. Let us go into details.

Discounting a bill means that the financial intermediary buys the bill (i.e. Bill of Exchange or Promissory Note) before it is due and credits the value of the bill after a prescribed discount amount is charged to the customer's account. The transaction is basically an advance against the security of the bill and the discount represents the interest charged upfront from the date of purchase of the bill until due date.

There are three types of credit facilities for bills finance. They are:

- Bill purchase
- Bill discount
- Advance against bills for collection.

- **Bill Purchase:** When the bank negotiates a bill payable on demand, irrespective of whether clean or documentary, the facility is known as Bills Purchase. The face value of the bill is immediately paid to the holder of the bill. After purchasing the bill, the bank acquires all rights of ownership over the instrument.
- **Bill Discount:** When the bank credits value of the bill (less discount) which is payable on a future date after acceptance by the drawee, it is said to be bill discount. It should be remembered that demand bill is purchased and usance bill is discounted.
- **Advance against Bills for Collection (ABC):** When the bank advances against the bill sent for collection, the facility is known as ABC. Under this type of facility, a prescribed margin is kept by the bank.

Terms Used

The following are the important terms that are used under the bill discounting-

- **Bill of Exchange (B/E):** According to section 5 of the Indian Negotiable Instruments Act, 1881, “The bill of exchange is an instrument in writing containing an unconditional order, signed by the maker, directing a certain person to pay a certain sum of money only to, or to the order of, a certain person, or to the bearer of that instrument.” The Bill of Exchange (B/E) is used for financing a transaction in goods.
- **Discount Charges (DC):** Discount is the margin between the advance which is provided by the bank and the face value of the bill. It is computed on the maturity value at a rate of specific percentage per annum.
- **Maturity:** The date on which the payment will fall due is known as maturity date. The normal maturity periods are 30, 60, 90 or 120 days. But the bills maturity within 90 days is more common.

- **Ready Finance:** In order to assist the customers in receiving immediate finance from the bank, the bank discounts and purchases the bills of their customers. The customer does not have to wait till the bank collects the payment of the bill.
- **Usance:** It is tenor or time available for payment of bill by the drawee or buyer.
- From banking point of view, bill discounting is very safe, secure and liquid finance. In case of emergency, the bills can further be rediscounted with the Reserve Bank of India (RBI).
- **At Sight:** On presentment payment is to be made- demand bills.
- **After Sight:** Immediate delivery of goods and payment after credit period is over-usance bills.

14.4 Process of Bill Discounting

Generally, the following requirements of bank are to be fulfilled to become eligible for bill discounting:

- Where a usance bill is drawn at a fixed period after sight, the bill must be accepted to establish the maturity. A usance bill must have been accepted and should bear at least two good signatures.
- The bank discounts only trade bills and accommodation bills without trade interest are not eligible for discounting.

14.4.1 Foreign Bills/ Bills under Letter of Credit

Letter of Credit (LC) is a written commitment / guarantee issued by the importers bank (Buyers bank) to the exporters bank (Sellers bank) guaranteeing to pay a specified amount in foreign currency as specified in the LC subject to the condition that the seller meets the defined conditions as mentioned in the LC within a specified period of time. The LC should normally include the documents such as Bill of Lading or Airway Bill, Commercial Invoice, Certificate of Origin and such documents as mentioned in LC.

LCs are trade instruments which confirm the credit worthiness of the importer. Many a times, an international bank acts as intermediary between the importer and exporter. The international trade through LCs is governed by Uniform codes and procedures of documentary credit called UCPDC 600. The most important factor in international trade is that the banking system deals only with documents and not responsible for the goods, their quality or any other provisions in the sale contract between the importer and exporter.

There are various types of LCs such as revocable LC, irrevocable LC, confirmed LC, non-confirmed LC, back to back LC, red clause LC and green clause LC. However, all LCs are irrevocable in nature.

The various parties to LC are:

- Applicant (Importer)
- LC Issuing Bank (Importer's bank)
- Beneficiary (Exporter)
- Beneficiary's Bank (Exporter's bank)
- Advising Bank (which advises the LC to the exporter's bank)
- Confirming Bank (which confirms the validity of LC)
- Negotiating Bank (which negotiates the documents under LC)
- Reimbursing Bank (the bank which makes the payment to the paying bank)

The International Chamber of Commerce (ICC) have suggested specific terms called Incoterms which is acronym standing for international commercial terms. These terms are frequently used in the transactions and the concerned parties should be aware of these terms. They are terms which define the responsibilities of sellers and buyers under sales contracts. Some of the important incoterms are:

FOB - Free on Board

DAP - Delivered at Place

EXW - Ex Works

CIP - Carriage and Insurance Paid To

FCA - Free Carrier

DAT - Delivered at Terminal

DDP - Delivered Duty Paid

FAS - Free Alongside Ship

CFR - Cost and Freight

CIF - Cost, Insurance and Freight

Foreign bills

As per RBI guidelines, banks should open Letters of Credit (LCs) and purchase / discount / negotiate bills under LCs only in respect of genuine commercial and trade transactions of their borrower constituents who have been sanctioned regular credit facilities by the banks and not to non-constituent borrower or / and non-constituent member of a consortium / multiple banking arrangement.

Bills may be presented to the nominated bank in two ways under Documentary Credits (DC), they are:

- **With Recourse**
    - The documents are checked and confirmed that they comply with the DC terms, and the bill is sent with the original DC to the nominated bank

requesting payment. The nominated bank need not recheck documents and it can claim a refund from collecting bank in the case of any discrepancy.

- **Without Recourse**
  - Original DC and unchecked documents are sent to the nominated bank on a collection basis, requesting payment. The nominated bank has to check the documents in the normal way.
  - If the importer refuses a bill which the nominated bank has purchased, the bank must be sure of being able to get the amount from the importer's bank based on the DC.

14.4.2 Other conditions

As per RBI guidelines, while purchasing / discounting / negotiating bills under LCs or otherwise, banks should establish genuineness of underlying transactions / documents. Accommodation bills should not be purchased / discounted / negotiated by banks. Further banks should not open LCs and purchase / discount / negotiate bills bearing the 'without recourse' clause. According to the guidelines-

- The bank always ensures that when a bill is purchased, it is drawn on approved drawee within limits.
- Banks also maintain approved list of operators.
- According to the credit worthiness and volume of transactions, the bank may fix a limit to the borrower.
- The purchaser (the beneficiary customer) should sign the required documents.
- At any point of time, the limit sanctioned will not exceed and if the purchased documents (cheques/bills) are returned for any reason, the amount should be remitted immediately and the bills purchased account must be adjusted.
- In case of demand documentary bills, the bill must have enclosure of
  - An invoice
  - A bill of exchange
  - Document of title to goods

14.4.3 Bill Discounting Process

The bill or the Bill of Exchange (B/E) arises out of a credit sales transaction. The seller of the goods (drawer) draws a bill on the buyer which may be payable on demand or after usance period — generally not exceeding ninety days. The bill is accepted by the buyer (drawee) and/or by the buyer's bank. Thereafter, the seller approaches his bank to discount the bill.

The bank or the finance company discounting bills prefers to discount bills which are accepted by the buyer under a letter of credit opened by the buyer's bank referred to as L/C (Letter of Credit) backed bills. The finance company discounts the bill up-front.

Usually the discount charge is payable in advance, which means that the effective rate of interest is higher than the quoted rate. The rate of discount varies from time to time depending upon the movements in the short-term interest rate. The rate of discount applicable to clean bills is usually higher than the rate applicable to documents backed bills.

Apart from this, when bills are dishonored, certain charges (penal interest) are incurred and in such cases the bank will debit the account of the customers with the bill's amount along with interest and other charges.

14.4.4 Parties involved in Bill Discounting Process

The parties involved in bill discounting are as follows:

- **Drawer:** The drawer is a seller who has signed the B/E.
- **Financing Bank:** The bank that discounts the bill at a specific rate of interest.
- **Drawee/Acceptor:** Drawee is the person on whom the bill of exchange is drawn and is obliged for acceptance. He is the person to whom credit has been granted by the drawer and he is liable to pay money to the creditor/drawer.

In commercial bill financing, there are two systems of bills i.e. the drawee bill system and the drawerbill system are as follows-

- **Drawer Bills System:** Under this system, the seller of goods draws the bills on the buyer of the goods. The banker basically takes into account the creditworthiness of the drawer of the bill, at the time of discounting or purchasing these bills. This system is very popular in India.
- **Drawee Bills System:** Under this system, at the instance of the buyer, the banker accepts the bill drawn by the seller. The banker provides support based on the strength of the creditworthiness of the buyer. This system is classified into:
  - **Acceptance Credit System:** In this system, the banker of the buyer accepts the B/E which is made for the goods purchased by the drawee. This type of bill can be drawn on the buyer or on the banker. The banker wants the borrower to show the goods which are purchased under the acceptance credit in periodical stock statements that are submitted to the banker.
  - **Bill Discounting System:** In this system, a bill is directly drawn on buyer's bank by the seller. The buyer's bank then discounts the bill and the proceeds are sent to the seller. The buyer's banker will show the bills as "bill discounted."

14.4.5 Contents of a Bills of Exchange

The following aspects are most important with regard to contents of bills of exchange:

Date: The date of a bill drawn is written on the top right corner of the bill. This helps in determining the maturity date of the bill.

Term/Tenor/Usance: Term/Tenor/Usance specifies the time period for which a bill is drawn and it should be specified in the body of the bill.

Amount: Amount, in figures, should be mentioned on the top left corner of the bill and amount, in words, should be mentioned in the body of the bill.

Stamp: Stamp of proper value, depending upon the amount of bill, must be affixed on the bills of exchange.

Name of the parties: The names and addresses of the drawer and the drawee should be mentioned in the bills of exchange.

For Value Received: It means the bill has been drawn in exchange of some consideration. These words are very important because the instruments drawn without consideration are legally invalid.

Activity 14.1

A format of bill of exchange is given below. Identify the various contents of the bills of exchange presented.

126, Chandni Chowk,
Delhi-110 006
5th May, 20xx.

₹ 10,000,00 P

Stamp

Three months after date, pay to us or our order a sum of Rupees Ten Thousand Only, for value received.

Accepted
For M/s Aggarwal Stores
(Signed) Nakul Gupta
5.5.20xx
Partner

For M/s Lakhmi Chand & Sons. (Signed) Lakmi Chand
(Lakhmi Chand)
Partner

To
M/s Aggarwal Stores
216, Malka Ganj,
Delhi-11007

Source: ICFAI Research Center

14.5 Types of Bills

The credit sale bills can be classified on the basis of their due date for payment, type of activity and title of goods attached with the bills. Broadly, we can put such bills in the following categories:

Demand Bill: The bill is payable immediately "at sight" or "on presentment" to the drawee is called demand bill. A bill with no due date is also demand bill.

Usance Bill: A bill with specified time of credit period and due date.

Documentary Bill: A bill backed by the documents which confirm that a trade transaction has taken place between the buyer and the seller of goods. These documents include invoices and documents of title to goods such as lorry receipts, railway receipts and bills of lading.

Documents against Acceptance (D/A) Bills: Once the drawee gives his acceptance then only the documents are delivered.

Documents against Payments (D/P) Bills: Documents will be held with the banks or the finance company till the maturity of B/E and the bill is paid by the drawee.

Clean Bill: A bill without any documentary proof but which can support trade transaction between buyer and seller. High interest rates are generally charged while discounting such bills.

Accommodation Bill: A bill drawn for accommodating each other without consideration. Such transactions are called kite flying transactions.

14.5.1 Supply Bills

Bills drawn by suppliers/contractors on government departments/public sector undertakings are called 'Supply Bills'. These are not accepted by the government. However, contractors are able to get them discounted by producing inspection note and acknowledgement of the power of attorney duly registered in banks favor to receive payments from govt. dept. /undertaking.

14.6 Financial and Accounting Aspects

Letter of Credit (L/C) accompanied by the documents is generally preferred for discounting by the banks and finance company against the clean bills. As stated previously, these bills are discounted up-front which means that the discount is payable in advance. Method generally used to discount bills is effective rate of interest method. Because the discount is payable in advance, the effective rate of interest is higher than the quoted rate. Discount rate is actually an interest rate which is fixed by the bank for holding the bill for its remaining life. Generally, the discount amount depends on the current interest rates and the unexpired period of the bill.

The discount can be calculated using following formula:

$$\text{Discount} = \text{Face value of the bill} \times \text{Rate on interest} \times \frac{\text{Unexpired days of the bill}}{365}$$

Illustration 14.1

The Khan Finance Ltd., discounts the bills of the clients at a specified rate mentioned below:

L/C backed bills : 18 percent per annum

Clean bills : 20 percent per annum

Required: The effective rate of interest implicit in two types of bills is calculated with assumed usance period of,

90 days for L/C backed bill

60 days for the clean bill

Value of the bill- ₹ 18,000

Solution

Effective rate of interest on L/C backed bill:

Value of the bill = ₹ 18,000

Discount Charges

$$= \text{Face value of the bill} \times \text{Rate on interest} \times \frac{\text{Unexpired days of the bill}}{365}$$

$$= ₹\ 18{,}000 \times 0.18 \times \frac{90}{365} = ₹\ 798.90$$

Amount Received by the Client = ₹ 18,000 – ₹ 798.90= ₹ 17,201.10

$$\text{Quarterly effective interest rate} = \frac{798.90 \times 100}{17{,}201.10 \times 100} = 4.64\text{percent}$$

Annualized effective rate of interest = $[(1.0464)^4 – 1] \times 100$ = 20.23 percent.

Effective rate of interest on Clean Bill:

Value of the bill = ₹ 18,000

Discount Charges

$$= \text{Face value of the bill} \times \text{Rate on interest} \times \frac{\text{Unexpired days of the bill}}{365}$$

$$= ₹\ 18{,}000 \times 0.20 \times \frac{60}{365} = ₹\ 591.78$$

Amount Received by the Client = ₹ 18,000 – ₹ 591.78 = ₹ 17,408.22

$$\text{Quarterly effective interest rate} = \frac{591.78 \times 100}{17{,}408.22 \times 100} = 3.40\text{ percent}$$

Annualized effective rate of interest = $[(1.0340)^4 – 1] \times 100$ = 14.31 percent

14.6.1 Accounting for Bill Discounting

The drawer of the bill after discounting the bill, debits the banks column of the cash book with the proceeds of the bill and credits the bills receivable account with the full value. The difference between the above two figures i.e. the discount is transferred to an account known as discount on bills account which is debited. Thus, the accounting entry in the books of drawer is

Bank a/c	Dr.
Discount on Bills a/c (expenditure)	Dr.
To Bills Receivable a/c	Cr.

A bill becomes a current asset of the drawer after it is drawn. A bill is not considered as an asset of the drawer and eventually disappears from the balance sheet if it is discounted.

Activity 14.2

A drawer has a bill for ₹ 20,000. He discounted this bill with his bank two months before its due date at 12% p.a. What will be the amount of discount?

Can you derive the journal entry to be passed in the books of the drawer? What entry will come in the books of the drawee?

Answer:

14.6.2 Impact of Bill Discounting

The following points help us to know the impact of discounting a bill:

- In the drawer's book, the balance of the bills receivable a/c is decreased by the face value of the bill and the bank a/c is increased by its present value.
- From the drawer's perspective, the discount paid to the banker is in the form of interest and has no relation with cash or trade discount.
- The discount is considered as an expense for the drawer and revenue for the banker.
- The banker basically realizes the face value of the bill from the drawee/ acceptor on the due date. Thus, when a discounted bill is honoured then there is no need to pass a journal entry in the books of the drawer.
- The discounting of a bill does not influence the drawer's position.

14.6.3 Discounted Bills Receivables as a Contingent Liability

A contingent liability arises when a firm has discounted bills receivable and at the end of the accounting period, if such bills have not reached the due date for payment. The banker will debit the account of the drawer in their books if a bill which has been discounted with the banker is dishonored. A limited company which is preparing accounts as per the Companies Act, 2013, needs to disclose the contingent liability in the balance sheet as “contingent liability for bills receivable discounted”. In case if the drawer makes the bill payment before the due date, then the contingent liability in the books is squared off.

The following explains the Indian Accounting Standards (Ind AS) 37 provisions as follows-

[10]Indian Accounting Standard (Ind AS) 37 Provisions, Contingent Liabilities and Contingent Assets

Definition of Contingent Liabilities: A contingent liability is:

(a) A possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity; or

(b) A present obligation that arises from past events but is not recognised because: (i) it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or (ii) the amount of the obligation cannot be measured with sufficient reliability.

Disclosure:

Unless the possibility of any outflow in settlement is remote, an entity shall disclose for each class of contingent liability at the end of the reporting period a brief description of the nature of the contingent liability and where practicable:

(a) An estimate of its financial effect,

(b) An indication of the uncertainties relating to the amount or timing of any outflow;

(c) The possibility of any reimbursement.

14.6.4 Proportionate Chargeability of Discount Charges

The discounting charges must be shared proportionately or equally when the amount of the discounting charge is large and the bill discounting date and its due date comes under the two accounting periods.

Entries in the Books of Bank

The banker after discounting the bill assumes that the drawer will pay in due course. The banker identifies the interest rate while discounting the bill. By the end of the maturity period, if the bill is presented and paid by the drawer then the

[10] https://mca.gov.in/Ministry/pdf/IndAS37_2019.pdf

cash receipt is recorded. Thus, if the bill is discounted by the bank, then the following entries are passed by them.

- If the bill is discounted

  Bills discounted a/c Dr.

  To Customer's a/c Cr.

  To Discount a/c Cr.

  (Being the customer's bill discounted)

- If cash is collected from drawer

  Cash a/c Dr.

  To Bills discounted a/c Cr.

  All bills discounted or purchased by the banker should be entered in the bills discounted or purchased register in serial order and the serial number is changed annually.

Check Your Progress - 1

1. Which of the following terms is to be used when credit is allowed by the seller to buyer and time is available for payment of bill by the drawee?
   a. After sight
   b. At sight
   c. Usance
   d. Payable on demand
   e. Ready finance
2. Which of the following terms is used when a bill is payable at sight or on presentment to the drawee?
   a. Usance bill
   b. Documentary bill
   c. Demand bill
   d. Clean bill
   e. Supply bill
3. What will be the amount that a customer will get if he gets a ₹ 20,000 bill discounted with his bank at 8% for 90 days?
   a. ₹ 19,605.50
   b. ₹ 18,750.00
   c. ₹ 19,785.00
   d. ₹ 19,245.50
   e. ₹ 19,325.00

4. What will be the effective annual rate of interest that a customer will pay for a bill of ₹ 30,000 discounted with his bank at 9% for 120 days?
   a. 10.30%
   b. 9.30%
   c. 8.30%
   d. 7.30%
   e. 11.30%
5. Which of the following will be the impact of discounting bills in drawer's books?
   a. The balance of the bills receivable a/c is decreased by the face value of the bill and the bank a/c is increased by its present value
   b. The discount paid to the banker is in the form of interest and has relation with cash or trade discount
   c. The discount is considered as an income for the drawer and expense for the banker
   d. When a discounted bill is honored then the drawer has to pass a journal entry in the books
   e. No entries need to be passed while discounting of a bill in the drawer's books.

14.7 Bill Discounting vs. Factoring

Based on the Kalyan Sundaram Committee Report in 1989, factoring services has made its entry in India and banks introduced factoring as one of the financial services to its clients. The first venture was SBI Factors & Commercial Services Limited followed by Canbank Factors Limited.

Factoring is a financial *service* extended to business community wherein the company sells its bill receivables to a third party to raise funds at a discount. The third party who is a financial intermediary after purchasing the receivables perform other activities such as maintenance of accounts & collection of debts.

Factoring in India is not effective and popular due to the absence of distinct statute, lack of specialized credit information agencies/bureaus, judgment on the risks associated etc.

Bill discounting differs from factoring in many ways as the scope of the first is narrow than the latter. These differences are summed up as under:

- Bill discounting covers only those trade debts which are backed by accounts receivables (with recourse) whereas factoring is a broader term covering the entire trade debts of a client.

- In bill discounting, the drawer undertakes the responsibility of bills collection and remittance of the proceeds to the financing agency, while the factor usually undertakes to collect the clients' bills.
- Under bill discounting, the financier acts simply as an agent of his customer and does not become the owner whereas under factoring, the factor purchases the trade debt and thus becomes a holder for value. In other words, discounting is a kind of advance against bills whereas factoring is an outright purchase of trade debts.
- Bill discounting facility implies only the provision of finance but a factor also provides other services like sales ledger maintenance and advisory services.
- Accounts receivables under discount are subject to rediscounting whereas under factoring this is not possible.
- Bill discounting finance is a specific one in the sense that it is based on an individual bill arising out of an individual transaction only. On the other hand, factoring is based on bulk finance which is provided against a number of unpaid invoices.
- Under bill discounting, the drawee is aware of the bank's charge on the receivables. But, under undisclosed factoring, everything is kept highly confidential.
- Bill discounting is always a kind of "in-balance sheet financing" whereas factoring is an "off-balance sheet" mode of financing.

The Factoring Regulation Act, 2011 was the regulatory law governing the assignment of receivables by making provision for registration there for and rights and obligations of parties to contract for assignment of receivables and for matters connected therewith or incidental thereto. This Act was amended in 2021 under the Factoring Regulation (Amendment) Act, 2021. The new Act proposed various changes to the regulatory landscape of factoring of receivables to benefit MSMEs as detailed in the example.

Example: Factoring Regulation Bill to Open more Credit Facilities for MSMEs

The Factoring Regulation (Amendment) Bill, 2021 will improve credit facilities for small businesses. It will help them in accessing funds from 9,500 NBFCs, Mrs Nirmala Sitharaman, Finance Minister tweeted. The amendments have been approved by Rajya Sabha in July 2021. These measures will give a boost to the economy and provides an efficient working capital cycle for micro, small and medium enterprises (MSMEs),

Source: Factoring Regulation Bill to open more credit facilities for MSMEs: FM | Business Standard News (business-standard.com), dated: 30th July, 2021, Accessed on 11th July, 2022

14.8 Legal Aspects of Bill Discounting in India

Bill discounting is a financial transaction and let us understand various legal issues involved.

14.8.1 Bill Rediscounting Scheme and New Bill Market Scheme

Bill re-discounting has been developed as a financial service due to emergence of a fully grown bill market. RBI has set up many committees for the development of commercial bills market.

Some of the important committees include are

- Dehejia Committee, 1969
- Tandon Committee, 1974
- Chore Committee, 1980
- Vaghul Committee, 1985
- K.R.Rammoorthy Committee, 2000

14.8.2 Features of the New Bill Market Scheme

The bill market scheme of the RBI, introduced in January 1952, could not take off for various reasons. Therefore, the RBI introduced a new bill market scheme in November 1970 with the object of developing a genuine commercial bill market in India. It has been modified since then from time to time.

The bills covered under the bill market scheme must be genuine trade bills, i.e. bills which evidence sale and/or dispatch of goods. The RBI rediscounts these bills. That is why it is also (and more appropriately) called 'Bills Rediscounting Scheme'.

Banks can get bills rediscounted with not only from the RBI but also from other RBI approved discounting institutions such as Discount and Finance House of India (DFHI), LIC and GIC.

The advantages of a genuine bill market to the banking system and others are:

1. Normally, bills are self-liquidating and the date of payment of a bank's advances by way of the discounting/rediscounting of bills is fixed.
2. Bills offer greater liquidity to their holders as they can be negotiated and traded in the market.
3. A well-developed bill market helps greatly in reducing liquidity crisis throughout the financial system, as those with short-term surplus funds of whatever duration can invest them in bills of desired maturities.
4. The commercial bill discount rate is much higher than the treasury bill rate. Therefore, commercial banks and other financial institutions with short-run surpluses find bills as attractive avenues of investment not only for their liquidity but also for their return.

5. To the borrower, the cost of bill finance is somewhat lower than that of cash credit, because the bills carry the additional security in the form of acceptor's signature, and are time-bound.
6. Extensive use of bills as an instrument of short-term commercial credit and rediscounting of bills by the RBI makes the monetary system highly elastic.

[11]Discounting / Rediscounting of Bills by Banks / RBI Guidelines

Banks may adhere to the following guidelines while purchasing / discounting / negotiating / rediscounting of genuine commercial / trade bills:

(i) Since banks have already been given freedom to decide their own guidelines for assessing / sanctioning working capital limits of borrowers, they may sanction working capital limits as also bills limit to borrowers after proper appraisal of their credit needs and in accordance with the loan policy as approved by their Board of Directors.

(ii) Banks should clearly lay down a bills discounting policy approved by their Board of Directors, which should be consistent with their policy of sanctioning of working capital limits. In this case, the procedure for Board approval should include banks' core operating process from the time the bills are tendered till these are realised. Banks may review their core operating processes and simplify the procedure in respect of bills financing. In order to address the often-cited problem of delay in realisation of bills, banks may take advantage of improved computer / communication networks like the Structured Financial Messaging System (SFMS) and adopt the system of 'value dating' of their clients' accounts.

(iii) Banks should open letters of credit (LCs) and purchase / discount / negotiate bills under LCs only in respect of genuine commercial and trade transactions of their borrower constituents who have been sanctioned regular credit facilities by the banks. Banks should not, therefore, extend fund-based (including bills financing) or non-fund based facilities like opening of LCs, providing guarantees and acceptances to non-constituent borrower or / and non-constituent member of a consortium / multiple banking arrangement.

However, in cases where negotiation of bills drawn under LC is restricted to a particular bank, and the beneficiary of the LC is not a constituent of that bank, the bank concerned may negotiate such an LC, subject to the condition that the proceeds will be remitted to the regular banker of the beneficiary. However, the prohibition regarding negotiation of unrestricted LCs of non-constituents will continue to be in force.

[11] https://m.rbi.org.in/scripts/BS_ViewMasCirculardetails.aspx?id=5780

(iv) Sometimes, a beneficiary of the LC may want to discount the bills with the LC issuing bank itself. In such cases, banks may discount bills drawn by beneficiary only if the bank has sanctioned regular fund-based credit facilities to the beneficiary. With a view to ensuring that the beneficiary's bank is not deprived of cash flows into its account, the beneficiary should get the bills discounted / negotiated through the bank with whom he is enjoying sanctioned credit facilities.

(v) Bills purchased / discounted / negotiated under LC (where the payment to the beneficiary is not made 'under reserve') will be treated as an exposure on the LC issuing bank and not on the borrower. All clean negotiations as indicated above will be assigned the risk weight as is normally applicable to inter-bank exposures, for capital adequacy purposes. In the case of negotiations 'under reserve', the exposure should be treated as on the borrower and risk weight assigned accordingly.

(vi) While purchasing / discounting / negotiating bills under LCs or otherwise, banks should establish genuineness of underlying transactions / documents.

(vii) Banks should ensure that blank LC forms are kept in safe custody as in case of security items like blank cheques, demand drafts etc. and verified / balanced on daily basis. LC forms should be issued to customers under joint signatures of the bank's authorised officials.

(viii) The practice of drawing bills of exchange claused 'without recourse' and issuing letters of credit bearing the legend 'without recourse' should be discouraged because such notations deprive the negotiating bank of the right of recourse it has against the drawer under the Negotiable Instruments Act. Banks should not therefore open LCs and purchase / discount / negotiate bills bearing the 'without recourse' clause. On a review it has been decided that banks may negotiate bills drawn under LCs, on 'with recourse 'or 'without recourse 'basis, as per their discretion and based on their perception about the credit worthiness of the LC issuing bank. However, the restriction on purchase/discount of other bills (the bills drawn otherwise than under LC) on 'without recourse 'basis will continue to be in force.

(ix) Accommodation bills should not be purchased / discounted / negotiated by banks. The underlying trade transactions should be clearly identified and a proper record thereof maintained at the branches conducting the bills business.

(x) Banks should be circumspect while discounting bills drawn by front finance companies set up by large industrial groups on other group companies.

(xi) Bills rediscounts should be restricted to usance bills held by other banks. Banks should not rediscount bills earlier discounted by non-bank financial companies (NBFCs) except in respect of bills arising from sale of light commercial vehicles and two / three wheelers.

(xii) Banks may exercise their commercial judgment in discounting of bills of the services sector. However, while discounting such bills, banks should ensure that actual services are rendered and accommodation bills are not discounted. Services sector bills should not be eligible for rediscounting**.** Further, providing finance against discounting of services sector bills may be treated as unsecured advance and, therefore, should be within the norm prescribed by the Board of the bank for unsecured exposure limit.

(xiii) In order to promote payment discipline which would, to a certain extent, encourage acceptance of bills, all corporates and other constituent borrowers having turnover above threshold level as fixed by the bank's Board of Directors should be mandated to disclose 'aging schedule' of their overdue payables in their periodical returns submitted to banks.

(xiv) Banks should not enter into repo transactions using bills discounted / rediscounted as collateral.

Example: Indian Banks Wary of Bill Discounting for Exports to Sri Lanka

Banks in India have turned cautious, as Sri Lanka faces a severe foreign exchange crunch since the late 2021. The Indian banks have become selective about their exposures to Sri Lanka.

Several banks have reduced discounting bills under LCs issued by many Sri Lankan lenders. Some banks are extending credit to exporters purely based on the standing of the party, tenor of the credit, amount, and standing of the LC issuing bank.

Source: https://economictimes.indiatimes.com/markets/stocks/news/banks-turn-cautious-on-sri-lanka-exposures/articleshow/88745053.cms?utm_source=contentofinterest&utm_medium=text&utm_campaign=cppst, dated: 7th January, 2022, Accessed on 11th July, 2022

14.9 Present Position of Bill Discounting Market in India

In India, financing post-sale operations against bill of exchange is always considered beneficial from the bankers' point of view. This is because bills represent the receivables stage of the operating cycle of a commercial activity, short term in tenor, self-liquidating in nature, enhance credit worthiness through acceptance by the drawee, a third party and offer liquidity to the bank through re-discounting window. However, in the Indian banking scenario, for decades now, cash credit/overdraft continues to be the preponderant style of working capital funding. While cash credit constitutes about 70% of the total bank credit, bill finance is barely at around 10% of total bank credit.

Apart from banks, NBFCs had been acting till the early nineties as bill broker for sellers and buyers of bills arising out of business transactions. They were acting as a link between banks and business firms. Sometimes, they used to take up bills on their own account, using own funds or taking short term loan from banks working as acceptance/discount houses. They had been handling businesses approximately to the extent of ₹ 5,000 crores annually. But after RBI's guideline to the banks in 1992 (mentioned earlier), there was substantial decline in the volume of bills discounting.

14.9.1 Bill Financing - Key Issues

Many issues are involved in bill discounting

The following are the key issues involved in bill financing-

- In India, the major reason cited for the non-development of bill financing is the hesitation of the industry and trade to subject themselves to the rigors of bill discipline.
- The development of bill culture, pre-supposes the willingness of trade and industry to subject themselves to the strict commitment to honour financial obligations on the contracted date.
- Operational and procedural hassles currently prevailing in banking system too are said to impede the growth of bill financing even amongst those business segments where it has found acceptance.
- Apart from above, commercial transactions are now generally tending to be more in the nature of open account sales. With the spread of e-Commerce, this trend may get accentuated and there is also growing expectation from trade and industry for on-line completion of transactions.

TReDS (Trade Receivables Discounting System)

TReDS (Trade Receivables Discounting System), a platform for discounting of trade receivables, invoice and bill discounting was launched in 2018 by RBI. There are three operational TReDS platforms in India –

1. RXIL (a joint venture of NSE and SIDBI)
2. Mynd Solution's M1Xchange
3. InvoiceMart (owned by A TReDS Limited – a joint venture between Axis Bank and mjunction services)

TReDs offer discount rates that are competitive and appealing. As of October, 2022, M1xchange facilitated with bill discounting of more than ₹ 36,000 cr to over 13,500 MSME suppliers spread across 1,200 towns from across the country[12].

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[12] https://www.m1xchange.com/nearly-13-lakh-MSMEs-in-TN-to-benefit-from-TReDS.php#:~:text=As%20of%20October%2031%2C%202022,towns%20from%20across%20the%20country.

Example: First Paperless Bill Discounting enabled by ICICI Bank

In June 2021, ICICI Bank had enabled a 'paperless bill discounting transaction' for ArcelorMittal Nippon Steel (AMNS). This end-to-end electronic transaction, comprises digital issuance of an LC, advisory and presentation of documents took place among AMNS, its customer Vijay Tanks and the banker (ICICI Bank). This is a step forward for digitizing trade payments and became the country's first domestic paperless BD transaction in India.

ICICI Bank was the intermediary between the buyer and seller. Bank's Baroda branch issued an LC for the buyer Vijay Tanks, and its Hazira branch advised and negotiated for the seller i.e. AMNS. One of the terms of the LC stipulated that AMNS digitally present the documents to the banker (ICICI Bank) thereby evidencing the transaction flow.

Source: ICICI Bank enables first paperless bill discounting - Banking Frontiers, dated: 1st July, 2021, Accessed on 11th July, 2022

Check Your Progress - 2

6. Which of the following funding facility will help the vendor to get finance against the receivables?
   a. Hire purchase
   b. Leasing
   c. Bill discounting
   d. Factoring
   e. Installment system
7. Which of the following will be facilitated by the drawee bills system?
   a. Acceptance credit system
   b. Bills discounting system
   c. Drawer bills system
   d. Both (a) and (b)
   e. (a), (b) and (c)
8. What is the name given to the practice of discounting the accommodation bills?
   a. Stamping bills
   b. Kite flying
   c. Hundi
   d. Clean bill
   e. Derivative

9. Which of the following represents time bills?
   a. Usance bill
   b. Kite flying
   c. Documentary bill
   d. Demand bill
   e. Clean bill
10. In this system, a bill is directly drawn on buyer’s bank by the seller. Which is the system we are referring to?
    a. Drawer bill system
    b. Bill discounting system
    c. Acceptance credit system
    d. Bank bill system
    e. Drawer and bank bill system

14.10 Summary

- Discounting of bill is a lucrative fund-based service provided by the finance companies.
- Discounting a bill means that the financial intermediary buys the bill (i.e. Bill of Exchange or Promissory Note) before it is due and credits the value of the bill after a discount charge to the customer's account. The transaction is basically an advance against the security of the bill and the discount represents the interest on the advance from the date of purchase of the bill until due date.
- The margin between the ready money paid and the face value of the bill is called the discount rate and is calculated at a rate percentage per annum on the maturity value.
- The maturity of B/E is defined as the date on which payment will fall due. Normally maturity periods are 30, 60, 90, 120 days but bills maturing within 90 days seem to be the most popular.
- There are different types of bills available in the market like demand bills, usance bills, documentary bills and clean bills.
- Bills accompanied by the documents are generally preferred for discounting by the banks and finance companies as against the clean bills.

14.11 Glossary

Book Debt Financing: Finance against receivables of client.

Cash Credit: A cash credit is short-term working capital finance.

Contingent Liability: Liability that may be incurred by an entity depending on the outcome of an uncertain future event of default.

Outright Purchase: To pay cash for the full purchase price.

Overdraft: A credit facility extended by Banks to the account holder for drawing from his account an amount over and above the credit balance in his account.

Present Value: The current worth of a future sum of money or stream of cash flows given a specified rate of return.

Proceeds: Realized monetary value of a commercial bill is called proceeds.

Usance Period: The allowable period of time, permitted by custom or credit period, between the date of bill and its payment. The usance of a bill varies between countries, often ranging from two weeks to two months.

14.12 Self-Assessment Test

1. Briefly explain the features of bill discounting, its types and advantages.
2. What is the process of discounting and purchasing of commercial bills of exchange?
3. Discuss the advantages of a genuine bill market to the banking system.
4. Why is bill financing not developed in India?

14.13 Suggested Readings/Reference Material

1. Anthony Saunders, Marcia Millon Cornett, Anshul Jain (2021), Financial Markets and Institutions, 7th edition, Tata McGraw-Hill Education
2. Prasanna Chandra (2020), Fundamentals of Financial M, 7th edition, Tata McGraw-Hill Education.
3. Devie Mohan (2020), The Financial Services Guide to Fintech, 1st edition, Kogan Page Limited.
4. Siddhartha Sankar Saha (2021). Indian Financial System. 2nd edition, Tata McGraw-Hill Education
5. DR. R. Shanmugham (2020). Financial Services. 2nd edition. Wiley India

14.14 Answers to Check Your Progress Questions

1. (c) Usance

When tenor or time is available for payment of bill by the drawee or buyer, such bills are termed as usance bills.

2. (c) Demand bill

A bill which is payable immediately at sight or on presentment with no due date to the drawee is called demand bill.

3. (a) ₹ 19,605.50

We need to calculate the discount charges as the first step which is given by the formulae

Discount charges = Face value of the bill x Rate on interest x $\frac{\text{Unexpired days of the bill}}{365}$

= 20,000 x 0.08 x 90 / 365= ₹ 394.50. Deducting this amount from principle amount = 20,000 - 394.50 = 19.605.50

4. (b) 9.30%

This is calculated in four steps.

Step-1 - Calculate the discount amount = 30,000 x 0.09 x 120/365= ₹ 888

Step-2 - Calculate the amount to be received after discounting the bill= 30,000 – 888 = ₹ 29,112

Step-3 - Calculate the effective rate for 120 days = 1/3rd of year = (888 x 100) / (29,112 x 100) = 3.05%

Step-4 - Calculate the effective rate on annualized basis = [(1.030)^3 – 1] x 100 = 9.30%

5. (a) The balance of the bills receivable a/c is decreased by the face value of the bill and the bank a/c is increased by its present value

In the drawer's book, the balance of the bills receivable a/c is decreased by the face value of the bill and the bank a/c is increased by its present value.

6. (c) Bill discounting

Easy access, safety of funds, certainty of payment and smooth liquidity are the benefits of bill discounting.

7. (d) Both (a) and (b)

The drawee bills system involves both acceptance credit system and bill discounting system.

8. (b) Kite flying

The practice of discounting the accommodation bills is known as kite flying or documentary bills wherein a bill is backed by the documents which confirms that a transaction has taken place between the buyer and the seller of goods.

9. (a) Usance bill

Usance bill with specified time period recognized by custom or usage for payment. Also known as time bill.

10. (b) Bill discounting system

Under bill discounting system, a bill is directly drawn on buyer's bank by the seller.

Unit 15

Factoring and Forfaiting

Structure

"Financial service providers act as lubricating oil in the economy."

- John Bruton, former Irish Prime Minister

15.1 Introduction

Factoring and forfaiting as financial services facilitate easy export-import financial transactions hence the quote is justified.

Post-sales financing (receivables financing) is an important part of working capital management.

In the previous unit, we discussed the concepts, definitions and characteristics of bill discounting and accounting of bills. We also discussed transactions and legal aspects of bill discounting in India.

In this unit, we shall discuss other types of receivables financing.

Monitoring the collection of the receivables is the most important objective of receivables management. Factoring is a versatile service entity for the management of receivables and credit risks. Factoring services include credit control, accounts ledger management, reporting, debt collection and credit-risk management.

Similarly, in the case of export-receivables forfaiting, a concept similar to factoring provides support to the exporter. Forfaiting is the export-receivables financing that the exporter receives in cash, by selling the medium-term receivables at a discount. In this case, the exporter eliminates risk, as the transaction is without recourse.

Factoring has started in India in the later part of the 20th century. In 1988, the Reserve Bank of India (RBI) constituted a high powered committee to examine the scope for offering factoring services in the country. This committee submitted its report in 1989 wherein it proposed the starting of factoring services in India through factoring subsidiaries.

In this unit, we shall discuss various aspects of factoring and forfaiting at length. This unit presents the conceptual framework underlying factoring and the salient features of factoring-transactions in the Indian context.

15.2 Objectives

After going through this unit, you should be able to:

- Appreciate the concept of factoring and forfaiting
- Discuss various forms of factoring and functioning of a factor
- Describe the legal aspects of factoring
- Elaborate on the intricacies of operating procedures associated with factoring and forfaiting

15.3 Introduction: Factoring

The word factoring is derived from the Latin word Factor which means to get things done. Factor is an agent who does things for his client at a cost (commission). According to the International Institute for Unification of Private Law, (UNIDROIT), factoring means an arrangement between a factor and his client that includes at least two of the following services.

a. Financing for the supplier
b. Maintenance of accounts relating to the receivables
c. Collection of debts/ receivables
d. Protection against credit risk/ default in payment of debtors[13]

[13] http://www.unidroit.org/instruments/factoring

Thus, factoring is a service that is associated with receivables management.

It involves the transfer of the collection of receivables, and the related bookkeeping functions from the firm to a financial intermediary called the factor. In addition, the factor often extends a line of credit against the receivables of the firm. Thus, factoring provides the firm with a source of financing its receivables and facilitates the process of collecting the receivables.

[14]In India The Factoring Act, 2011 defines the 'Factoring Business' as the business of acquisition of receivables of assignor by accepting assignment of such receivables or financing, whether by way of making loans or advances or in any other manner against the security interest over any receivables.

In India, an entity not registered with the RBI may not conduct the business of factoring unless it is an entity mentioned in Section 5 of the Factoring Act 2011 i.e. a bank or any corporation established under an Act of Parliament or State Legislature, or a Government Company as defined in Companies Act, 2013.

NBFC-Factor is a non-banking financial company fulfilling the principal business criteria i.e. whose financial assets in the factoring business constitute at least 75 percent of its total assets and income derived from factoring business is not less than 75 percent of its gross income, has net owned funds of ₹ 5 crore and has been granted a certificate of registration by RBI under section 3 of the Factoring Regulation Act, 2011. However, Factoring Bill 2021 Amendment had removed earlier guidelines that allowed NBFCs to remain in factoring business only if their financial assets in the factoring arm and income earned from it was over 50 per cent of the company's gross assets and net income.

Example: SBIGFL: SBI's Factoring Company

SBI Global Factors Ltd. (SBIGFL), a subsidiary of State Bank of India (SBI), provides domestic and export factoring services in India. Extension of up to 90% of finance against receivables, credit protection, follow-up for collection of receivables, ledger management as part of maintenance of accounts were the services provided by SBIGFL.

Source: https://www.sbiglobal.in/about-us.php & https://www.sbiglobal.in/highlights-of-SBIGFL-services.php Year: 2022 Accessed on September 17, 2022.

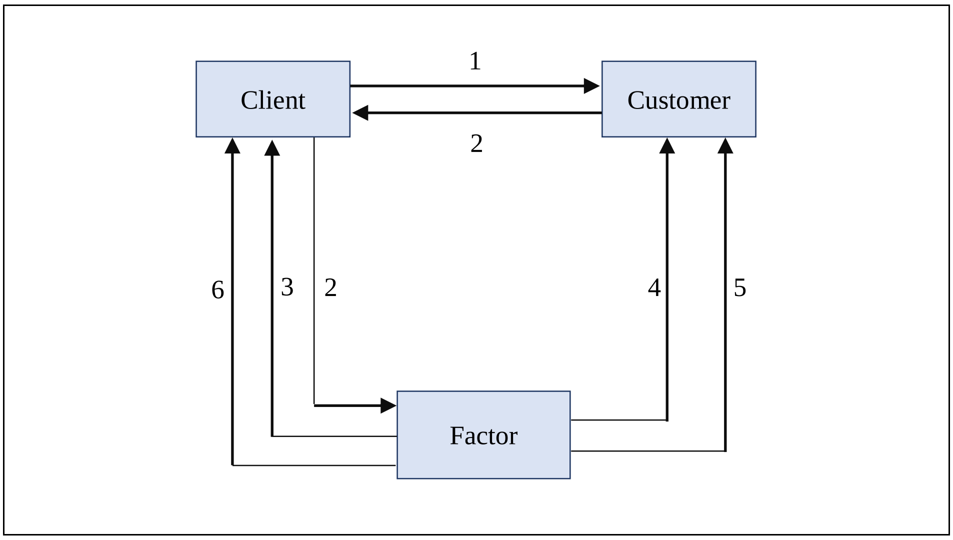
15.4 Concept of Factoring

Factoring can be defined as the act of selling the book debts (or receivables) of a firm (called as 'client') to a financial intermediary called the Factor on the understanding that the Factor will pay for the debts whenever they are collected, or on a guaranteed payment date. Normally, the factor gives a part-payment after

[14] https://m.rbi.org.in/scripts/FAQView.aspx?Id=88

the purchase of debts, thus ensuring immediate liquidity to the client. Figure 15.1 depicts the process of factoring.

Figure 15.1: Process of Factoring



Source: ICFAI Research Center

The following Table 15.1 provides the factor services as –

Table 15.1: Factor and Related Transactions

Transaction No.	Description
1.	Client concludes a credit sale with the customer.
2.	Client sells the customer's account to the factor and notifies the customer.
3.	Factor makes a part payment (advance) against the account purchased after adjusting for commission and interest on the advance.
4.	Factor maintains the customer's account and follows up for payment.
5.	Customer remits the amount due to the factor.
6.	Factor makes the final payment to the client when the account is collected or on a guaranteed payment date.

Source: ICFAI Research Center

For rendering the services of collection and maintenance of sales ledger, the factor charges commission expressed as a flat percentage of the value of debts purchased and collects this commission upfront (at the time of purchasing the debts). The factor charges interest on the part payment made on the receivables.

This interest will be usually more than the bank interest on working capital loans. The interest charge is calculated for the period between the date of the advance payment and the date of collection or the guaranteed payment date. If the interest charge is collected up-front, it is referred to as the discount charge. Illustration 15.1 explains the mechanics involved in calculating the discount charge and the amount of advance.

Illustration 15.1

Under an advance factoring arrangement, Bharat Factors Limited (BFL) has agreed to advance a sum of ₹ 14 lakh against the receivables purchased from ABC Limited. The factoring agreement provides for an advance payment of 80 percent of the value of the factored receivables and for guaranteed payment, after three months from the date of purchasing the receivables. The advance carries a rate of interest of 16% p.a. compounded quarterly, and the commission of the factor is 1.5 percent of the value of factored receivables. Both the interest and the commission are collected upfront.

How to do this?

a. Compute the amount made available to ABC Limited.

b. Calculate the effective cost of funds made available to ABC Limited.

c. Assume that the interest is collected in arrear and the commission is collected in advance. Calculate the effective cost of funds made available to ABC Limited.

Solution

(₹ in lakh)

a.

Value of factored receivable (= 14/0.8)	17.50
Maximum permissible advance	14.00
Less: Commission @ 1.5 percent (= 17.5 x 0.015)	0.26
	13.74
Less: Discount charge (14 x 0.16 x 90/360)	0.56
Funds made available to ABC Limited	13.18

b. Discount charge expressed as a percentage of funds made available to ABC Limited $\left(\frac{0.56}{13.18}\right)$ x 100 = 4.25%

Therefore, the effective rate of interest is 4.25 percent per quarter. The annualized rate of interest = $[(1.0425)^4 - 1)]$ x 100 = 18.11%

Put differently, the annualized cost of funds made available to ABC Limited is 18.11%.

c.

Maximum permissible advance	14.00
Less: Commission payable up-front (= 17.5 x 0.015)	0.26
Funds made available to ABC Limited	13.74

Interest charge collected in arrear = (14 x 0.16 x 90/360) = 0.56

Interest charge expressed as a percentage of funds made available

$= \frac{0.56}{13.74} \times 100 = 4.08\%$

Annualized interest cost = $[(1.0408)^4 - 1] \times 100 = 17.35\%$

In the above illustration, it is assumed that the advance amount offered by the factor is limited to 80 percent of the value of book debts factored. In fact, the factor never provides a hundred percent finance. They maintain a margin called the 'factor reserve' to provide for disputes and deductions relating to the bills assigned to them.

Example: Factoring Services by India Factoring and Finance Solutions Pvt. Ltd

India Factoring and Finance Solutions Pvt. Ltd provided a six-step explanation of its domestic factoring services in India. In the first and second steps, the client ships goods on credit terms to the buyer and submits invoice + shipping documents to India Factoring; then, India Factoring pays 80% immediately to the client; in the fourth step,, India Factoring follows up with the client's buyer say Daimler/TCS and collects money on due date; in the fifth step, pays balance 20% to the client and finally, in the sixth step recovers 80% on Maturity date if unpaid by client's buyer (Daimler/TCS).

Source: https://www.indiafactoring.in/en/domestic-factoring Year: 2022 Accessed on September 18, 2022.

15.5 Forms of Factoring

The different types of factoring classified based on their features are as follows:

- Recourse factoring
- Non-recourse factoring
- Maturity factoring
- Advance factoring
- Invoice discounting
- Full factoring
- Bank participation factoring
- Supplier guarantee factoring
- Cross border factoring.

The following features are, of course, common to most of the factoring arrangements: (i) the factor is responsible for the collection of receivables; (ii) the factor maintains the sales ledger of the client.

In addition to the above-mentioned common features, there are certain unique features for each of the factoring types. These unique features of the various types of factoring are discussed below:

15.5.1 Recourse Factoring

The factor purchases the receivables on the condition that the loss arising on account of irrecoverable receivables will be borne by the client. For instance, suppose that a factor has advanced an amount of ₹ 3.4 lakh against a receivable of ₹ 4 lakh. Then if the book-debt becomes irrecoverable, the factor can get back the amount advanced ₹ 3.4 lakhs from the client in case of recourse factoring. In other words, a recourse factoring arrangement allows the factor to have recourse to the client if the debt purchased turns out to be irrecoverable.

15.5.2 Non-Recourse Factoring

As the name implies, the factor has no recourse to the client, if the debt purchased turns out to be irrecoverable. To accommodate for the losses to be incurred if the debt becomes bad or irrecoverable, the factor will charge a higher rate of commission. This additional commission is referred to as *del credere* commission.

In addition, the factor participates actively in the credit granting process and decides/approves the credit lines extended to the customers of the client. While non-recourse factoring is the most common form of factoring in countries like the USA and the UK, in the Indian context, factoring is done with recourse to the client.

The comparison of recourse and non-recourse factoring is shown in Table 15.2 below.

Table 15.2: Comparison of Recourse and Non-Recourse Factoring

Recourse Factoring	Non-recourse Factoring
It is the responsibility of the business/ originator to follow up for the realization of the invoice. Loss arising on account of irrevocable receivables will be borne by the applicant. Though the factoring company pursues with the buyer, it will ultimately not take the responsibility of collecting the invoice. It will be returned to the originator of the invoice.	Once a business sells its invoices, the deal is done. The originator need not worry about the realization of the bills. The entire loss due to non-realization of receivables is borne by the factor. The factoring company takes all the risks and responsibilities of collecting the bills.

The cost is low compared to the non-recourse factoring. Popular in India	The cost associated is higher as the debts are irrevocable. Not Popular in India but popular abroad

Source: ICFAI Research Center

15.5.3 Maturity Factoring

Under this type of factoring arrangement, the factor does not make any advance payment. The factor pays the client either on a guaranteed payment date or on the date of collection. The guaranteed payment date is usually fixed taking into account the previous ledger experience of the client and a period for slow collection after the due date of the invoice.

15.5.4 Advance Factoring

Under this arrangement, the factor provides an advance varying between 75-85 percent of the value of receivables factored. The balance is paid upon collection or on the guaranteed payment date. As we have already seen, the factor charges interest from the date on which advance payment is made to the date of actual collection or the guaranteed payment date. The rate of interest is usually determined depending upon (i) the prevailing short-term rate of interest, (ii) the client's financial standing, and (iii) volume of turnover.

15.5.5 Invoice Discounting

Strictly speaking, this is not a form of factoring because it does not carry the service elements of factoring. Under this arrangement, the factor provides a pre-payment to the client against the purchase of book-debts, and charges interest for the period spanning the date of pre-payment to the date of collection. The sales-ledger administration and collection are carried out by the client. Hence, the client should give an account of the value of unpaid invoices and the aging schedule of debts periodically. This facility is usually kept confidential, i.e., the customers (whose debts have been purchased by the factor) are not informed of the arrangement. Therefore, this arrangement is also called 'Confidential Factoring'.

A variant of the invoice discounting is the Protected Invoice Discounting arrangement, where the factor bears the credit risk of the receivables purchased. In other words, the factor acquires the debts without recourse. However, he does not offer the services of sales-ledger administration and debt collection. Invoice discounting in general and protected invoice discounting in particular, are offered to clients with a sound financial position and with no serious problem of debt collection or debt write-offs.

If the invoice discounting facility is not confidential in nature, the customers of the client are advised to make payment directly to the factor and this facility is referred to as 'Bulk Factoring'. Bulk factoring is undertaken when the client is not in a position to fulfill the norms laid down for invoice discounting. In addition, the client may want to avail the security associated with payments made directly to factor by the customers' discounting, and requires the security associated with direct payments from the customers. Bulk factoring offered with a non-recourse feature is referred to as 'Agency Factoring' in some countries, because the client acts as an agent of the factor, in collecting the debts.

15.5.6 Full Factoring

A factoring arrangement, which combines the features of non-recourse and advance factoring arrangements, is called 'Full Factoring or Old Line Factoring'. Full factoring is a complete form of factoring that provides a range of services such as collection, sales ledger administration, credit protection, and short term financing.

15.5.7 Bank Participation Factoring

This arrangement can be viewed as an extension of advance factoring. Under this arrangement, a commercial bank participates in the transaction by providing an advance to the client against the reserves maintained by the factor. For example, assume that a factor has advanced 80 percent of the value of factored receivables and the commercial bank provides an advance limited to 50 percent of the factor reserves. The client is required to fund only 10 percent of the investment in receivables, the balance 90 percent is provided by the factor and the commercial bank.

15.5.8 Supplier - Guarantee Factoring

Supplier Guarantee Factoring is a form of factoring that owes its emergence to the practices followed by American factors. This form of factoring is aimed at helping the importers/distributors involved in executing import orders, on behalf of their customers. The typical steps involved are as follows:

i. The customer places an import order with the distributor.

ii. The distributor seeks the approval of the factor for extending credit to the customer.

iii. On receiving the credit approval from the factor, the distributor makes arrangements for shipping the supplies directly to the customer.

iv. The factor guarantees payment to the foreign supplier for the specific shipment. Upon shipment, he credits the account of the distributor and debits the account of the customer for an amount equal to the invoice value of the goods shipped plus the distributor's commission.

v. Instead of making an advance payment to the distributor against the customer's account that has been factored, the factor pays the supplier directly for the invoice value of the goods shipped.

vi. The factor follows up with the customer, collects the amount due and makes the final payment to the distributor, after deducting his commission and guarantee charges.

Thus, apart from offering the usual services, the factor guarantees payment to the supplier on behalf of his client (the distributor) thereby engendering greater confidence in supplier-distributor dealings.

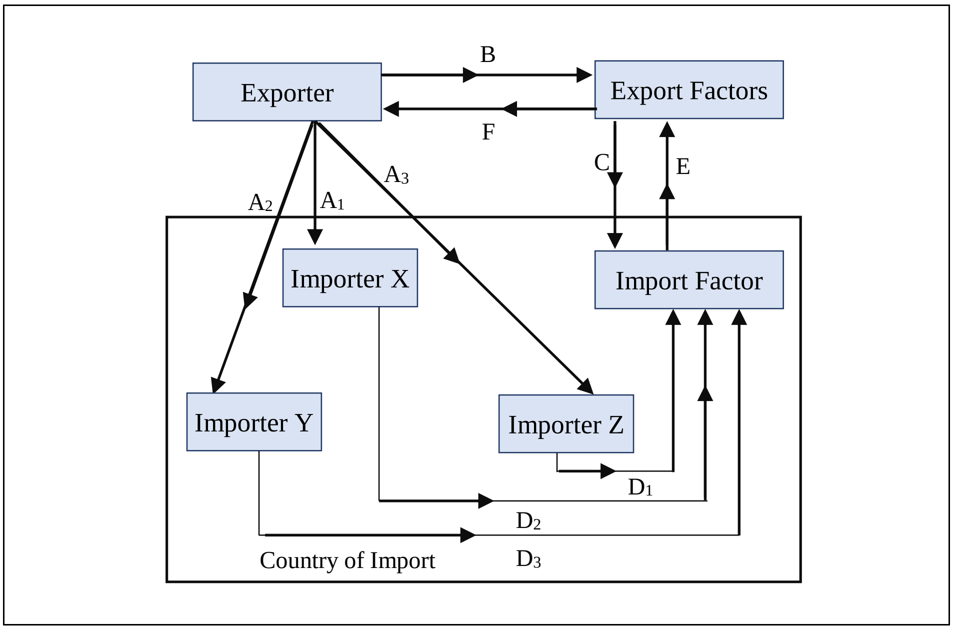
15.5.9 Cross-border Factoring

The features of cross-border factoring (also referred to as international factoring or export factoring) are akin to domestic factoring, except that there are usually four parties to the transaction – exporter, export factor, import factor and importer. (See Figure 15.2) Under this system of factoring, referred to as the two-factor system of factoring, the exporter (the client) enters into a factoring agreement with the export factor domiciled in his country and assigns to him export receivables as and when they arise. The payment against the factored debts is made exactly the same way as under a domestic factoring facility. If the sale value is denominated in the currency of the importer's country, the factor usually covers the exchange risk associated with the remittances.

The export factor enters into an arrangement with a factor, based in the country where the importer resides (import factor) and contracts out the tasks of credit checking, sales ledgering and collection for an agreed fee. The debt is usually not assigned to the import factor.

The relationship between the import factor and the importer (the customer) is clarified by a notation on the sales invoice that the payment is to be made directly to the import factor. The import factor collects the amount from the customer and remits it to the export factor. (Figure 15.2)

Figure 15.2: Cross-border Factoring with Two Factors



Source: ICFAI Research Center

Explanatory Notes to Figure 15.2:

a.	A_1, A_2 and A_3	Exporter sells goods on open credit.
b.	B	Export receivables are factored on a non-recourse basis. The documents that are to be delivered to the export factor are relevant invoices, bills of lading and other supporting documents.
c.	C	Export factor carries out the work of credit checking, sales ledger accounting, and collection to the import factor, with respect to the customers located in the country of imports.
d.	D_1, D_2 and D_3	Import factor collects the money due from the customers concerned.
e.	E	Import factor affects payments to the export factor on assignment or maturity or collection, as per the terms agreed upon between them.
f.	F	Export factor effects payments to the exporter upon assignment, maturity or collection, depending upon the type of factoring arrangement between them.

Source: ICFAI Research Center

Thus, the two factor system results in two separate but linked agreements: one between the client (the exporter) and the export factor and the other between the export factor and the import factor. Both export and import factors are part of a formal chain of factors having well defined rules for conducting the business. Otherwise, the export and import factors evolve an *ad hoc* relationship to conduct specific transactions.

Even though cross-border factoring involves two factors, the exporter necessarily deals with only one factor residing in his country, and the factoring formalities to be gone through are more or less identical to those governing domestic operations. At the same time, the credit rating of the importer and collection of receivables are carried out by a factor who can speak the language of the importer (the customer) and who is thoroughly conversant with the business practices and commercial procedures of the customer’s country. Cross-border factoring involving two factors will be expensive in comparison to the other arrangement where only one factor – the export factor or the import factor is employed. Then the advantages of the two factor system seem to outweigh the extra cost consideration, and it remains the most popular form of cross-border factoring.

Example: Recourse and Non-Recourse Factoring: SBIGFL's Distinction

SBI Global Factors Ltd. (SBIGFL) differentiates its recourse and non-recourse factoring services. In the case of recourse factoring, SBIGFL mentioned that in the scenario of client's buyer failed to pay on maturity, the client needed to return the advance taken from SBIGFL. In the case of "non-recourse" factoring, SBIGFL provided finance and takes the default risk by the client's buyer.

Source: https://www.sbiglobal.in/faq.php Year 2022 Accessed on September 18, 2022

15.6 Factoring Vis-À-Vis Bills Discounting

While factoring started in the later part of the 20th century in the Indian context, most readers will be familiar with the bill discounting arrangement offered by commercial banks and finance companies. The bill discounting arrangement works as follows: The bill or the bill of exchange arises out of a credit sales transaction. The seller of the goods (drawer) draws a bill on the buyer which may be payable on demand or after a usance period not exceeding ninety days. The bill is accepted by the buyer (drawee) and/or by the buyer's bank. Later, the drawer of the bills can discount the bill with his banker, or the banker of the buyer with a finance company.

The bank or the finance company discounting bills prefers to discount bills, which are accepted by the buyer under a letter of credit opened by the buyer's bank. This is referred to as L/C (Letter of Credit) backed bills, as opposed to bills, which are not backed by L/Cs referred to as clean bills. The finance company discounts the bill up-front. Put differently, the discount charge is payable in advance, which means that the effective rate of interest is higher than the quoted rate. The rate of discount varies from time to time, depending upon the movements in the short-term interest rate. The rate of discount applicable to clean bills is usually higher than the rate applicable to backed bills.

Illustration 15.2

Ananya Finance Limited has the following process for discounting the bills of its clients at the following rates:

L/C backed bill	–	21% p.a.
Clean bill	–	24% p.a.

Calculate the effective rates of interest implied by (a) a L/C backed bill with a usance period of 90 days and (b) a clean bill with a usance period of 60 days.

Solution

a. Value of the L/C backed bill = ₹ 1,000

Discount charge = 1,000 x 0.21 x $\frac{90}{360}$ = ₹ 52.5

Value received by the client = ₹ 947.5

Effective rate of interest per quarter = $\frac{52.5}{947.5}$ x 100 = 5.54%

Effective rate of interest per annum = $[(1.0554)^4 – 1]$ x 100 = 24.07%

b. The reader can verify that the effective rate of interest on the clean bill is 28.54% per annum.

The similarity between factoring and bill discounting lies in the fact that both enable the provision of finance against the security of accounts' receivables of the client. There are, however, some important differences between the two arrangements, which are listed below:

1. Bill discounting is transaction oriented in the sense that each bill is separately assessed and discounted by the financial, whereas factoring involves a pre-payment made against all unpaid and not-due invoices purchased by the factor.
2. In a bill discounting arrangement, the financial intermediary concerned does not take on the responsibilities of sales ledger administration and collection of debts, which the factor does under the factoring arrangement.
3. Under bill discounting, notice of assignment of factoring is not given to the customer of the client.
4. The bill discounting arrangement is usually with recourse to the client, whereas a factoring arrangement can be of the non-recourse type.
5. From the financial intermediary's angle, the bills that are discounted can be rediscounted several times before they mature for payment. The last holder of the bill receives the full value of the bill. On the other hand, the factor cannot rediscount the receivables purchased under an advance factoring arrangement.

Example: Factoring vs. Bill Discounting in Canara Bank

Canara Bank offering factoring services differentiated between factoring and bill discounting on several aspects. For Canara Bank, factoring implied off balance sheet finance whereas bill discounting involved on balance sheet finance. Secondly, the margin amount was only 10% in the case of factoring whereas the margins ranged from 30 to 40% in the case of bill discounting. Thirdly, factoring involved longer credit periods up to 120 days where as bill discounting involved credit period of maximum 90 days.

Source: https://canbankfactors.com/ Year: 2022 Accessed on September 21, 2022

15.7 Factoring Vis-À-Vis Credit Insurance

In countries where credit insurance is in popular use, a firm can insure its receivables against credit risk. While the insurance company does not help in the collection of receivables, it settles the claims arising on account of insured accounts that have turned delinquent. (An account is considered to be delinquent not only if the customer becomes insolvent, but also if an account has reached a particular point in being overdue.) Thereafter, it takes over the delinquent accounts and makes vigorous efforts to collect. To ensure that the insured does not throw caution to the winds by adopting liberal credit standards, the insurance company specifies the maximum amount it will cover for accounts with a particular credit rating.

Credit insurance is similar to non-recourse factoring as both provide credit protection to the client. Therefore, firms that want protection only against bad debts but do not want help with regard to collection and finance may find credit insurance to be more cost-effective than non-recourse factoring.

Example: Factoring vs Credit Insurance by The Credit Insurers

The Credit Insurers, the Netherland based credit insurance company, differentiated factoring from credit insurance. The company pointed out that factoring was majorly a cash-flow service where the outstanding invoices were paid directly. On the other hand, credit insurance enabled payment of outstanding invoices in case of insolvency of the debtor. While credit insurance offers multiple options including debtor portfolio evaluation, factoring enables perfect cash flow opportunity.

Source: https://www.thecreditinsurers.com/difference-credit-insurance-and-factoring/ Year: 2022 Accessed on September 21, 2022

Check Your Progress - 1

1. Which one of the following statements is correct according to the International Institute for the Unification of Private Law (UNIDROIT) with reference to factoring?
   a. Financing for the supplier
   b. Maintenance of accounts relating to the receivables
   c. Financing for suppliers and collection of debts/ receivables
   d. Collection of debts/ receivables
   e. Protection against credit risk/ default in payment of debtors
2. Identify the factoring form in which the factor does not make any advance payment.
   a. Recourse factoring
   b. Non-recourse factoring

   c. Maturity factoring
   d. Advance factoring
   e. Bank participation factoring

3. Identify the factoring arrangement that combines the features of both non-recourse and advance factoring.
   a. Recourse factoring
   b. Non-recourse factoring
   c. Maturity factoring
   d. Advance factoring
   e. Full factoring

4. Advance factoring and bill discounting are similar in one of the following ways.
   a. Both make available finance against the accounts'-receivables held by the client
   b. Both are non-recourse
   c. Both are recourse
   d. Both are maturity forms of factoring
   e. There is no similarity between these forms

5. Which one of the following forms of factoring is similar to credit insurance, as far as credit protection is concerned?
   a. Recourse factoring
   b. Non-recourse factoring
   c. Maturity factoring
   d. Advance factoring
   e. Full factoring

Activity 15.1

You are working in Smart Factors, a reputed NBFC offering factoring services as an operational manager. One of the clients approaches you to understand the various forms of factoring. Explain.

15.8 Factoring Vis-À-Vis Forfaiting

Factoring and Forfaiting share many common features. However, there are also certain differences between the two. Let us take a look at these differences exhibited in Table 15.3:

Table 15.3: Factoring vs. Forfaiting

Basis of Difference	Factoring	Forfaiting
Extent of Finance	Usually, 80% of the value of the invoice is considered for advance	100% financing
Credit-Worthiness	Factor does the credit rating of the counterparty in case of a non-recourse factoring transaction	The forfaiting bank relies on the credibility of the availing bank.
Services Provided	Day to day administration of sales and other allied services are provided	No service is provided.
Maturity	Advances are short-term in nature	Advances are generally medium-term.

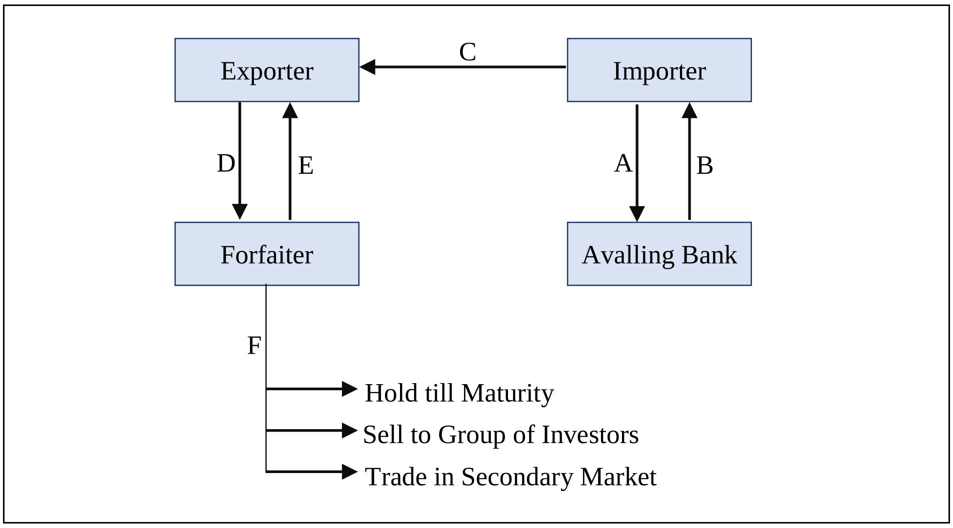
Source: ICFAI Research Center

In international trade transactions, forfaiting is a common form of financing export-related receivables. Under this arrangement:

1. The exporter sells the goods to the importer on a deferred payment basis spread over 3-5 years.
2. The importer draws a series of promissory notes in favor of the exporter for the payments to be made inclusive of interest charges.
3. The promissory notes are availed or guaranteed by a reputed international bank, which can also be the importer's banker. (An aval is an endorsement on the promissory notes by the guaranteeing bank that it covers any default of payment by the buyer.)
4. The exporter sells the availed notes to a forfaiter (which can be the exporter's banker) at a discount and without recourse. The discount rate offered by the forfaiter depends on several factors such as the terms of the promissory notes, the currencies in which they are denominated, the credit rating of the availing bank, the country risk of the importer, and the prevailing market rate of interest on medium term loans.
5. The forfaiter may hold these notes until maturity or sell these notes to groups of investors interested in taking up such high yielding unsecured paper.

The mechanics of forfaiting is graphically presented in Figure 15.3.

Figure 15.3: Mechanics of Forfaiting



Source: ICFAI research Center

A. Promissory notes sent for availing to the importer's bank

B. Availed notes returned to the importer

C. Availed notes sent to the exporter

D. Availed notes are sold at a discount on a non-recourse basis to the forfaiter

E. Exporter obtains finance

F. Forfaiter holds the notes until maturity or securitizes these notes and sells the short-term paper either to a group of investors or to investors at large in the secondary market.

Thus, we find that a forfaiting transaction resembles a cross-border factoring transaction with features of non-recourse and advance payment. Then the two transactions are not identical. The important differences are:

1. In a factoring transaction, the factor does not provide a hundred percent finance; he maintains a factor reserve. On the other hand, in a forfaiting transaction, the forfaiter discounts the entire value of the promissory notes.

2. In a non-recourse factoring transaction, the factor participates in the credit-granting decision of the exporter (the client), whereas in a forfaiting transaction, the forfaiter relies on the unconditional and irrevocable guarantee provided by the availing bank. Therefore, he is more concerned about the financial standing of the availing bank than with the credit standards applied by the exporter.

3. While the factor takes on the responsibilities of accounting, monitoring and collection of receivables, the forfaiter does not assume any of these responsibilities.

4. The factor usually acquires book-debts that are of a short term maturity period, whereas the forfaiter buys bills/promissory notes arising out of deferred credit transactions.

Example: Factoring vs Forfaiting by SMB Compass

SMB Compass, the US based financing company, differentiated between factoring and forfaiting. The company pointed out that while factoring could be used in both domestic and international trade, forfaiting applied to international trade finance only. Secondly, factoring dealt with short-term accounts receivables typically of less than 90 days duration, forfaiting dealt with medium to long-term accounts receivables. Thirdly, factoring could be recourse or non-recourse, forfaiting is always non-recourse.

Source: https://www.smbcompass.com/factoring-vs-forfaiting/ Year: 2022 Accessed on September 21, 2022

15.9 Functions of a Factor

From our discussion of the different forms of factoring, we find that a factor offers one or more of the following services:

1. Collection
2. Sales-ledger administration
3. Credit protection
4. Short-term funding
5. Advisory services

This section provides a brief description of each of these services.

15.9.1 Collection

Collection of receivables can be considered as the most important function of a factor for two reasons. First, the clients'-receivables are the only productive assets of the factor. Therefore, a lax collection program will impair the profitability of the factor's operations. Second, any incorrect handling of the collection activity can prejudice the relationship between the client and his customer, which in turn is detrimental to the interests of both the client and the customer – the client loses potential business and the factor loses potential commission.

A typical collection program of the factor consists of the following steps:

1. The factor sends statements of accounts to the customers before the due dates and sends routine collection-letters around the due dates.
2. If a debt reaches a certain point in being overdue, the factor initiates personal collection efforts, which can be in the form of a personal letter, telephonic reminder, or visit to the premises of the customer.

3. When a debt becomes irrecoverable and the factor finds no other means to recover it, he may resort to legal action.

While a factor is not required to consult the client with regard to the collection procedures used, many factors do consult the client particularly to ascertain the length of time that can be allowed to elapse before any irrevocable action, such as legal action, is initiated. In normal practice, any debt, which is outstanding for more than ninety days, is regarded as a subject for legal action.

Sometimes the customer can refuse to pay on account of an unresolved dispute relating to the quantity or quality of goods supplied or on account of an inordinate delay in delivery and so on. Under such circumstances, the factor draws the attention of the client and allows a specific period to clear the dispute. If the dispute is not settled within the specified time, the factor may take recourse to the client's warranty that the debts sold are valid and undisputed, and release him from the obligation to collect the account. (See legal aspects of factoring)

15.9.2 Sales Ledger Administration

The factor maintains a sales ledger for each client. The ledger is maintained under one of the following methods – the Open Item Method or the Balancing Method. Under the open item method, each receipt is matched against the specific invoice. Therefore, the customer's account clearly reflects the various open invoices, which are outstanding on any given date. Under the balancing method, the transactions are recorded in chronological order. The customer's account is balanced periodically and the outstanding net amount is carried forward.

When accounts are maintained manually, the balancing method is easy to operate. However, the open item method permits better control because collection efforts can be focused on identifiable debts. Since most of the factors employ mechanized accounting systems for sales ledger maintenance, the open item method is widely followed. The factor also maintains a record of payments for each customer, which is spread over some time, so that any change in the pattern of payment can be easily picked up.

15.9.3 Credit Protection

When receivables are purchased under a non-recourse factoring arrangement, the factor establishes a line of credit or defines the credit limit up to which the client can sell to the customer. The credit line or limit approved for each customer will depend upon the customer's financial position, his past payment record and the value of goods sold by the client to the customer.

Operationally, the monitoring of the credit utilized by a customer poses some problem to the client, because he has turned over the ledgering work to the factor. To overcome this difficulty, some factors define the monthly sales turnover for each customer, which will be automatically covered by the approved credit limit.

For example, if the approved credit limit for a customer is ₹ 3 lakh and the average collection period is say 45 days, sales up to ₹ 2 lakh $\left(\frac{3 \times 30}{45}\right)$ per month will be automatically covered. Instead of setting a limit on the monthly sales turnover, some factors provide periodic reports to their clients on customer-wise outstanding and aging schedules, to enable the client to assess the extent of credit utilization before any major sale is made.

To assess the creditworthiness of a customer, the factor relies on many sources. They include:

i. Credit ratings and reports

ii. Bank reports and trade references

iii. Analysis of financial statements

iv. Prior collection experience

v. Customer visits

Credit Rating and Reports

To evaluate the customers of his client, the factor relies primarily on the credit ratings made available by professional rating agencies like the Dun & Bradstreet (D&B) Inc. in the USA. Such agencies analyze the trade creditworthiness of a large number of business firms, and disseminate their findings in the form of credit ratings and reports. The D&B ratings, for example, give the user an indication of the estimated size of net worth and a credit appraisal for companies of a particular size, ranging from "High" to "Limited". The composite credit appraisal done by D&B takes into account the character, capacity, and capital of the rated entity. A "High" composite credit appraisal is an indicator of (a) sound legal constituency, (b) track-record of three years or more, (c) well-balanced management, (d) no criticized failures, (e) obligations being retired according to agreements, and (f) healthy financial position. Similarly, a "good" rating would mean that all the aforesaid conditions are met, but to a somewhat less, although still, satisfactory degree.

In addition to its range service, D&B provides credit reports containing a brief history of the company and its principal officers, the nature of the business, certain financial information, and a track check of suppliers – the length of their experience with the company and its promptness in payments. Of course, the quality of the credit reports will vary; with the amount of information available externally, and the willingness of the company being checked to cooperate with the reporter.

Bank Reports and Trade References

One of the standard means of credit investigation is to seek information from the banker of the customer in terms of the average cash balances maintained, the loan accommodations sought for, and the commitment and capacity demonstrated by the customer. If the factor is a subsidiary of a commercial bank, it can get information that is more candid through this route than if it is not. The reason for this is because banks, generally, are more willing to share such information with other banks or with their affiliates.

Analysis of Financial Statements

Financial statements for the most recent period, preferably audited ones, form an important source of information for credit analysis. It has been often observed that there is a correlation between a firm's refusal to provide financial statements and its weak financial position. The factor usually analyzes the trends in the following ratios to assess the capacity to pay:

$$\text{Current Ratio} = \frac{\text{Current assets}}{\text{Current liabilities}}$$

$$\text{Quick Ratio} = \frac{\text{Current assets less inventory}}{\text{Current liabilities}}$$

$$\text{Net Profit Margin} = \frac{\text{Profit after tax}}{\text{Sales}}$$

$$\text{ROI} = \frac{\text{Profit before interest and taxes}}{\text{Total assets}}$$

An inter-firm comparison or comparison of these ratios with the industry averages can provide useful insights into the liquidity and profitability of the customer's business.

Prior Collection Experience

If the factor has had prior trading experience with the customer, he can review the trend of credit taken by the customer and the promptness with which payments were made in the past, and relate the experience to the present assessment.

Customer Visits

A practice that is popular in the USA and gaining acceptance elsewhere is to visit the customer with the client's consent to obtain more information about the present trading volumes and future prospects. This enables the factor to assess if the credit requests are reasonable in relation to the business conducted.

15.9.4 Short-Term Funding

A factor usually makes a payment for a part of the debts purchased immediately and then charges interest on the part payment made for the period between the date of purchase and the collection date/guaranteed payment date. The factor does not provide a hundred percent finance and maintains a margin called the factor reserve. The factor reserve provides safety to the factor and protects him against any contingencies arising from sales returns, disputed debts, etc.

The factor is usually wary of financing recourse receivables because they do not participate in the credit granting decision. Therefore, they prefer to purchase such receivables with the clear understanding that no advance payment will be made against such receivables. However, some factors provide an advance against all receivables purchased, yet closely monitoring the outstanding of recourse receivables. This is done to initiate necessary corrective action if such outstanding tend to get out of control.

15.9.5 Advisory Services

These services are spin-offs of the close relationship that develops between a factor and the client. Given the specialized knowledge of the factor about the market(s) in which the client operates, he is in a better position to advise the client; on the customers' perceptions of the firm's products, changes called for in the marketing strategies, emerging trends and ways of responding to these trends. In practice, a senior executive of the factoring organization operates as an accounts executive for the client; not only to carry out the usual services but also to provide such advisory services as the client may require.

Besides the above, a factor also extends another service that is an audit of the procedures followed for invoicing, delivery and dealing with sales returns. The factor regularly audits these procedures to minimize the problems at the time of collection. From the client's angle, such an audit reveals the weak links, which have to be strengthened and areas where the existing procedures have to be modified or toned-up. For example, the audit carried out by the factor may reveal that abnormal sales returns experienced by the client are on account of inadequate quality control procedures, or it might reveal that disputes arise when customers do not confirm in writing their acceptance of any variation in the sales contracts.

In addition, the factor can help the client in areas that fall outside the purview of the factoring services. For instance, where the factoring organization happens to be the subsidiary of a commercial bank, it may provide a recommendation report to the credit department of the bank or to the other subsidiaries of the bank, which are involved in providing other financial services like; leasing, hire purchase or merchant banking. This report improves the credit standing of the client when he/she is procuring funds from financial intermediaries.

Example: Assignment of Receivables by Siemens Factoring

Siemens Factoring Private Ltd, one of the earliest factoring companies in India, offered flexible and cost-effective financing solutions through factoring to the Micro, Small and Medium Enterprises (MSME). For the collection of receivables, Siemens Factoring enabled cash flow by means of 'Deferred payment agreement' and 'Assignment of Receivables agreement'. In the former, a deferred receivable period of 6 to 60 months was offered and in the latter, option of loans and leases were offered for the receivable.

Source: https://new.siemens.com/in/en/products/financing/assignment-of-receivables.html Year: 2022 Accessed on September 23, 2022

15.10 Legal Aspects of Factoring

The legal relationship between a factor and the client is governed by the provisions of the factoring agreement or the master agreement. Some of the salient features of the factoring agreement are as follows:

a. The client provides an undertaking to the factor to sell its book debts. The factor agrees to purchase the same, subject to the terms and conditions mentioned in the agreement.

b. The client warrants that the debts are valid, enforceable, undisputed and recoverable. The client also undertakes to settle problems of dispute, damage and deductions relating to the bills assigned to the factor.

c. The client agrees that the bills purchased by the factor on a non-recourse basis (called approved bills) will arise only from transactions specifically approved by the factor, or those falling within the credit limits authorized by the factor.

d. The client agrees to serve a notice of assignment in the prescribed form to all customers whose receivables have been factored.

e. The client should provide photocopies of all invoices, credit notes, etc., pertaining to the factored accounts to the factor and remit money received by the client against the factored invoices to the client.

f. The factor acquires the power of attorney to assign the debts further and to draw negotiable instruments of such debts.

g. The time frame for the agreement and the mode of termination are specified.

The legal status between the factor and the customer is that of an assignor and assignee. Therefore, the customer has the same set of defenses against the factor as he would have against the client. If a customer whose account has been factored is informed of the assignment made, then he is under a legal obligation to remit the money due directly to the factor. Consequently, a customer who continues to make such payments directly to the client is not discharged from his obligation to pay the factor, until and unless the client remits the amount to the factor.

Let us also discuss the relationship between the factor and the client’s bank. Suppose, a firm that wants to avail advance factoring facility has been financing its book debts through bank finance (in the form of bill discounting or overdraft) before the factoring arrangement, the factor has to fill a letter of disclaimer before undertaking the factoring of receivables. Such a letter should be taken from the bank concerned. The letter of disclaimer will indicate that with effect from the date of the letter, the bank will not create a charge against the receivables. This letter signifies that the bank should not provide any post sale finance because the financing arrangement is done with the factor. This avoids the possibility of double-financing the receivables.

Evaluation of Factoring

From the client's point of view, factoring offers the following benefits:

i. Factoring in general and maturity factoring in particular, reduces the uncertainty associated with collections and the corresponding cash inflows. This reduces the cash float and improves the velocity of current assets turnover i.e., the ratio of net sales to gross current assets.

ii. Since the factor assumes the responsibility for collection and credit administration, the marketing department of the firm concerned can sharply focus its attention and efforts on improving sales. In the case of small scale units, it is often found that the promoter is a technocrat or a marketing oriented person with little or no exposure to the finer aspects of credit management. This results in sub-optimal investment in receivables and undertaking of credit risks on a haphazard basis. Availing factoring services results in better receivables management.

iii. As noted in an earlier section, advance factoring serves as a source of working capital finance. There is, however, an important difference between this arrangement and the other forms of funding like cash credit or public deposits. The difference is that the other forms of current asset financing reduce the current ratio while advance factoring maintains the current asset ratio. To illustrate this aspect, Panel-A of the Table presents the pre and post balance sheet of a firm availing of the advance factoring arrangement. Panel-B of the Table presents the pre and post balance sheets of an identical firm availing of the bank overdraft for funding its investment in receivables. We have assumed that under either of these arrangements, the finance is restricted to 80 percent of the value of receivables.

An example of how the various ratios will be impacted in the financial statement on advance factoring and bank overdraft is worked out below:

Impact of Advance Factoring and Bank Overdraft on Liquidity Ratios *Amount in ₹ Crs.*									
Panel A					**Panel B**				
1.	Balance Sheet as on March 31, 2022				1.	Balance Sheet as on March 31, 2022			
	Liabilities		Assets			Liabilities		Assets	
	Net worth	45	Fixed Assets	30		Net worth	45	Fixed Assets	30
	Long-term Debt	15	Inventory	25		Long-term Debt	15	Inventory	25
	Current Liabilities	45	Receivables	45		Current Liabilities	45	Receivables	45
			Cash	5				Cash	5
		105		105			105		105
	Current Ratio = $\frac{75}{45}$ = 1.67 : 1					Current Ratio = 1.67 : 1			
	Firm Opts for Factoring					Firm Opts for Bank Overdraft			

2. Balance Sheet as on March 31, 2022

Liabilities		Assets	
Net worth	45	Fixed Assets	30
Long-term Debt	15	Inventory	25
Current Liabilities	45	Factor Dues	9
		Cash	41
	105		105

Current Ratio = $\frac{75}{45}$ = 1.67 : 1

Firm utilizes additional cash to reduce its current liabilities by ₹ 30 lakh and increase inventory by ₹ 6 lakh. The post-utilization balance sheet will be as follows:

3. Balance Sheet as on March 31, 2022

Liabilities		Assets	
Net worth	45	Fixed Assets	30
Long-term Debt	15	Inventory	31
Current Liabilities	15	Factor Dues	9
		Cash	5
	75		75

Current Ratio = $\frac{45}{15}$ = 3 : 1

2. Balance Sheet as on March 31, 2022

Liabilities		Assets	
Net worth	45	Fixed Assets	30
Long-term Debt	15	Inventory	25
Bank Borrowings	36	Receivables	45
Current Liabilities	45	Cash	41
	141		141

Current Ratio = $\frac{111}{81}$ = 1.37 : 1

Firm utilizes additional cash to reduce its current liabilities by ₹ 30 lakh and increase inventory by ₹ 6 lakh. The post-utilization balance sheet will be as follows:

3. Balance Sheet as on March 31, 2022

Liabilities		Assets	
Net worth	45	Fixed Assets	30
Long-term Debt	15	Inventory	31
Bank Borrowings	36	Receivables	45
Current Liabilities	15	Cash	5
	111		111

Current Ratio = $\frac{81}{51}$ = 1.59 : 1

Source: ICFAI Research Center

The above reveals the following:

1. Advance factoring *per se* does not alter the current ratio of the firm. This is because the arrangement does not result in the creation of a current liability. It simply rearranges the current assets by replacing receivables with cash and factor dues. Of course, the current ratio can be increased by utilizing the additional cash in the manner specified in the table. In fact, the current ratio

can be increased to a maximum of 4.33: 1 by utilizing the entire factor advance to reduce the current liabilities. At the other extreme, the firm can choose to keep the current ratio at 1.67: 1 by not utilizing the additional cash or by utilizing it for increasing the investment in inventory.

2. The impact of bank overdraft on the current ratio of the firm is obvious. Prior to the utilization of cash in the manner specified, the current ratio was 1.37:1, which has been improved to 1.59: 1 by utilizing a major portion of the additional cash to reduce the current liabilities. The reader can verify that the maximum current ratio of 1.67: 1 can be reached by utilizing the entire bank overdraft to reduce the current liabilities.

3. Is factoring advantageous to firms that can afford to have a full-fledged credit department? The answer is 'Yes', provided the factor can carry out the functions of the credit department more efficiently. For example, take the case of Walter E. Hellers and Company, a Chicago based factoring organization. Its clientele includes many large scale manufacturers of synthetic fiber carpets because the factor has a specialized knowledge of the payment patterns of a large cross-section of the customers of this industry and is able to carry out the functions of collection and credit protection more efficiently.

   While there are distinct advantages in factoring, the service carries a price. Therefore, a firm that has been managing its receivables in-house must necessarily weigh the benefits against the costs, before opting for the factoring arrangement. Illustration 15.3 explains the framework that can be employed for this purpose.

Illustration 15.3

Innovative Factors, the subsidiary of Fair Bank offers the following fund-based facilities:

	Facility	Recourse Factoring	Non-Recourse Factoring
A.	Discount Charge (payable upfront)	19% p.a.	19% p.a.
B.	Reserve	20%	20%
C.	Commission (payable upfront)	1.5%	3.5%

The finance manager of Varun Textiles has recently approached Innovative Factors for factoring the receivables. After a careful analysis of the sales ledger of Varun Textiles, the Vice President (Operations) of Innovative Factors agrees for a guaranteed payment period of 60 days. The finance manager is not clear about the type of facility he should opt for and seeks your help in this regard. He provides you with the following additional information:

- The firm sells on terms 2/10 net 60. On an average 40% of the customers pay on the tenth day and avail the discount. The remaining customers pay, on an average, 90 days after the invoice date.

- The bad debt loss amounts to 1.5% of the sales turnover.
- The sales executives are responsible for following up collections and they, on average, spend 20% of their time on collection efforts. A subjective (and conservative) assessment is that the firm can increase its annual sales by ₹ 20 lakh, if the sales executives are relieved from collection responsibilities. The gross margin on sales is 20% and the projected sales turnover for the following year (without considering the increase of ₹ 20 lakh) is ₹ 240 lakh.
- By hiving off sales-ledger administration and credit monitoring, the firm can save administrative overheads to the tune of ₹ 1 lakh per annum.
- As of now, the firm has been financing its investment in receivables through a mix of bank finance and long-term funds in the ratio of 2:1. The effective rate of interest on bank finance is 18% p.a., and the cost of long-term funds is around 24% p.a. (pre-tax).

Solution

The relevant costs associated with the in-house management of receivables and the alternative forms of factoring are listed below:

Relevant Costs of In-house Management of Receivables		
A.	Cash discount	= 240 x 0.02 x 0.4 = ₹ 1.92 lakh
	Average collection period	= (10 x 0.4) + (90 x 0.6) = 58 days
	Cost of bank finance	= 240 x 2/3 x 58/360 x 0.18 = ₹ 4.64 lakh
	Cost of long-term funds	= 240 x 1/3 x 58/360 x 0.24 = ₹ 3.09 lakh
B.	Cost of funds invested in receivables	= ₹ 7.73 lakh
C.	Bad debt loss	= 240 x 0.015 = ₹ 3.6 lakh
D.	Contribution lost on foregone sales	= 20 x 0.2 = ₹ 4 lakh
E.	Avoidable costs of sales ledger administration and credit monitoring	= ₹ 1 lakh
Relevant Costs of Recourse Factoring		
F.	Factoring commission	= ₹ 260 x 0.015 = ₹ 3.9 lakh
G.	Discount charge	= $0.8 \times 260 \times 0.19 \times \frac{60}{360}$ = ₹ 6.59 lakh
H.	Cost of long-term funds invested in receivables	= $0.2 \times 260 \times 0.24 \times \frac{60}{360}$ = ₹ 2.08 lakh
Relevant Costs of Non-Recourse Factoring		
I.	Factoring commission	= 260 x 0.035 = ₹ 9.1 lakh
J.	Discount charge	= 0.8 x 260 x 0.19 x 60/360 = ₹ 6.59 lakh
K.	Cost of long-term funds invested in receivable	= 0.2 x 260 x 0.24 x 60/360 = ₹ 2.08 lakh

Cost-Benefit Analysis of Recourse Factoring	
L.	Benefits associated with recourse factoring
	= A + B + D + E = ₹ 14.65 lakh
M.	Costs associated with recourse factoring
	= F + G + H = ₹ 12.57 lakh
N.	Net Benefit = L–M = ₹ 2.08 lakh
Cost-Benefit Analysis of Non-Recourse Factoring	
O.	Benefits associated with non-recourse factoring
	= A + B + C + D + E = ₹ 18.25 lakh
P.	Costs associated with non-recourse factoring
	= I + J + K = ₹ 17.77 lakh
Q.	Net Benefit = O – P = ₹ 0.48 lakh

Since the net benefit associated with recourse factoring is higher than that of non-recourse factoring, the firm is advised to opt for recourse factoring.

Illustration 15.4

Creative Financial Services Ltd. offers two types of fund based facilities, recourse factoring and non-recourse factoring. Terms and conditions of both kinds of factoring are as follows:

Recourse Factoring: The factoring agreement provides for an advance payment of 70% of the value of factored receivables. Advance carries a rate of interest of 16% p.a., and the factoring commission is 1.5% of the value of factored receivables. Both the interest and commission are collected upfront.

Non-recourse Factoring: The factoring agreement provides for an advance payment of 70% of the value of factored receivables. Advance carries a rate of interest of 17.5% p.a. The factoring commission is 2.5% of the value of factored receivables. Both the interest and commission are collected upfront.

The Manager (Finance) of Chilling Air Conditioners has recently approached Creative Financial Services to factor the receivables. After the careful analysis of the sales ledger of Chilling Air Conditioners, the VP – Finance of Creative Financial Services, agrees to a guaranteed payment period of 45 days. The Manager Finance of Chilling Air Conditioners is not clear about the type of factoring he should opt for and seeks your help in this regard.

He provides you with the following information:

- His company sells on terms 2/10, net 45. On an average 60% of the customers pay on the 10th day and avail the discount, and the remaining customers pay 75 days after the invoice date.
- The sales executives are responsible for following up collections and on an average spend 25% of their time on collection.

- The bad debts amount to 5% of the sales.
- If the sales executives are relieved from collection responsibilities, the annual sales would increase by 10%.
- The gross margin on sales is 25% and the projected sales for the year (without considering the increase) are ₹ 300 lakhs.
- By giving off sales ledger administration and credit monitoring, Chilling Air Conditioners can save administrative overheads up to ₹ 1.5 lakh.
- Chilling Air Conditioners has been financing its investments in receivables through a mix of bank finance and long-term funds in the ratio of 3: 1. The effective rate of interest on bank finance is 18%, and the cost of long-term funds is around 20.0% p.a.

You are required to advise the finance manager of Chilling Air Conditioners on the type of factoring he should select.

Solution

(₹ in lakhs)

Relevant costs for in-house management of receivables:	
Cash discount	
= Sales turnover x cash discount x % of customers availing the discount	
= 300 x 2% x 60%	3.60
Average collection period	
= % of customers on 10th day x No. of days + % of customers on 75th day x No of days = 60% x 10 + 40% x 75 =36 days.	
Cost of bank finance	
300 x (3/4) x (36/360) x 18% = 4.05	
Cost of long term funds	
300 x (1/4) x (36/360) x 20.0% =1.5	
Cost of funds invested in receivables = 4.05 + 1.5	5.55
Bad debt losses = 300 x 5%	15.00
Hence, the expected increase in sales, if the sales executives are relieved from collection responsibilities = 10% of ₹ 300 lakhs = ₹ 30 lakhs.	
Contribution lost on foregone sales	
30 x 25%	7.50
Avoidable costs of sales ledger, administrative, and credit monitoring	1.50
= Total costs of the in-house management of receivables	33.15

(₹ in lakhs)

Relevant Costs of Recourse Factoring:	
Factoring commission =330 x 1.5%	4.950
Discount charge =330 x 70% x 16% x (45/360)	4.620
Cost of long term funds invested in receivables =330 x 30% x 20% x (45/360)	2.475
Bad debts = 0.05 x 330	16.5
Total cost of recourse factoring	28.545
Relevant Cost of Non-Recourse Factoring:	
Factoring commission =330 x 2.5%	8.250
Discount charge = 330 x 70% x 17.5% x (45/360)	5.050
Cost of long term funds invested in receivables = 330 x 30% x 20% x (45/360)	
Total costs of non-recourse factoring	15.775
Hence non-recourse factoring is recommended.	

15.11 Benefits of Factoring

Factoring, a credit cum collection facility provides instant cash against credit sales. Improved cash flow leads to more profits and growth. While a factor provides related financing and services only, a banker renders comprehensive financing. However, factoring as a financial option against receivables scores over bank finance on many counts. We summarize below the benefits of factoring vis-á-vis bank finance in Table 15.5 as under:

Table 15.5: Benefits of Factoring vis-á-vis Bank Finance

Sl. No.	Area	Factors	Bank
1.	Availability of finance	Instant against each invoice akin to cash sales	Periodically (Monthly/ Fortnightly) No DP for intermediate invoice
2.	Grace period	Up to 60 days for payment	Nil
3.	Sanction response time	Very Fast (Within 3-4 days)	Normal (Too many tiers 15 days – 3 months)
4.	Delayed Payments	i. Finance continued up to grade period.	i. Finance withdrawn on due date (DP reduced)
		ii. No over-due interest up to grade period	ii. OD interest charged for irregular amount

Sl. No.	Area	Factors	Bank
5.	Collection	In-Built (Collection Agents employed)	Not Done
6.	Collection time	Very Fast (Branches/ Collection Agents advise payments by fax)	Takes time (Collection of Cheques)
7.	Credit Period	Market related and flexible approach – up to 150 days	Generally uniform – 50-90 days only.
8.	Customer Evaluation	Customers evaluated and sub-limits fixed (Indirect Credit Protection)	No such exercise
9.	Follow up of receivables	Closely followed up	No such service
10.	Computerization	Total	Partial (depends on Br.)
11.	Receivables based services	Sales Ledger Administration, MIS Data furnished (Age-wise break-up, over dues statement, etc.	No such services financing alone done
12.	Receivables of Associates	Selectively factored	Not financed
13.	Processing Fees	Maximum: SSI – ₹ 10,000 Non-SSI – ₹ 15,000	1% of limit- and is flexible depending on the clients
14.	Bifurcation of Limits	No bifurcation like CC account	Higher limits are bifurcated to CC and demand loan
15.	Submission of Returns	Stock/ Receivable statements, select monthly operational data, financial follow-up reports need not be submitted	Financial follow-up Reports, etc. should be submitted

Source: ICFAI Research Center

We give below in Table 15.6, some of the other important benefits arising from factoring services to:

Table 15.6: Other Important Benefits arising from Factoring Services

Clients (units availing of factoring services)	Customers (on whom invoices are drawn)	Banks
Substantial funds up to 80% of factored	There is no need to accept any bills. Only invoices duly assigned for payment to the factor, are drawn.	Factoring facility extended is within the assessed bank finance to the clients. Over financing is thus guarded.
The factor assumes the responsibility of certain services such as collection, and sales ledger administration thereby enabling the client to focus on running his business.	Adequate credit period is given for payment of assigned debts.	The factor closely monitors the credit sales of the client, and ensures that the proceeds are transferred through the clients.

Source: ICFAI Research Center

Example: Benefits of ICICI Factoring Services

ICICI Bank, the leading private bank in India, also provided factoring services and listed out certain benefits of its factoring services. The benefits included "enhanced liquidity and improved cash flows", "non-debt mode of financing", "no credit risk on the Seller's book of accounts", and "reduced working capital cycle". ICICI Bank offered factoring services to both domestic and export receivables.

Source: https://infiniteindia.icicibank.com/?url=factoring Year: 2022 Accessed on September 23, 2022

15.12 Factoring in the Indian Context

As indicated before, the committee constituted by the Reserve Bank of India under the chairmanship of C.S. Kalyanasundaram (Kalaynasundaram Committee hereafter), has recommended promotion of factoring organizations in the country. It identified the small scale sector and the export sector as the primary target markets. Acting upon the recommendations of the committee, the Reserve Bank of India issued guidelines permitting commercial banks to start separate subsidiaries for rendering factoring services.

[15]Factoring Regulation Act 2011

Hitherto, factoring activity was regulated by the Indian Contract Act, the Sale of Goods Act, and the Transfer of Property Act. Factoring Regulation Act, 2011, was enacted to regulate the assignment of receivables in favor of factors, and delineating the rights and obligations of parties to the assignment of receivables.

The Indian Parliament, in 2011 enacted the Factoring Regulation Act, 2011 (‘Act’ for short), to provide for and regulate the assignment of receivables by making provisions for registration. Therefore, the rights and obligations of parties to contract for assignment of receivables and matters connected therewith are incidental thereto. This act extends to the whole of India. The provisions of this Act shall have effect, notwithstanding anything inconsistent therewith contained in any other law for the time being in force, or any instrument having effect by virtue of any such law.

The Act also envisages that all transactions of assignment of receivables shall be registered with the central registry established under the SARFAESI Act, 2002, to reduce the possibility of frauds and for strengthening the due diligence process for the clients. The Act has given powers to the Reserve Bank to stipulate conditions for ‘principal business’ of a Factor, and also powers to give directions and collect information from factors.

Broad features of the Act include:

1. Assignment of debts under factoring being exempted from stamp duty; assignment of debts being provided with legal recognition;
2. Notice of assignment being made mandatory;
3. Every factor (NBFC) shall get registered with RBI;
4. Reserve Bank has created a separate category of NBFCs for factoring.

Factoring Regulation (Amendment) Act, 2021

This Act became effective from 23rd August, 2021. Some of the important amendments introduced in this Act were:

1. The definition of the term ‘assignment’ was amended. The new definition means the transfer by agreement to a factory of an undivided interest (whole or part) of an assignor in the receivables due from the debtor. The assignment includes transfer where the assignor or debtor is situated/ established outside India.
2. The definition of the term ‘Factoring Business’ is amended. Amended definition means acquisition of receivables of assignor by an assignment for a consideration. The acquisition should be for collection of the receivables/ for financing against such assignment.

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[15] https://www.taxmanagementindia.com/visitor/detail_article.asp?ArticleID=5989 (January 2015)

3. The definition of the term 'Receivables' was entirely substituted. According to the new definition, the receivables means-
   - The money owned by the debtor; and
   - which is not yet paid to the assignor of goods/ services.

   The term receivables as includes payment of any sum for the toll/ use of any infrastructure facility/ services.
4. The threshold limit for NBFC to be engaged in factoring business was removed.
5. Registration of every transaction that a factor undertakes was made compulsory. Such registration is to be done with the Central Registry set up under the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 [SARFAESI Act, 2002].
6. The Act empowered the Reserve Bank to make regulations for the manner of granting of the registration certificate to a factor and to make regulations for the manner of filing of the transactions with the Central Registry for trade receivables financed through TReDS.

   In addition to the above amendment Act, RBI in January, 2022 brought in the Registration of Factors (Reserve Bank) Regulations, 2022 and the Registration of Assignment of Receivables (Reserve Bank) Regulations, 2022. These regulations permitted NBFCs classified as Investment and Credit Companies holding assets of more than ₹ 10 billion to offer factoring business[16].

Features of Factoring Operations

The salient features of their factoring operations are as follows:

a. The type of factoring facility offered can be classified as Advance Recourse Factoring. Under this arrangement, the factoring company (a) provides pre-payment up to 80 percent of the invoice value; (b) undertakes follow-up of payment by customers by mailing personalized statements of accounts and reminder letters to the customers of the client; and (c) furnishes periodic reports to the client on analysis of outstanding, aging schedule of debts, and the amount drawn by the client under the pre-payment limit.

b. The clients of the factoring companies include sole proprietary concerns, partnership firms and companies, which are engaged in the supply of goods or rendering of services. To avoid concentration of credit exposure, a limit is set on the value of invoices that will be purchased from each client. The upper limit is usually fixed as a percentage, say 25 percent of the net worth of the client.

[16] https://www.mondaq.com/india/asset-finance/1185486/regulations-to-implement-changes-to-factoring-act

c. The client entering into a factoring arrangement must agree to (a) assign all debts in favor of the factor, and notify the customers concerned, (b) route all credit sales invoices through the factor whether or not an advance is drawn, and (c) furnish proof of dispatch of the factored credit sales invoices. It must be also noted that not all credit sale transactions are eligible for factoring.

   The following types of transactions are not factored:

   (a) Deferred Credit Transactions—because the factoring companies deal only in short term debts, and

   (b) Export Transactions—because the factoring companies have been permitted to undertake only domestic (inland) factoring.

d. The factoring companies are collecting a service fee (payable upfront) ranging between 0.5-2 percent of the invoice value depending upon (a) gross sales turnover, (b) number of customers, (c) number of invoices and credit notes, and (d) work involved in monitoring and collection. On the pre-payment made against the value of invoices, the factoring companies levy a discount charge (payable monthly) in arrear, which is determined with reference to (a) the interest rates charged by commercial banks on working capital advances, and (b) the client rating. The rating assigned to the client depends upon the present level of receivables turnover, (the higher the turnover, the better the rating) the credit quality of the receivables portfolio, present volume of credit sales turnover, anticipated growth in sales, and production volumes, etc.

   The pricing of the services offered by the factor is obviously linked to the costs incurred by the factor. It is, therefore, necessary to take a look at the cost structure of factoring operations. Table 15.7 presents the cost structure, taking into account the current cost of funds and the fixed costs, as estimated by the Kalyanasundaram Committee.

Table 15.7: Cost Analysis of Factoring Operations

	Elements of cost	Percentage of Turnover
a.	Variable	Range
	Cost of Funds	17.5 to 19
b.	Fixed	Range
	Screening	0.5 to 0.6
	Collection and Sales-Ledger Administration	0.6 to 0.7
	Other Overheads (including depreciation)	0.5 to 0.6

Source: ICFAI Research Center.

Note: The term 'turnover' refers to the gross value of invoices factored. Based on the cost structure presented in Table 15.7, it can be observed that the discount charge on prepayment has to be 19% per annum, and the service charge can be in the range of 2 – 3% of the debts service.

15.12.1 Future Prospects

With the advent of globalization and opening up of the Indian economy, the financial sector is to play a pivotal role in the overall economic development of the country. Mergers and Acquisitions (M & A) are the order of the day for the corporate giants taking birth to fetch the maximum advantage of optimum size and economies of scales of production. Big corporates are able to raise ECBs at cheaper rates. In the process, weaker and smaller SSI Sectors suffer from the competition posed by the big corporates. To enable the SSI sector to withstand the competition from big corporates, MNCs and foreign companies, it is imperative that SSI units manage their collections more efficiently and professionally. SSI sector is looking for an agency that can offer liberal terms and sanction facilities expeditiously with a speedier collection service. In light of the above, factoring is going to play an important role in filling the gap and enabling the SSI sector to be competitive and profitable.

The factoring industry in India has been growing rapidly in recent years. This industry has been able to provide access to credit and cash flow to small and medium-sized businesses, which is critical for their growth and development. According to a report by FICCI, the factoring industry in India reached a size of around ₹ 5,500 crore in FY2019-20. This represents a robust growth of around 17% compared to the previous year. The report says that factoring is a very effective tool as it helps in managing the cash flows of the company who have deficient working capital arrangements. Also, international factoring is growing to be an effective avenue for exporters who prefer this to the traditional letter of credit[17].

[18]According to FCI (established in 1968), the Global Representative Body for Factoring and Financing of Open Account Domestic and International Trade Receivables, the factoring business across the globe recorded €2,724 billion in 2020 and the factoring business in 2021 was estimated at a volume of €3,093 billion. The Asia Pacific region represents approximately 24% of global volume with €751 billion. In 2021, the volume of €562 billion relates to the Greater China region, including Mainland China (+8.4%), Hong Kong (-3.8%) and Taiwan (+15.3%). Japan displayed a growth rate of +14.5% reaching €58.6 billion euro. India experienced the most explosive growth rate of +141% with €8.6 billion euro.

[19]In January 2022, the Reserve Bank of India (RBI) issued regulations for the amended Factoring Regulation Act, 2011 after the Parliament had passed the Factoring Regulation (Amendment) Bill in July 2021 that made eligible as many as 9,000 NBFCs to participate in the factoring market, instead of just seven till 2021, boosting cash flow to small businesses.

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17 https://ficci.in/spdocument/23035/Key-to-SME-Growth.pdf
18 https://fci.nl/en/about-fci Press Release Dated 18th May 2022 complied on 6th March 2023
19 https://www.financialexpress.com/industry/sme/msme-fin-how-indias-first-nbfc-into-factoring-post-revised-rbi-regulations-is-helping-msmes-unlock-cash-in-unpaid-invoices/2510556/

15.12.2 Factoring and the Economy

The economic significance of factoring stems from the stabilizing influence it will have on industry and trade. The immediate impact of factoring will be the promotion of efficiency and profitability of the small and medium sized industrial units, which cannot go to the capital market for their capital requirements for growth or diversification. Factoring could also serve as a springboard for growth. Further, factoring will also promote a prompt payment culture among industrial and trading units by facilitating the overall acceleration of the receivables turnover. The impact of this accelerated receivables turnover will result in a better return on capital because of the facilitation of a greater volume of business on the same amount of capital, or the same amount of business on a smaller amount of capital. Thus, such a prompt payment culture prompted by factoring among industrial land trading units, and the resultant overall accelerated receivables turnover will ultimately have a multiplier effect on production, employment, and economic growth. Various steps taken for the growth of factoring business is listed below.

Measures to Promote Factoring Services in India

Various measures are undertaken to address the challenges faced by the factoring industry and to increase the scope for factoring across the country.

Some of the features are:

- RBI has introduced factors as a new category of the non-banking financial company (NBFC).
- RBI has simplified the eligibility criteria with regard to the principal business.
- The NBFC factor needs to ensure that financial assets in the factoring business constitute at least 50 percent of its total assets.
- Income derived from factoring business should not be less than 50 percent of its gross income for NBFC's.
- Factors can now also access credit information from credit bureaus.
- The government has approved the establishment of a Credit Guarantee Fund for Factoring (CGFF) with ₹ 500 crore under the National Credit Guarantee Trustee Company (NCGTC). Credit guarantee cover for a maximum of 50 percent of factored debt will be provided under the Fund. The guarantee fee chargeable from the MLIs (Member Lending Institution) shall not exceed 0.75 percent per quarter of the guaranteed factored debts for the amount of guarantee cover.

These steps, along with the improved economic sentiment, should help drive factoring industry development, and change the face of conventional working capital finance in the country.

15.12.3 Role of Factoring in Indian Small and Medium Enterprises (SMEs)

Small and Medium Enterprises (SMEs) in India have seen good growth over the last decade. According to the latest reports by the SME Chamber of Commerce and the Ministry of Micro, Small and Medium Enterprises, India currently has more than 48 million SMEs. The SMEs contribute to more than 45% of India's industrial output and almost 40% of the country's total exports. Yet, these SMEs continue to struggle due to various reasons and one such is the timely availability of finance. Factoring is expected to play an important role in receivables financing for SME's, especially, post-sale finance.

Example: The Factoring Regulation (Amendment) Bill 2021 Enacted

In July 2021, the Government of India enacted the Factoring Regulation (Amendment) Bill 2021 amending the principal Factoring Regulation Act, 2011. The new amendment would enable all the existing Non-banking Financial Companies (NBFCs) to extend factoring services to the Micro, Small and Medium Enterprises (MSME). Earlier, NBFCs who do only factoring business were allowed to extend factoring services.

Source: https://economictimes.indiatimes.com/small-biz/money/why-factoring-failed-to-address-delayed-payments-for-msmes-and-how-recent-amendments-can-help/articleshow/85708448.cms?from=mdr Date: August 28, 2021. Accessed on September 24, 2022

15.13 Introduction: Forfaiting

Forfaiting is a form of trade financing undertaken to facilitate export transactions. The process of forfaiting thus has a lot of significance as it undertakes to solve the cash flow problems of the party taking the benefit of factoring.

In a forfaiting transaction, the exporter surrenders his right for claiming the payment for services rendered or goods supplied to the importer in favor of the forfaiter.

A deed is prepared stating the same and the exporter receives a cash payment from the facilitator. All the forfaiting transactions are performed with the support of a bank. The bank undertakes the default risk possessed by the importer.

Before extending finance for a forfaiting transaction, the exporter looks into several critical aspects of the underlying goods or commodity. For example, the bank would pay special attention to the durability/perishability nature of the goods, authentication of the product (date of manufacturing, product code, etc.), packaging arrangements, and other precautions adopted during the stage of shipment, etc. After these checks and verifications, the banker provides the exporter with the funds. Forfaiting transaction is beneficial to the exporter as it supplies him with instant cash and removes his cash related deficiencies.

Forfaiting is a relatively new concept. It is a specialized form of factoring, which is undertaken on export transactions on a non-recourse basis.

Example: Forfaiting Services at Gujarat's GIFT City

Four platforms gtt license to provide forfaiting services at Gujarat's GIFT city. Two of them are RBI-licensed TReDS (trade and receivables discounting system) platforms - M1xchange and RXIL. The other two are KredX and Vayana. India had huge potential for forfaiting as until mid of 2022 forfaiting consisted of only 0.2% value of GDP unlike higher share in developed countries like France (18.3%) and UK (17.3%).

Source: https://usabusinessmagazine.com/four-platforms-get-ifsca-licence-for-factoring-business-at-gift-city/ Year: 2022 Accessed on September 24, 2022

15.14 Operating Procedures associated with Forfaiting

A forfaiting transaction involves the following individuals: an exporter, an importer, a domestic bank, a foreign bank, and a primary forfaiter. A primary forfaiter is a financial entity or an individual who does a contract of forfaiting with the exporter, and sells the payments of the importer. There is also a secondary forfaiter too, who is a person or an intermediary who purchases the securities from the primary forfaiter and sells them in the secondary market.

The act of the secondary forfaiter helps in the growth of the secondary market activities of the documents involved in a typical forfaiting transaction. The process of forfaiting gets underway; the moment an exporter asks for quotations from the overseas buyer, on the issues of price, delivery, interest structure, currency involved, etc. Once the exporter is satisfied with the data received/quotation he approaches the EXIM Bank and furnishes; the name of the overseas party, name of the country, description of the goods, order details, base price, payback period and the details of the export agency who will facilitate the transaction for the exporter.

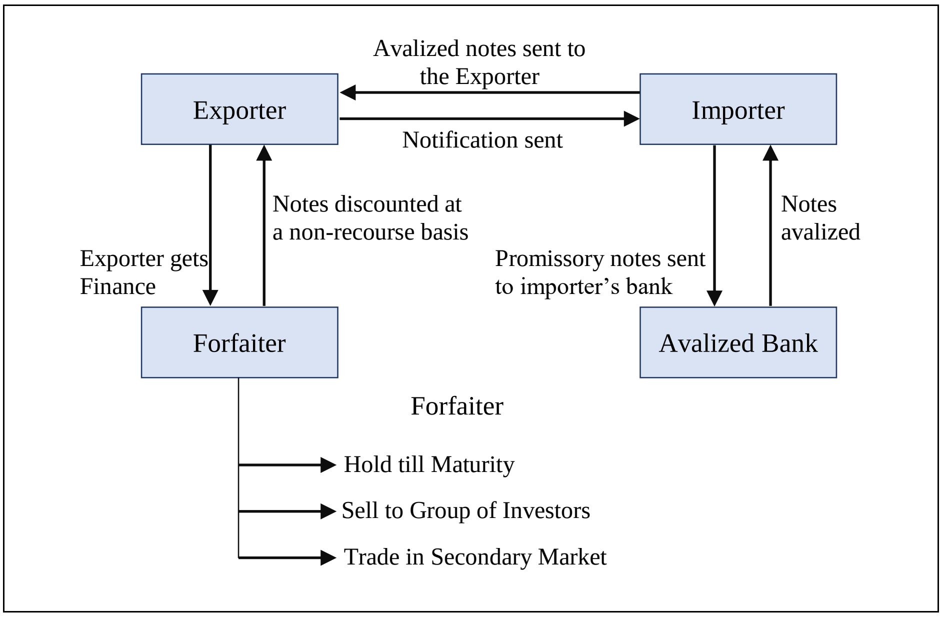
To make a complete transaction of forfaiting, the forfaiter asks for the details of the banker of the overseas importer. The overseas banker accepts and validates the documents of the transaction. This is known as the banker's co-acceptance. The co-acceptance serves as a yardstick for the forfaiter to judge the credit quality and the marketability of the instruments accepted.

The EXIM Bank then collects from the overseas forfaiting agencies the representative quotes on rates of discount, documentation charges and the commitment charges and then informs the same to the exporter. If the terms are acceptable for the exporter, he requests the EXIM Bank to obtain a firm quote from the forfaiter.

The exporter begins a contract with the overseas forfaiting agency by taking the help of EXIM Bank. Once the deal is executed, EXIM Bank issues a formal certificate to the party in India. Subsequently, the exporter ships the goods as per the specification.

The following Figure 15.4 provides a chart that explains the forfaiting.

Figure 15.4: Forfaiting



Source: ICFAI Research Center

With the shipment, the exporter's bank in India sends the relevant documents to the importer's bank. The importer's bank supplies them to the importer when the importer produces the avalized promissory notes to the bank. In this context, let us discuss what avalization is all about.

Bill of exchanges in forfaiting transactions are backed by the co-acceptance of the banker of the foreign country, or in other words the banker of the importer. Co-acceptance is also known as avalization. After the submission of the documents, they are sent to the exporter by the bank. The Indian exporter has to endorse the note with the "Without Recourse" clause.

Without Recourse Debt is a kind of debt instrument on which the right of recourse (or, reverting, in case of difficulty in the collection, back to the originator) has been surrendered by the buyer. These without-recourse notes are sent back to the forfaiting agency by the EXIM Bank. When the forfaiting agency receives these documents, the same are verified for authenticating the signature of the availed and then payment is released with discount value, in consultation with the EXIM Bank. The transaction is done through the Nostro account of the exporter's bank in the country where the forfaiting agency is located. After the overseas bank receives the proceeds, it transfers them to the exporter. All these are performed at the instructions given by the EXIM Bank.

Immediately after the inward remittance of the funds, the exporter is issued a certificate of foreign inward remittance. At the time of maturity of the bills of exchange or the promissory note, the forfaiting agency displays certain documents to the co-acceptor for payments. The documents, which are presented at this time, are a commercial contract between the foreign buyer and the domestic exporter such as evidence of delivery of goods by the exporter to the overseas buyer, endorsement of debt instruments without recourse in favor of the forfaiter, etc.

Example: Forfaiting as per US International Trade Administration (ITA)

The US International Trade Administration (ITA), the trade administering body led by Under Secretary of Commerce for International Trade, had put down a four-step explainer of forfaiting. Firstly, the exporter communicates with the importer who needed extended credit facility. Secondly, the exporter contacts a forfaiter so also to include forfaiting cost into the sale price and then presents the transaction details to the forfaiter. Finally, after the forfaiter ratifies the deal at a discounted price the exporter signs the forfaiter's commitment letter.

Source: https://www.trade.gov/forfaiting Year: 2022 Accessed on September 24, 2022

15.15 Costs Involved in a Transaction of Forfaiting

A transaction of forfaiting involves different types of fees and charges. The fee charged by the forfaiter depends on the relationship with the exporter, the volume of trade, and above all the cost of funds of the forfaiter.

The fees that come into play during a transaction of forfaiting fall into three broad categories. The costs associated with or the fees payable in a transaction of forfaiting can be classified into the following three categories:

- **Commitment Fee:** A commitment fee is payable to the forfaiter by the exporter in consideration of the commitment made by the forfaiter to execute a particular transaction of forfaiting at a particular discount rate and within a specific time. The commitment fee ranges between 0.5-1.5 per annum. It is always calculated on the unutilized amount of the forfaiting transaction. Irrespective of the execution of the export contract, the commitment fee must be paid.
- **Discount Fee:** It refers to the cost payable on the credit sanctioned under the factoring agreement for the total period of credit under consideration. It is payable by the exporter to the forfaiter. Instead of charging the same separately, the forfaiter deducts it from the amount it owes to the exporter against the promissory note or bills of exchange, as the case may be. Discount rate is arrived at based on the London Inter-Bank Offered Rate (LIBOR) for the period under consideration. The forfaiter pays the exporter the money almost instantly, but it takes some time to recover the same from the importer. During the intervening period, the adverse movements in the international currency market may wipe out the profits of the forfaiter.

Therefore, this also includes the possible loss/gain that can be expected due to changes in the exchange rates in the intervening period.

- **Documentation Fee:** Documentation fee is generally charged for transactions involving elaborate legal formalities and complexities. However, it may not be charged when the legal procedures and the documentation required are low.

Example: Forfaiting Charges of Credit Europe Bank

Credit Europe Bank NV, the Netherlands based bank with presence in 7 countries, had the components of discount rate and commitment fee in their forfaiting charges. The discount rate was based on currency and maturity based on "Libor" (London Inter-Bank Offered Rates) and on the "Spread" based on involved risk, tenor and currency and the transaction value. The commitment fee was calculated on the face value of the transaction from the date of acceptance until the actual date of discounting.

Source: https://www.crediteuropebank.com/bank-relations/forfaiting-loan-trading/ Year: 2022 Accessed on September 24, 2022

15.16 Other Considerations Associated with a Transaction of Forfaiting

In addition to the costs studied above, there are certain charges applicable on a case-to-case basis like charges for handling, etc. Besides all these, EXIM bank (or, the forfaiter, whatever the case may be) is entitled to receive service charges for its participation in the forfaiting service. The charges of EXIM bank are payable in Indian rupee. However, the discount fee, commitment fee and documentation fee are passed on to the overseas forfaiter.

As per the guidelines issued by the apex bank, the exporter should finalize the export contract in such a manner that the total amount earned by the exporter in foreign currency after appropriating for the costs incurred in the forfaiting transaction is equal to the price which the exporter would obtain if the goods were sold on cash payment basis.

The consignment has to be of a minimum value of $250,000 or its equivalent to be generally considered for forfaiting by the agencies. The contract may be executed in all the major currencies of the world like US Dollar, Pound Sterling, and Japanese Yen, etc. The usual term of the receivables in a forfaiting contract varies between 1–5 years. The acceptance of a forfaiting offer by the forfaiting agency is also dependent on the agency's outlook on the country involved, and its risk perception on the macroeconomic fundamentals of that country.

For a long time, forfaiting was unknown to India. Export Credit Guarantee Corporation was guaranteeing commercial banks against their export finance. However, with the setting up of export-import banks, forfaiting is available on a liberalized basis.

Example: RBI Master Circular on AD-1 Banks to Offer Forfaiting

The RBI in its Master Circular of January, 2021 had permitted Authorized Dealer (AD)- Category 1 banks in India to offer forfaiting services. Earlier only Export Credit Guarantee Corporation and EXIM Bank were only offering forfaiting services. AD-1 banks are those banks licensed by RBI to deal in foreign exchange for specified purposes.

Source: https://www.rbi.org.in/scripts/NotificationUser.aspx?Mode=0&Id=10395 Year: 2021 Accessed on September 24, 2022

Activity 15.2

'Factoring' differs from 'Forfaiting'. How?

Check Your Progress - 2

6. Which one of the following is not a function of a factor?
   a. Collection
   b. Sales ledger administration
   c. Credit syndication
   d. Credit protection
   e. Short term funding
7. Which one of the following is not a correct source to assess the creditworthiness of a client by a factor?
   a. Credit ratings and reports
   b. Bank reports and trade references
   c. Analysis of financial statements
   d. Prior collection experience
   e. Collateral security
8. Identify the person or an intermediary who purchases the securities from the primary forfaiter and sells them in the secondary market.
   a. Subsidiary of the forfaiting company
   b. Banker
   c. NBFC
   d. Secondary forfeiter
   e. A dealer/ broker

9. Identify the term given to the fee payable to the forfaiter by the exporter to execute a particular transaction of forfaiting at a particular discount rate and within a specific time.
   a. Discounting fee
   b. Commitment fee
   c. Documentation fee
   d. Miscellaneous fee
   e. Handling charges/ fee
10. Which of the following terms suits the trade financing facilitated by forfaiting?
   a. Import transaction
   b. Domestic transaction
   c. Export transaction
   d. Local bills transaction
   e. Overdraft transaction

15.17 Summary

- The Factoring Act, 2011 defines the '*Factoring Business*' as "*the business of acquisition of receivables of assignor by accepting assignment of such receivables or financing, whether by way of making loans or advances or in any other manner against the security interest over any receivables and it requires RBI permission for starting factoring business.*
- The factor often provides a pre-payment (advance payment) up to a specified percentage of the debts purchased and charges interest on the pre-payment for the period between the date of pre-payment to the date of collection or the guaranteed payment date. This arrangement is referred to as the advance factoring arrangement. If the factor provides credit protection to the client, the factor assumes the risk of bad debt loss – the arrangement is referred to as non-recourse factoring.
- Factoring Bill 2021 Amendment had removed restrictions on NBFCs to enter into factoring business and it facilitated entry of as many as 9,000 NBFCs to participate in the factoring market and boosted cash flow to small businesses.
- FCI (established in 1968), the Global Representative Body for Factoring and Financing of Open Account Domestic and International Trade Receivables recorded factoring trade of €2,724 billion in 2020 and estimated a volume of €3,093 billion in 2021. India recoded €8.6 billion euro in 2021.

- Forfaiting is a form of trade financing undertaken to facilitate export transactions.
- The major parties involved in forfaiting are exporter, importer, domestic bank, foreign bank and the forfaiter, who could be the primary or the secondary forfaiter.

15.18 Glossary

Avalized Notes: It is a promissory note/bills duly endorsed by the importers' banker in a forfaiting transaction, guaranteeing the payment.

Availing Bank: It is the importer's bank in a forfaiting transaction. The bank endorses/ guarantees the payment to the forfeiter on the due date.

Bills Discounting: Bills discounting is a kind of advance against a bill of exchange at less than face value, after the bank deducts fees and applicable interest charges.

Credit Insuring: Credit insurance is a financial intermediary and protects the companies against customers' defaults. It covers credit risk that a company may face which may include non-realization of credit sales to its buyers due to insolvency, political risks, and counterparty default due to various reasons.

Factoring: Factoring is the non-recourse sale of accounts receivables of a business on a daily, weekly or monthly basis in exchange for payment.

Financial Intermediary: A financial intermediary is a financial institution, which serves as a bridge between individual and firm to save or borrow money.

Forfaiting: Forfaiting is a financial transaction in trade finance wherein the forfaiter purchases receivables from exporters, and takes on all the risks associated with the receivables as the transaction is without recourse.

Non-recourse: A non-recourse loan is an agreement where the lender does not have any right to collect the amount from the borrower if he is unable to pay.

Recourse: A recourse is a legal agreement wherein the lender has the legal rights to collect from the borrower if he is unable to repay the debt.

15.19 Self-Assessment Test

1. Explain the process of factoring diagrammatically while listing out the various steps in the transaction.
2. Discuss in brief the various forms of factoring.
3. List out the basic differences between factoring and forfaiting.
4. Explain the various functions of factor.
5. What are the salient features of a factoring agreement?
6. Explain the operational procedure of forfaiting diagrammatically.

15.20 Suggested Readings/Reference Material

1. Anthony Saunders, Marcia Millon Cornett, Anshul Jain (2021), Financial Markets and Institutions, 7th edition, Tata McGraw-Hill Education
2. Prasanna Chandra (2020), Fundamentals of Financial M, 7th edition, Tata McGraw-Hill Education.
3. Devie Mohan (2020), The Financial Services Guide to Fintech, 1st edition, Kogan Page Limited.
4. Siddhartha Sankar Saha (2021). Indian Financial System. 2nd edition, Tata McGraw-Hill Education
5. DR. R. Shanmugham (2020). Financial Services. 2nd edition. Wiley India

15.21 Answers to Check Your Progress Questions

1. (c) Financing for suppliers and collection of debts/ receivables

According to the International Institute for Unification of Private Law (UNIDROIT), factoring means an arrangement between a factor and his client that includes at least two of the services pertaining to receivables.

2. (c) Maturity Factoring

It is the type of factoring arrangement where the factor does not make any advance payment and pays the client either on a guaranteed payment date or on the date of collection.

3. (e) Full Factoring

It is a factoring arrangement which combines the features of both non-recourse and advance factoring.

4. (a) Both make available finance against the accounts receivables held by the client

Advance factoring and bill discounting are similar to the extent that both make available finance against the accounts receivables held by the client.

5. (b) Non-recourse Factoring

Credit insurance is similar to non-recourse factoring as far as the credit protection aspect is concerned.

6. (c) Credit Syndication

A factor does not undertake the service of credit syndication. The rest of the services are offered by a factor.

7. (e) Collateral Security

To assess the creditworthiness of a customer, the factor relies on a number of sources such as credit ratings and reports, bank reports, trade references, analysis of financial statements, prior collection experience, and customer visits. Collateral security may not be totally reliable as it may sometimes be that of a third party.

8. (d) Secondary Forfaiter

Secondary forfaiter purchases the securities from the primary forfaiter and sells them in the secondary market.

9. (b) Commitment Fee

A commitment fee is payable to the forfaiter by the exporter in consideration of the commitment made by the forfaiter to execute a particular transaction of forfaiting at a particular discount rate and within a specific time.

10. (c) Export transaction

Forfaiting is a form of trade financing undertaken to facilitate export transactions.

Unit 16

Housing Finance in India

Structure

"If the housing market is liquid, loans are easier to come by."

- Raghuram Rajan, Former RBI Governor

16.1 Introduction

In the previous unit, we discussed how receivables are funded through financial services like factoring and forfaiting. We have also discussed various aspects of factoring and forfaiting including legal issues involved in these transactions. One of the important funding activity done by financial institutions and NBFCs, is housing finance. In order to establish sound and sustainable institutional housing finance framework in the country, the government of India has taken various measures.

This unit deals with the broad framework of housing finance in the country. We also discuss various steps taken at the government level to build a sound, healthy, and viable housing finance system to cater to all segments of the population, and how it is integrated with the overall national financial system.

Government of India, in 2015, unveiled the policy “Housing for all by 2022”. This has given impetus to budget houses in India. Indian government is attempting to improve happiness quotient of the citizens. One way of increasing the happiness quotient is to guarantee house to all, especially in urban area where the migratory population seems to be ever increasing. The total number of houses to be created is 20 million under the policy. Till 2022, projects worth USD 11.3 bn have been undertaken[20].

Funding of these houses is dependent on the housing finance industry.

The housing finance industry is important from the point of view of overall development of the economy. Housing is being increasingly viewed as being important for overall infrastructural development in the economy.

Apart from companies approved by National Housing Board (NHB), entities such as commercial and co-operative banks, apex co-operative housing finance societies, insurance companies and Housing and Urban Development Corporation (HUDCO) provide finance for the purpose of construction of residential and commercial real estate properties. Of these, specialized housing finance institutions approved by NHB constitute a major chunk of housing finance provided in India.

16.2 Objectives

After going through this unit, you will be able to:

- Discuss the role of National Housing Bank (NHB)
- Describe the objectives of NHB
- Explain the refinance facility by NHB
- State the regulatory guidelines of NHB
- Understand the housing finance schemes offered by NHB: HLAS
- Brief on housing finance schemes offered by major financial institutions

16.3 Role of National Housing Bank (NHB)

National Housing Bank was formed as a subsidiary of the RBI when National Housing Policy was announced in 1988. As per the 2019-2020 budget announcements, the shares held by RBI in NHB were transferred to Government of India, making Government of India the sole contributor of capital of NHB[21].

[20] https://indiainvestmentgrid.gov.in/schemes/housing-for-all#:~:text=Housing%20for%20All%20is%20an,dwellers%20through%20four%20programme%20verticals

[21] https://nhb.org.in/en/about-us/#Genesis

The policy was framed to regulate the housing finance industry in India. The National Housing Policy has reflected the thrust the government wished to give to the housing sector. The policy pointed out that housing was not merely consumption expenditure, but also a productive investment which would provide economic activity besides creating a base for attaining several national policy goals such as: providing shelter, and raising the quality of life. The National Housing Policy also envisaged that an impetus given to housing would stimulate economic activity through creation of substantial employment opportunities.

The NHB specifies various norms to be followed by the HFCs and regulates the industry on lines of regulation of NBFCs by the RBI. It specifies the interest rate to be followed in lending and borrowing, income recognition and prudential norms, borrowing limits and audit to the housing finance companies. It provides refinancing facility to the housing finance companies and facilitates promotion of these companies on the specified lines.

Example: NHB Fined HDFC

In July 2021, the National Housing Bank (NHB) imposed monetary penalty on Housing Finance Development Corporation (HDFC). A penalty of ₹ 4.75 lakh was imposed on HDFC for non-compliance of NHB circulars of 2013 and 2016. HDFC acknowledged taking further steps to comply.

Source: https://www.thehindubusinessline.com/money-and-banking/nhb-imposes-475-lakh-fine-on-hdfc/article35169964.ece June 6, 2021 accessed on September 8, 2022.

16.4 Objectives and Functions of NHB

The following are the major objectives of NHB:

- To promote a sound, healthy, inclusive development and to integrate the housing finance companies (HFCs) system with the overall national financial system.
- To develop a network of dedicated housing finance institutions to serve all regions and sections in the society.
- To facilitate finance and other resources, and to create a framework for institutions for enhancing the quality of credit and affordability.
- To regulate and supervise the activities of Housing Finance Companies (HFCs) (This is now under the jurisdiction of RBI from April 2019).
- To innovate and develop new products in housing finance to cater to the specialized needs of different categories of the population.
- To create an appropriate environment for development of sustainable habitat and housing finance system through eco-friendly housing using energy efficiency and sustainable practices by partnership or collaboration with domestic and international agencies.

Functions

NHB performs multi-dimensional activities in pursuit of its objectives.

NHB main functions are:

a) Financing and promotion of housing projects

b) Development of housing sector -

- NHB (National Housing Bank) issues Certificate of Registration (CoR) to HFCs for commencement and carrying on the business of housing finance in India.
- NHB supervises HFCs through on-site inspection and off-site surveillance.
- The bank) provides refinance to Primary Lending Institutions (PLIs) including HFCs and banks at concessional rates.
- NHB provides project finance assistance to public agencies and public-private partnership for their housing projects.
- It provides assistance in the formulation of the central and state housing policies.
- The bank acts as Central Nodal Agency (CNA) in the implementation of government schemes for housing to the targeted segments.

16.4.1 NHB Nod for Housing Finance Company (HFC)

An HFC is a company which is primarily engaged in the business of housing finance. An HFC should register with NHB in addition to fulfilling the conditions stipulated in the Companies Act, 1956, to commence its business.

[22]Government of India with effect from 9th August 2019, has made RBI as the regulator for all HFC's which was hitherto NHB. RBI has examined the existing regulatory measures and proposed some changes and one such change is increase of NOF from ₹ 10 crore to ₹ 20 crore. Further in 2020, RBI fixed the minimum NOF for HFCs at ₹ 25 crore. The housing finance companies (HFCs) holding a Certificate of Registration (CoR) and having an NOF of less than ₹ 25 crore will be required to achieve NOF of ₹ 15 crore by March 31, 2022 and ₹ 25 crore by March 31, 2023.[23]

Another important criteria for qualifying a company as HFC is its portfolio composition. Accordingly, a company will be classified as HFC if the exposure to the extent of 50% of net assets is to real estate lending, of which at least 75% should be towards individual housing loans. The HFC's which do not qualify for this criteria will be treated as non-banking financial institution (NBFC).

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[22] https://www.livemint.com/industry/banking/rbi-proposes-new-rules-for-housing-finance-companies-11592403986803.html dated 18th June 2020.

[23] https://economictimes.indiatimes.com/news/economy/finance/rbi-pegs-minimum-nof-for-housing-finance-companies-at-rs-25-crore/articleshow/78813112.cms?from=mdr

Companies having no credit rating can accept deposit only up to 2 times of their net owned funds or ₹ 10 crore, whichever is less and should comply all prudential norms besides having capital adequacy ratio of not less than 15 percent. HFCs can accept public deposits for periods of 1-7 years only.

Example: Key Highlights of NHB Functioning in FY 2021-22

Launch of 'Online Inspection Report System' for digitization and easy submission of reports, "Automated Data Flow System (ADF)", for feeding 'granular' HFC system data to NHB and the publication of the quarterly NHB RESIDEX (Residential Index) were the highlights in 2021.

With the gradual resumption of economic activities, the outstanding individual housing loan portfolio of primary lending institutions registered a growth rate of 13.15 per cent in FY 2021-22 with a total outstanding increased to ₹ 24,30,775 crore from ₹ 21,48,322 crore in FY 2020-21 with an incremental growth of ₹ 2,82,453 crore. The home loan disbursements also picked pace to register record highs during FY 2021-22 with a y-o-y growth rate of 34.97 per cent.

National Housing Bank stepped up its support to the HFCs to obviate the liquidity issues faced, by launching the Liquidity Infusion Facility Scheme (LIFt). The bank disbursed a total of ₹ 1,10,000 crore (₹ 93,820 crore to HFCs) from September 1st 2018 till June 2022. Out of these, around ₹ 82,394 crore (₹ 70,176 crore to HFCs) were disbursed from March 2020, i.e. from the onset of COVID 19, till June 30th 2022. This support to the HFCs and banks was under LIFt, Affordable Housing Fund (AHF), Special Refinance Facility 2020, Additional Special Refinance Facility, and Special Refinance Facility 2021. The last three schemes were under the ambit of Atmanirbhar Bharat Package announced by Government of India.

Source: https://nhb.org.in/en/about-us/ NHB Homepage: 2022 Accessed on September 8, 2022. NBH Annual Report 2021-22

16.5 Refinance Facility by NHB

Refinance by apex institutions will facilitate liquidity to the lending institutions. NABARD, SIDBI, EXIM Bank, RBI will provide refinance to commercial banks for respective activities.

16.5.1 Refinance Assistance

Eligibility criteria was fixed by NHB for Housing Finance Companies (HFCs), Scheduled Commercial Banks (SCBs), Small Finance Banks (SFBs), Urban Cooperative Banks (UCBs) and State Cooperative Banks (SCoBs), Regional Rural Banks (RRBs), Apex Cooperative Housing Finance Societies (ACHFS) and Agriculture and Rural Development Banks (ARDBs). Fresh guidelines were issued on 18-06-2022 and from time to time guidelines will be amended by NHB.

The National Housing Bank (NHB) offers refinance assistance to HFC's in respect of the following loans provided by the HFC's:

HFCs fulfilling the following criteria will be eligible to draw refinance from NHB:

- The HFC should be registered with NHB/RBI to carry out housing finance activity in the country.
- The HFC should provide long-term finance for construction / purchase / repair / upgradation of dwelling units by home-seekers.
- The HFC should qualify under Principal Business Criteria prescribed in Paragraph 4.1.17 of the NBFC-HFC (Reserve Bank) Directions, 2021 dated 17-02-2021 as updated from time to time. (*Applicable w.e.f. 01-07-2022 for fresh sanctions*).

Timeline	Min. % of total assets towards housing finance	Min. % of total assets towards housing finance for individual
31-03-22	50%	40%
31-03-23	55%	45%
31-03-24	60%	50%

However, the maximum quantum of refinance as a percentage of the total individual housing loan portfolio of the HFCs which can be extended by NHB would be

% of total assets towards housing finance for individual*	Max. Refinance as a % of the total individual housing loan portfolio
40% & above and upto 45%	40%
45% & above and upto 50%	45%
50% & above	50%

Minimum Net Owned Fund (NOF) as prescribed by NBFC-HFC (Reserve Bank) Directions, 2021 dated 17-02-2021 was updated from time to time. HFCs holding a Certificate of Registration (CoR) and having net owned fund of less than ₹ 20 crore are eligible, if such company achieves net owned fund of ₹ 15 crore by March 31, 2022 and ₹ 20 crore by March 31, 2023 (*requirement to continue to carry on the business of housing finance as per latest RBI direction*).

- The HFC should comply with the provisions of the National Housing Bank Act, 1987 and Housing Finance Companies (NHB) Directions, 2010 and RBI circulars/guidelines issued from time to time.
- The Net Non-Performing Assets (NNPA) of the HFC should not be more than 3.50% of the Net Advances. NPA shall carry the same meaning as defined in Housing Finance Companies (NHB) Directions, 2010, as modified upto date and modified by RBI henceforth. NNPA means 'NPA less provision'. Net Advances shall mean 'Advances less provision'. 'Advances' shall, apart from housing loans, include mortgage loans, lease transactions, hire purchase assets, bills of exchange, inter-corporate deposits and unquoted debentures.

The above eligibility conditions shall remain same for existing as well as new clients.

Similar guidelines are issued for other financial institutions also for refinance facility.

Extent of Refinance

The maximum quantum of refinance (as percentage of the individual housing loan portfolio of the PLI) which can be extended by NHB is: For HFCs, SCBs, UCBs, RRBs, SCoopBs, ACHFs, ARDBs, the refinance is available at 50%.

Tenure of Refinance

The refinance may be available for a period of not less than 1 year and not exceeding 15 years subject to the maturity of the flagged loan list provided by the PLI as security/parameters of the refinance scheme availed/discretion of NHB. The tenure is also subject to the conditions of the respective scheme under which refinance is availed.

Types of refinance schemes by NHB

The following are the types of refinance schemes by NHB.

[24]**Refinance Support by National Housing Bank**

National Housing Bank stepped up its support to the HFCs to obviate the liquidity issues faced, by launching the Liquidity Infusion Facility Scheme (LIFt). The bank disbursed a total of ₹ 1,10,000 crore (₹ 93,820 crore to HFCs) from September 1st 2018 till June 2022. Out of these, around ₹ 82,394 crore (₹ 70,176 crore to HFCs) were disbursed from March 2020, i.e. from the onset of COVID 19, till June 30th 2022. This support to the HFCs and banks was under LIFt, Affordable Housing Fund (AHF), Special Refinance Facility 2020, Additional Special Refinance Facility, and Special Refinance Facility 2021. The last three schemes were under the ambit of Atmanirbhar Bharat Package announced by Government of India.

Three schemes are available for refinance under NHB:

1. Regular Refinance Scheme	LRS
2. Affordable Housing Fund	AHF
3. Refinance for Construction Finance for Affordable Housing	RCFAH

1. **Regular Refinance Scheme**

   To provide refinance assistance in respect of housing loans extended by HFCs for:

   - Construction / purchase of dwelling units
   - Repairs / renovation / upgradation of dwelling units

[24] NHB Annual Report 2021-22

Tenure of refinance – 1 year to 15 years

Interest Rate: Fixed with Resets or Floating. The interest rate will be determined at the time of disbursement based on market conditions.

Concessions in interest rate

- Loans upto 10 lakh
- Loans in rural areas (as per 2011 Census)
- Loans to women (where the woman is owner / co-owner of financed property)
- Loans to persons of 3rd gender (where the beneficiary is owner / co-owner of financed property)
- Loans to disabled or differently abled persons (where the beneficiary is owner / co-owner of financed property)
- Loans to persons belonging to Scheduled Castes / Scheduled Tribes (where the beneficiary is owner / co-owner of financed property)
- Loans for green housing (concession for green housing may be considered after submission of the flagged loans certified by green rating agencies viz. GRIHA, IGBC etc. (4 or above star/Platinum or Gold star))
- Loans in aspirational districts as circulated by Niti Aayog
- Loans in North Eastern States
- Loans in Jammu & Kashmir, Ladakh

2. Affordable Housing Fund

Salient features of Refinance Scheme under AHF are as follows.

Objective

The AHF shall be utilized for refinancing the individual housing loans having outstanding as on date of request for refinance which were disbursed during previous 12 months, falling under rural and urban category based on the demands received from the PLIs.

PLIs eligible for refinance under Affordable Housing Fund:

- Housing Finance Companies (HFCs)
- Scheduled Urban Cooperative Banks (UCBs)
- Regional Rural Banks (RRBs)
- Small Finance Banks (SFBs)
- Apex Cooperative Housing Finance Societies (ACHFS)
- Agricultural & Rural Development Banks (ARDBs)

Areas Covered

- **Urban –** All areas falling under the statutory town definition of Pradhan Mantri Awas Yojana – Urban;
- **Rural –** Any other areas not falling under the statutory Town definition of Pradhan Mantri Awas Yojana – Urban.

Eligible individual housing loans

- Individual housing loans having outstanding as on date of request for refinance which were disbursed during previous 12 months.
- Individual housing loans disbursed as provided in para 12.1(i) of Master Directions on priority sector lending.
- Individual housing loans under weaker section category as defined in the RBI's guidelines on lending to the priority sector and women.
- In respect of loans to borrowers other than weaker section and women, the annual household income of borrowers does not exceed ₹ 3 lakh in rural areas and ₹ 6 lakh in urban areas.

Loan Tenure – Maximum 7 years

On-lending interest rate cap:

The on-lending interest rate cap is 350 bps over the 10 year yield (yield as on the last day of the quarter will be considered for refinance for the ensuing quarter).

- Payment of Interest – Compounded monthly and payable quarterly
- Repayment of Principal – Quarterly

Others

Any disbursement made under the AHF will be within the PLI's annual sanction limit approved by the NHB and other terms and conditions applicable under NHB's Regular Refinance Scheme. PLIs are required to submit the category wise eligible individual housing loan accounts list in soft format as well as print outs.

Special Dispensation for EWS households and rural portfolio

In respect of rural and urban portfolio of HFCs in respect of EWS category, 100% of the claim amount is disbursed.

In respect of rural and urban portfolio of RRBs/SFBs etc. in respect of EWS and LIG category, 100% of the claim amount is disbursed.

- Funds shall be provided on first come first serve basis.

3. Refinance for Construction Finance for Affordable Housing

As defined under the Harmonized Master List of Infrastructure Sub-sectors vide notification dated 14.11.2017 by Department of Economic Affairs, Ministry of Finance, Government of India, at present, Affordable Housing is defined as a housing project using at least 50% of the FAR (Floor Area Ratio) / FSI (Floor Space Index) for dwelling units with carpet area of not more than 60 Sq. Mts.

Purpose - To provide refinance assistance in respect of loans extended by primary lending institutions to public agencies, private agencies / developers / builders for their affordable housing projects.

Eligibility Criteria:

Housing Finance Companies (HFCs) whose Net Owned Fund (NOF) is more than ₹ 500 crore as on the last day of the previous financial year and who are eligible under the Liberalized Refinance Scheme (LRS) scheme of NHB will be eligible for refinance under this scheme. All Scheduled Commercial Banks (SCBs), who are eligible for refinance under the Liberalized Refinance Scheme (LRS) of NHB are also eligible under this scheme.

The construction finance project of the PLI against which this refinance is availed, should have a minimum external rating of “Moderate Project or Equivalent” from the credit rating agency registered with SEBI.

Refinance would be available to the extent of the project cost apportioned for the affordable housing viz. in terms of proportion of the sum of carpet area for units having individual carpet area not exceeding 60 sq. mts to the total carpet area under the project.

Projects Eligible for Refinance

The total cost shall not exceed ₹ 50 crores per project and loan by PLIs to the project shall be as follows: Net Owned Fund	Loan amount not exceeding per project.
Above ₹ 500 crore and up to ₹ 1,000 crore	₹ 10 crore
Above ₹ 1,000 crore and up to ₹ 2,000 crore	₹ 15 crore
Above ₹ 2,000 crore	₹ 25 crore

Overall exposure of NHB under the scheme be restricted to 5% of NOF of the NHB.

Margin or asset cover:

A margin of 20% over and above the refinance or the asset cover will be 120% of the refinanced amount.

Security to be obtained from primary lending institutions:

In the case of housing finance companies, book debts against which refinance have been availed will be charged to National Housing Bank. Further, HFCs will also recognize the rights of NHB under Section 16B of the NHB Act, 1987.

In the case of scheduled commercial banks, refinance under the scheme will be extended as is being extended at present in the case of individual housing loans i.e. the list of all the projects against which refinance has been availed will be flagged to NHB and will be covered by Section 16B of the NHB Act, 1987 along with a Letter of Authorization (LoA).

NHB shall have the unencumbered charge on the Affordable Housing Project loan refinanced/security offered.

Additional Conditions:

- At the time of drawdown of the refinance, Statutory Auditors' of the HFC / bank will certify that outstanding loan against which refinance is sought, was utilized for the respective project only. Further, the auditor will certify that the book debt account is standard with not more than 30 days DPD and free from litigation. Financial closure is to be ensured by the PLI for the project.
- All the projects will be geo-tagged by the primary lending institution and registered under the provisions of the Real Estate (Regulation and Development) Act, 2016 (RERA), wherever such regulations are in force.
- Repayment period will be a maximum of five years.
- The total exposure of NHB to any group (builder) will not exceed ₹ 100 crore across all the PLIs.
- Any amount received by the PLI from the builder upon sale on residential units or otherwise will be repaid to National Housing Bank as per Section 16B of the NHB Act 1987.
- The rate of interest, terms of prepayment and other conditions will be as prescribed under the LRS/Regular Refinance scheme.

16.5.2 Rural Housing Fund (RHF)

NHB has formulated Rural Housing Fund (RHF), 2008 scheme for lending towards rural housing undertaken by people falling under the weaker section category, as defined in the RBI guidelines on lending to priority sectors. The corpus of the RHF was contributed by SCBs out of their priority sector lending shortfall. Quantum of funds to be contributed by each SCB and the applicable interest rate were determined by the RBI depending upon the priority sector shortfall of the respective SCBs. The tenure of the deposits under RHF is seven years. Since inception, total amount of ₹ 31,278.00 crore was received under the RHF. The total outstanding under RHF as on June 30, 2022, was ₹ 8,500.00 crore.

Example: Refinance Scheme for NHB's AHF for FY 2021-22

National Housing Bank (NHB) allocated a corpus of ₹ 10,000 crore for FY 2021-22 for its refinance scheme under the Affordable Housing Fund (AHF). This fund would be utilised for refinancing individual housing loans routed through Primary Lending Institutions (PLIs). The target beneficiaries would come under urban and rural areas falling and not falling respectively, under the statutory town definition of Pradhan Mantri Awas Yojana – Urban.

Sources: https://nhb.org.in/wp-content/uploads/2016/10/Refinance-Scheme-under-AHF.pdf August 19, 2022 Accessed on September 8, 2022

Check Your Progress - 1

1. Which of the following entity regulates housing finance institutions?
   a. Forwards Markets Commission
   b. SEBI
   c. NHB
   d. IRDA
   e. Finance Ministry
2. Which of the following is not an objective of National Housing Bank?
   a. To promote, establish, support or aid in the promotion and establishment of housing finance institutions
   b. To provide home for all Indians by 2022
   c. To act as a regulatory and supervisory authority to monitor and regulate the activities of housing finance companies
   d. To make loans and advances or render any other form of financial assistance whatsoever to housing finance institutions and scheduled banks to any authority established by/under any Central/ State Act and engaged in slum clearance
   e. To enhance resources for the industry and render them for housing.
3. Which of the following is not covered by the definition of weaker section?
   a. Small and marginal farmers with land holding of 5 acres and less, and landless laborers, tenant farmers and share croppers
   b. Women
   c. Minors
   d. Scheduled castes, scheduled tribes
   e. Persons from minority communities as may be notified by the government of India from time to time.

4. Which of the following loans are not eligible for refinancing by NHB?
   a. Direct housing loans up to ₹ 15 lakh disbursed by the HFCs to individuals. All new housing constructions along with extension and renovation works would be eligible but refinance. But, the extension and renovation works would be capped at ₹ 5 lakh per borrower
   b. Housing loan component under the productive housing in rural areas (PHIRA) programme of NHB
   c. Any other assistance provided by the HFCs for implementation of subsidy cum self-finance schemes of the government
   d. All water and sanitation component along with requisite housing infrastructure either as a part of project or independently for up gradation of existing housing projects
   e Loans to the weaker sections provided in rural areas.
5. What is the minimum size of a refinance claim?
   a. ₹ 50 lakh
   b. ₹ 10 lakh
   c. ₹ 5 lakh
   d. ₹ 40 lakh
   e. ₹ 1 crore

16.6 NHB Regulatory Guidelines

As mentioned above, NHB is the regulator of housing finance companies. Several guidelines have been issued to regulating different aspects of HFC functioning. The regulations that have been issued by NHB may be classified into:

a. **Capital Adequacy Norms:** Capital adequacy norms are prescribed for each of the financial entities viz., NBFCs, banks, financial institutions, HFCs, etc. Each of these entities have to mandatorily maintain a minimum level of capital adequacy ratio. By ensuring a minimum capital adequacy ratio, the regulators are assured that 'sufficient capital' is existent so as to withstand the abnormal shocks in the financial system (and therefore, the financial entity is less susceptible to wind up).

   Capital adequacy ratio, the prime indicator of capital adequacy, is calculated as risk weighted assets over total capital. Risk weighted assets are calculated by assigning a 'risk weight' (0 to a government security, 0.20 to a bank guaranteed security and so on, depending on the actual risk perception of the asset) to an asset and adding the same. Total capital includes both tier I and tier II capital. The risks for each of the assets are similar to the risk weightage for NBFCs.

b. **Income Recognition Norms:** For any entity involved in lending of money (for the purpose of construction of dwelling units in this case), recovery forms a major activity unto itself. Though the HFCs do take required precautions while lending to the individuals, recovering the amount involves proper recovery mechanism. The regulator's responsibility lies in overseeing that no lending entity piles up irrecoverable assets to an extent that it would hamper the normal business of such entity. National Housing Bank has specified that of the total receivables of housing finance company, at least 95% of the total money should be recovered.

   Also, on the sources generating income for a HFC, NHB has specified Income Recognition Norms that would classify income sources as standard assets, sub-standard assets, doubtful assets and loss assets. These income recognition norms are similar to the rules issued by the RBI for NBFCs.

c. **Loans/Lending Norms and Interest Rate Caps for Various Maturities:** The parameters for determination of the amount of money that is to be lent for construction of a house varies with each HFC. NHB does not specify any norms as far as determination of money that is to be lent is concerned. Also, the interest rate that may be charged by these HFCs for the amount lent is freely determinable. The interest rate charged by the HFC depends on factors such as competition in the industry, interest rates in the economy and money supply among other things.

d. **Reporting Norms:** All HFCs are mandatorily required to file annual returns with NHB, a copy with the RBI stating the following aspects of business:

   i. Particulars of deposits.

   ii. Particulars of exempted borrowings not counted as deposits.

   iii. Statements showing the net owned funds, statements showing outstanding loans and advances, statements of loans and advances to others.

   iv. Statements showing investments.

   v. Statements relating to deposits and maintenance of liquid assets.

   Also, audited balance sheets of the company along with the certificate from auditors stating that the full liabilities of the company have been reflected in the balance sheet, and that the company is in a position to meet the amount of such liabilities, must also be submitted to the NHB.

   NHB is empowered to instruct HFCs to submit information from time to time under the format it desires on matters relating to deposits, its maturities, rate of interest, annual accounts of depositors holding specified amount of deposits.

e. **Procedures for Conducting General Business:** NHB has also specified rules and regulations for the general working of the housing finance companies. The regulations relate to methodology of raising deposits and advertising thereto for such deposits. All the advertisements of HFCs soliciting deposits should conform to the NBFC advertisement rules issued by SEBI in 1992.

HFCs can accept deposits for a minimum period of 12 months, and a maximum of 84 months with interest rate offered not more than the rate applicable, as directed by NHB from time to time. Similar to the cap on the amount of deposits raised by NBFCs, a maximum amount linked to the net owned funds of the HFC is also laid down by the NHB.

16.6.1 HFC Loan Disbursement Procedure

Almost all Housing Finance Companies which provide long-term finance for construction or purchase of houses in India for residential purposes, come under the purview of National Housing Bank. So, all the lending of these companies should be sound, healthy and on viable proposals satisfying all the norms, guidelines, and directions of National Housing Bank.

Any proposal should be considered only if the applicant satisfies all the following conditions stipulated by NHB as tests of eligibility. Broadly, the eligibility criteria are as follows:

- The loans should be directly to individuals or groups of individuals.
- A co-applicant, if there is any, either the spouse of the applicant or son or brother (if there were no male children in the family) or daughter (if only child), co-applicant may be a co-owner of the property. Minors cannot be co-applicants.
- Residential active (earning) life of the applicant reckoned at 60 years – should cover the repayment period.
- Any other criteria that may be stipulated by NHB from time to time.

16.6.2 Appraisal

Having decided upon the eligibility, the application is accepted with the processing fee (ranging from 0.8%-1% depending upon the institution) along with the necessary documents. The third step consists of appraisal of the proposal. This appraisal can be broadly divided into 3 steps:

- Credit appraisal.
- Legal appraisal.
- Technical appraisal.

Credit Appraisal

The main objective of this credit appraisal is to assess the applicants' sustained repayment capacity over the period.

The main points considered are:

- Income
- Age

- Academic background and employment stability
- Family background
- Assets and Liabilities
- Servicing record with respect to other institutional borrowings
- Savings history/capacity
- Number of dependents
- Income and Expenditure Pattern

The list cannot be exhaustive and fool-proof. The inputs differ from case to case.

Some of the documents that throw light in the desired direction when obtained and scrutinized are:

a. **Salaried Class:**

   1. Salary Slip or Certificate for deduction from salary
   2. Salary Certificate
   3. Copy of Ration Card (third, fifth and sixth page)
   4. Electricity Bill (latest available)
   5. Rent Receipt (if applicable).

b. **For the Self-Employed:**

   1. A brief introduction to business/profession.
   2. Balance Sheet, and Profit and Loss Account certified by a chartered accountant.
   3. Income Tax/Wealth Tax returns for the last 3 years certified by a chartered accountant.
   4. Acknowledgment from the Income Tax Department for the above returns.
   5. Copies of advance tax paid.
   6. Assessment Orders.
   7. Registration Certification of establishment under Shops and Establishment Act.
   8. Confidential Credit Report from the bank.
   9. Rent Receipt for the establishment.
   10. Copy of Certificate of Practice (where applicable).
   11. Membership Certificate of respective professional association.
   12. Copy of Bank Sanction Letter for term loans/overdraft, etc. facilities.
   13. Electricity Bill (latest available).

14. Ration Card.
15. Rent Receipt.

The sources of income of the individual may be:

- Employment (salary)
- Business/Profession
- Other Income (to be specified and verified)
- Income from Employment (Salary)

Three main factors are to be considered here:

i. Gross Salary
ii. Deductions
iii. Adjusted Take-Home Salary

The gross salary shall not include annual payment like bonus/LTA/medical benefits, etc. which are not a regular source of income. Thus, it will not help the borrower in repayment of the installments regularly.

In the case of certain other income, like overtime allowance, incentives, commissions, etc., the stability and regularity of such income is the criteria for consideration.

Deductions of a regular nature and/or statutory deductions shall be deducted from the gross salary. However, deductions which are of a savings or an investment in nature shall be added back to the net salary. This is to remove the disparity between individuals who save or invest directly through their salaries and those who do not do so.

Further, deductions of short-term nature may also be added back to the income to arrive at the exact net income or adjusted take-home salary. While assessing the income, due weightage should be given to the age of the person, his qualifications and experience, his alternative employment prospects, whether his salary is commensurate with these factors, and his previous employment history.

Business or Professional Income

In this category, the individual may be a sole proprietor or a partner or a director of a private limited company; the individual may be a manufacturer or a trader or a provider of a service.

In all these cases, the income is to be ascertained from the financial statements for three years produced, supported by other relevant documentary evidence.

Some key points in assessing professional/business income:

- Expenses which are of a personal nature and debited to the profit and loss account may be given due weightage while assessing the income.

- Non-cash expenses like depreciation or investment allowance over and above normal rates required for asset replenishment can be written back.
- Excessive stock and fluctuations in income to be viewed with concern and appropriately assessed.
- Financial ratios like debt/equity, debtors/creditors, current assets/ liabilities, debt/income, fixed assets/income, gross profit to turnover, net profit to turnover, etc. are to be compared with previous performance as well at the industry levels.

Other Income

This may be from investments, rental, agricultural or vocational.

Legal Appraisal

After credit appraisal is done, the next step is legal appraisal wherein all the other documents like original title deeds, revenue receipts, encumbrance (search) certificates for the past 30 years are verified by an experienced lawyer to confirm that the withholder can create an equitable mortgage in favor of the Housing Finance Company by simple deposit of title deeds.

Technical Appraisal

The technical officer will first verify the original documents and counter-check upon all the furnished information, records, approval, clearance, certificates and orders. The applicant should submit all the documents relating to guarantees, collateral securities (LIC policies, fixed deposits, etc.). The needed documents differ from case to case depending upon, whether the house is being purchased – and, if so from whom – or whether it is a self-construction.

Following documents are generally called for in the case of self-construction:

i. Lay-out plan
ii. Approved plan
iii. No-encumbrance certificate
iv. Clearance under ULC
v. Commencement certificate, if applicable
vi. A detailed estimate of cost of construction
vii. NOC for mortgage of said property in case the purchase is from a development authority or any government allotted scheme.

By scrutiny of documents submitted, prior information about the proposed property like approval and clearance from competent authorities can be verified. A check on the estimate submitted can prevent the HFC from financing additional amount more than the actual cost of property.

It should be appreciated that after the credit appraisal, technical appraisal is the most important stage in the processing of any loan. Technical appraisal safeguards the borrowers' interest before and after the property is selected by him. If any property has been found to be illegal or unauthorized, prior information given to the borrower can prevent him from losing his money and/ or property by entering into an agreement with the builder of unauthorized property, where proper approval is not there from competent authority. Quality of work and materials used by builder can be checked at various stages of work so that the borrower gets the benefit for the amount invested by him for the said property. Assessing the work at various stages and recommending the correct disbursement to be released will prevent the borrower from paying additional amount to the builder for work not carried out by him. A check can also be carried out on the estimate submitted by a borrower of current rates of materials by the finance company, so that they do not finance more than the actual cost of the property. A check on the progress of construction and interaction with the builder can safeguard the borrower, if the project suddenly comes to a standstill due to lack of funds.

16.6.3 Disbursement Amount

Though disbursement may be done by the housing finance company in its entirety or in installments, the amount that is disbursed depends on factors such as the amount of own funds that are brought in by the borrower and the extent of construction completed among other things.

The amount of disbursement that is made by the HFC may be indicated by the following:

$$RD = AV \times CC/100 \times PC/100 + AV \times LC/100 - BC - CM$$

Where,

RD – Recommendation for disbursement in rupees

PC – Progress of construction in % points

AV – Aggregate value = LC + CC

LC – Land component

CC – Cost of construction + Overheads + Profits

BC – Borrower's contribution

CM – Cumulative disbursement made

Example: Flats

Loan = ₹ 1,50,000

PC = 70%

AV = ₹ 2,00,000

LC = 20%

CC = 80%

BC = ₹ 50,000

CM = ₹ 40,000

RD = ₹ 2,00,000 x 80/100 x 70/100 + 2,00,000 x 20/100 – 50,000 – 40,000

= ₹ 62,000

Maximum Amount of Loan Granted

In any financial system, there is a general parameter laid down which restricts the advance levels to a certain percentage of the property cost which includes the land cost as well as the construction cost.

The guidelines are set by the NHB, which is 85% of the cost of the proposed, including land cost.

The difference between the property cost and the maximum loan permissible is called margin or own contribution.

Other Limiting Factors: The maximum loan possible is again restricted to levels as decided on the basis of repayment capacity (whichever is lower). The loan's possible limit is limited to an extent such that the installment payable every month by the borrower shall not exceed 1/3rd of their joint take-home income. The period available at the disposal of the borrower to repay the loan is another limiting factor, which directly affects the payment capacity.

Installments: Installments are collected in the form of Equated Monthly Installments (EMI), which provide for the payment of interest with principal simultaneously and is derived by the formula:

$$\frac{1}{12}\left[\frac{Lr(1+r)^n}{(1+r)^n - 1}\right]$$

Where

L = Loan

r = Rate of Interest in decimals

n = Period

EMI can commence:

i. Immediately after full disbursement, or

ii. After the loan is fully disbursed or until 12 months from the date of first disbursement, whichever is earlier.

Note: This formula gives an approximate value of EMI's.

Example: X approaches HDFC for a loan of ₹ 5,00,000 for a period of 10 years for construction of a house, the rate of interest being 14.5% p.a. X has to pay in the form of EMI, an amount calculated as

$$\frac{1}{12}\left[\frac{5{,}00{,}000 \text{ x } 0.145\left(1+\frac{0.145}{12}\right)^{120}}{\left(1+\frac{0.145}{12}\right)^{120}-1}\right]$$

= ₹ 7,914.36

16.6.4 Sanction

After credit, legal and technical appraisal, and fixation of loan amount, the application is sent to head office for sanction. When sanction is accorded, a sanction letter is issued to the applicant.

16.6.5 Guarantees

HFC also insists on one guarantee from well employed persons or established businessmen as further securities who act as sureties that the loan taken may be disbursed. However, it may be noted that though the surety is legally responsible for making the borrower repay the borrowed amount, the surety's own property cannot be used as a guarantee or cannot be mortgaged for that purpose.

Example: NHB Mandated Weekly Submission of LCR by HFCs

The National Housing Bank (NHB) in its new Master Circular effected December 31, 2021 wanted all the deposit/non-deposit taking Housing Finance Companies (HFCs) to submit Liquidity Coverage Ratio (LCR) returns on a weekly basis. This would be irrespective of the size of HFCs and put in place to monitor the liquidity coverage of the HFCs in the subsequent 30 days.

Source: https://nhb.org.in/wp-content/uploads/2021/12/Circular-No.7-2021-22.pdf Accessed on September 10, 2022

16.7 Housing Finance Schemes Offered by HDFC

HDFC is the pioneer in the housing finance in India. HDFC was promoted by the late H T Parekh in 1977. The company has till 2022 sanctioned loans for 9 million units and its gross loans stood at ₹ 6.2 trillion. It has an extensive distribution network of 651 interconnected offices. HDFC has three representative offices in Dubai, London and Singapore offering home loan products to non-resident Indians and persons of Indian Origin. The various schemes offered by HDFC are illustrated in the following Exhibit 16.1 as follows:

Exhibit 16.1: Schemes Offered by HDFC for Resident Indians

Scheme	Amount of Loan Maximum	Maximum Period of Repayment
Fixed/Adjusted Rate Home Loans (individuals)	90% of the cost of the property (including the cost of the land) and based on the repayment capacity of the customer.	30 years
Home Renovation Loans	Existing customer 100% of the renovation estimate; not exceeding 90% of the market value of the property New customer 90% of the cost of renovation subject to market value of the property	15 years
Home Extension Loans	90% of the cost of extension	20 years
Land Purchase Loans	80% of cost of the land and based on the repayment capacity of the customer	15 years

In this section, we will discuss the following housing finance schemes offered by HDFC.

16.7.1 Home Loans (Individual)

Under this scheme, HDFC grants loans for acquisition of self-contained flats in an existing or proposed co-operative society or in an apartment owners' association for independent single family or multi-family bungalows and row houses, for immediate self-occupation. These loans are not available for resort houses or for repaying loans taken for housing purposes. Assistance is, however, provided for improvements and extensions to existing homes.

The loan amount will be determined with regard to the repayment capacity of the applicant as evaluated by HDFC by taking into account factors such as age, income, qualifications, number of dependents, spouse's income, assets, liabilities, stability and continuity of income and savings history. Loans to individuals will not normally exceed 85% of the cost of the dwelling unit including the cost of land.

The following documents are to be submitted along with the application form:

i. If the applicant proposes to obtain financial assistance for acquisition of residential accommodation from any source other than HDFC, the source with amounts and repayment terms.

ii. Allotment letter and bye-laws of the co-operative society/association of apartment owners.

iii. Copy of approved drawings of proposed construction/purchase/extension/ renovation.

iv. Agreement for sale/detailed cost estimate from architect/engineer for the proposed dwelling unit.

v. If the applicant's job is transferable, permanent address where correspondence, relating to the application can be mailed.

vi. Applicable processing fees.

vii. Any other information regarding the applicant's repayment capacity that is necessary and would assist HDFC in appraising the case.

viii. If the applicant is employed, then latest salary slip/salary certificate showing all deductions.

ix. If the applicant is self-employed, the balance sheets and profit and loss accounts of the business/profession along with copies of individual income tax returns for the last three years certified by a chartered accountant, also a note on the nature of business/profession, form of organization, clients, etc. must be submitted.

The applicant is required to pay interest on the portion of the loan disbursed. This is payable every month from the date of each disbursement up to the date of commencement of EMI.

HDFC also offers certain facilities such as Step-Up Repayment Facility, Telescopic Loan Plan and Short-term Bridging Loan Facility. The Step-Up Repayment Facility helps individuals get larger loans than under the normal facility by stepping up the repayment of the loan at regular intervals. Telescopic Loan Plan helps individuals get larger loans than under the normal facility by providing an initial repayment term of up to 30 years. Short-term Bridging Loan Facility helps individuals obtain short term finance during the interim period between the sale of existing unit and acquisition of a new unit.

16.7.2 Other Housing Loan Facilities offered by HDFC

HDFC offers housing loan facilities to various segments of borrowing groups.

For Non-Resident Indians

HDFC offers home loans to non-resident Indians, as per the following guidelines issued by the Reserve Bank of India:

- The maximum loan amount depends on the country. For instance, for NRIs in Singapore, the maximum funding is 60% of the property cost;

- Own contribution, i.e. the total cost of the dwelling unit minus the loan amount can be met from direct remittances from abroad through normal banking channels, from the Non-Resident (External) Account in India and/or the Non-Resident (Ordinary) Account in India;
- The repayment of the loan, comprising principal and interest, including all charges, can be remitted to HDFC from abroad through normal banking channels, the Non-Resident (External) Account in India and/or the Non-Resident (Ordinary) Account in India;
- The maximum term of repayment is 20 years; and
- Persons of Indian origin holding foreign passports will not be eligible to obtain financial assistance from HDFC.

Along with the application, a one-time fee of 2% of the loan amount applied for is payable.

The following documents should be submitted along with the application form:

I. **Photocopies of:**

1. ***Employment/Residency Documents:***
    - Employment contract (If the contract is in a language other than English, an English translation attested by the Embassy/Employer should be given)
    - Latest salary slip
    - Latest work permit
    - Identity card issued by current employer
    - Visa stamped on the passport
    - Continuous discharge certificate (CDC) – (if applicable)
    - Last four months overseas bank account statement.
2. ***Property Related Documents:***
    - Copy of approved drawings of proposed construction/purchase/ extension.
    - Agreement for sale/sale-deed/detailed cost-estimate from architect/ engineer for property to be purchased/constructed/ extended.
    - Allotment letter from the co-operative society/association of apartment owners.
    - Receipts for payments made for purchase of the dwelling unit.

II. **Power of Attorney as per HDFC's Draft.**

16.7.3 Flexi-Rate Individual Housing Loans

HDFC, in partnership with certain developers, offers the Flexi-Rate Individual Housing Loans (FRIL). Under this facility, the developer will share the interest burden of the borrower, thus, offering an opportunity to make substantial savings in interest rate cuts to the borrower.

When the borrower avails a FRIL, the developer offers to bear a certain portion of interest burden. The subsidized interest rate means a lower equated monthly instalment (EMI), which enables you to qualify for a higher loan amount.

16.7.4 Home Renovation Loans

HDFC offers home improvement loans for external repairs, waterproofing and roofing, internal and external painting, plumbing and electrical maintenance of your existing home.

Any improvements that increase the life of the property and which contribute towards better living environment adding value to the house, is eligible to be financed by the home improvement loan.

Existing borrowers of HDFC are also allowed to apply for home improvement loans.

The maximum funding is 100% of renovation cost for existing customers and the period of the loan cannot exceed 15 years. The rate of interest charged on home improvement loans depends on the period of the loan.

Interest is calculated on annual basis. Principal repayments are credited at the end of HDFC’s financial year.

The size of loan offered by HDFC will depend on your repayment capacity, as determined by HDFC. Repayment capacity takes into consideration factors such as income, age, qualifications, number of dependents, spouse’s income, assets, liabilities, occupation and savings history.

HDFC’s main concern is that you should be able to comfortably repay what you borrow.

All other terms and conditions applicable to HDFC’s home loans will apply to home improvement loans.

16.7.5 Home Equity Line of Credit (HELOC)

A home equity line of credit, also known as a HELOC, is a line of credit secured by house property to any person. This facility is extended by some of the commercial banks as a revolving credit line to use for large expenses or to consolidate higher-interest rate debt on other loans1 such as credit cards. Here the house is used as collateral for the line of credit. If the borrower repays the loan / or part of the outstanding the amount of available credit is replenished – much like a credit card. Drawing period will be fixed by the bank. At the end of the draw period, the repayment period begins.

A HELOC often has a lower interest rate than some other common types of loans, and the interest may be tax deductible.

16.7.6 Non-Residential Premises Loans to Professionals

HDFC also offers non-residential premises loans to doctors, chartered accountants, architects, lawyers and other self-employed professionals.

- Non-residential premises loans are available to purchase or construct office premises of your own, or to renovate your existing office.
- Non-residential premises loans work very much like HDFC's home loans.
- The maximum period is 15 years.
- All other terms and conditions applicable to HDFC's home loans will apply to home improvement loans.

Equity Loans

For encashment of the present value of the property by taking a loan by mortgaging the property for the purpose of personal expenses, HDFC introduced equity loans. These loans are given on residential or non-residential house properties. The maximum limit of this loan is 50% of the market value of the property (including the cost of the land) subject to minimum market value of the property being ₹ 5,00,000 for residential property and ₹ 7,50,000 for non-residential property. The maximum tenure of the loan is 15 years for residential property and 10 years for non-residential property.

Example: Highest Ever Home Loans by HDFC

For the FY 2021-22, HDFC had approved a record ₹ 2 lakh cores under its retail home loan sector. This was 30% increase compared to ₹ 1.55 lakh crore disbursal by HDFC last fiscal of 2020-21. Focus on digital initiatives and inherent housing demand helped HDFC achieve this milestone. Affordable and high-end segments were the main drivers for home loans with the price range of ₹ 50 lakh to ₹ 1 crore considered as the 'Sweet spot'.

Source: https://economictimes.indiatimes.com/industry/banking/finance/hdfc-ltd-approves-highest-ever-rs-2-lakh-crore-home-loans-in-fy22/articleshow/90391730.cms March 24, 2022

Accessed on September 9, 2022

16.8 Housing Finance Schemes by LIC Housing Finance Ltd.

[25]LIC Housing Finance Ltd (LICHFL) was promoted by LIC of India on 19th June 1989. LIC Housing Finance is one of the largest housing finance companies in India with its corporate office in Mumbai. Its main objective is to provide long-

[25] http://www.lichousing.com/aboutus.php

term finance to individuals for purchase or construction of house or flat for residential purpose. The company also finances for existing residential dwellings for repairs/ renovation, etc. It has nine regional offices, 23 back offices, 283 marketing offices and more than 12000 marketing intermediaries across India and 2 overseas offices in Kuwait and Dubai, to cater to the non-resident Indians living in Bahrain, Dubai, Kuwait, Qatar, and Saudi Arabia. The company has financed over 25 lakh home owners with a cumulative disbursement of over ₹ 3.35 lakh crore since inception. LICHFL presently holds a loan book of over 2 lakh crore as on December, 2022.

LICHF is a subsidiary of LIC and it has 6 regional offices, 67 area offices and 45 extension counters throughout the country. It can access over the half a million agents of LIC for soliciting housing finance clients. Out of the existing market players, it can be said that only two players dominate: HDFC and LICHF. These two companies share between themselves around 75% of the market share in the housing finance industry.

Housing Loans

They provide home loans of various types such as:

1. Home loan for Resident Indian - Home loans or housing loans are available for Resident Indians for purchase of under-construction or ready to move homes. Housing loans can also be availed for construction of own house.
2. Home loan for Non Resident Indian – These loans are available for salaried employees having NRI/PIO status. The loans are available for purchase of under construction or ready to move homes. Housing loans can also be availed for construction of own house.
3. Plot Loans – There are two types of loans provided under this:

a. Loans for purchase of plot from government bodies, development authorities and approved layouts.

b. Composite loan towards purchase of plot and house construction. This loan is available only if the applicant is intending to complete the construction within 3 years from the date of plot purchase.

4. Home improvement loans – These are loans given for improvement or renovation of house. Maximum funding is upto 90% of the renovation cost.
5. Top up loans - Top up loans are available for both existing and new customers. New customers can avail top up when they switch their existing home loan to another housing loan company or with the same lender.
6. Balance Transfer – This facility enables switching the home loan without any hassle to LIC housing finance and enjoy benefits such as lower rate of interest, affordable EMIs, top up loan and much more.

Example: LIC Housing Finance Ltd and India Post Payment Bank Tie-up

In September 2021, LIC Housing Finance Ltd., (LIC HFL) announced a strategic partnership with India Post Payment Bank (IPPB) to target the 4.5 crore customer base of IPPB. The aim was also to take LIC HFL home loan products to the unbanked remote areas. IPPB would act mainly as sourcing agent for LIC HFL.

Source: https://www.livemint.com/companies/news/lic-housing-finance-partners-with-india-post-payments-bank-to-offer-home-loans-11630999304098.html September 7, 2021

Accessed on September 9, 2022

16.9 Tax Treatment of Loans for Constructing Houses

Section 24(1) of the Income Tax Act allows deduction of interest on borrowed capital from the gross annual value of the house on accrual basis. Any interest paid on the loan borrowed for the purpose of constructing/buying or upgrading the house for which the annual value is assessed, is allowed as deduction. Also, any interest on the amount borrowed during the pre-construction period (starting from the date of borrowing and ending on March 31st or the date of completion of the construction, whichever is earlier) is allowed to be deducted in five successive years.

Similarly, interest on capital borrowed will be deductible as it is deductible under the existing provisions, subject to a maximum of ₹ 30,000. If, however, the property is acquired or constructed with capital borrowed on or after April 1, 1999, and the property is acquired or construction is completed before April 1, 2003, the amount of deduction will be limited to ₹ 2,00,000. Note that the limits are applicable only for self-occupied house property.

Example: Home Loan Benefit under Section 80 EEA Discontinued

From FY 2022-23, the Govt. of India discontinued the additional income tax benefit of upto 1.5 lakhs under Section 80 EEA for the first time individual home loan borrowers for properties worth upto 45 lakhs.

This additional tax benefit which was announced in Budget 2019 and extended on yearly basis till 2021 was discontinued in Budget 2022. However, those who availed this home loan benefit earlier would continue to do so for the rest of their loan tenure.

Source: https://www.livemint.com/money/personal-finance/income-tax-this-home-loan-benefit-cannot-be-availed-after-march-31-11646719460908.html March 11, 2021

Accessed on September 9, 2022

16.10 Concessions to the Housing Sector by Government

Considering the social and economic importance of housing, the government has started taking right steps towards facilitating healthy growth of housing and housing finance in India. Some of the concessions announced by the government towards this end are discussed below:

Tax Holiday

- A tax holiday is provided to enterprises carrying on infrastructure facility commencing between 01 April, 1995 to 01 April, 2017 under Section 80-IA. This tax holiday allows a deduction of 100% of the profits for 10 consecutive assessment years. Initial assessment year should start within 15 assessment years in which assessee starts its operations. Infrastructure facility covers the following activities.
  - A road including toll road, a bridge or a rail system
  - A highway project
  - A water supply project
- A port, airport, inland waterways or inland port or navigational channel is the sea

Concessions in calculation of Income from House Property

The Income Tax Act has given many concessions to the persons deriving income from house property.

In the calculation of 'Income from House Property', actual expenditure on repairs and expenditure on collection is not taken into account while allowing deduction on account of repairs and collection of rent. A flat deduction equal to 30% of the annual value of the property is being allowed for repairs and expenditure on collection of rent, irrespective of the actual expenditure.

Previously, interest on borrowed capital on accrual basis used for the purpose of purchase, construction, repair, renewal or reconstruction of the house property was allowed to be deducted up to ₹ 15,000 p.a. Such deduction is now being increased to ₹ 30,000 p.a. From annual year 2000-01, interest on borrowed capital is deductible up to ₹ 1,50,000 p.a. where the property is acquired/constructed with capital borrowed on or after April 1, 1999. Besides, such acquisition/construction must have been completed before April 1, 2003. If the assessee had lent the house, the entire interest payment is deductible. These tax-breaks would encourage owners to build houses for sake of rentals.

Loss from house property is adjusted against income under other heads in the same assessment year. Any balance loss remaining shall be allowed to be carried forward and set off in subsequent years up to a maximum of eight assessment years against house property income. Under Section 80 C, amount paid (maximum ₹ 1,50,000) towards repayment of loan principal is applicable for tax rebate.

Example: Budget 2022: 48,000 Crores for Affordable Housing

In the Budget of 2022, the Central Government of India allocated 48,000 crores for affordable housing under its flagship Pradhan Mantri Awas Yojana (PMAY). The allocation was aimed at giving aid in the form of beneficiary led construction with subsidy of upto 2.5 lakh for each household and housing construction in public-private partnership with concessions to the private realtor like no land cost etc.

Source: https://www.moneycontrol.com/news/business/real-estate/budget-2022-real-estate-sector-welcomes-rs-48000-crore-allocation-for-affordable-housing-homebuyers-unhappy-8022181.html

Accessed on September 10, 2022

Activity 16.1

Is there any difference between HDFC and LIC Housing Finance Schemes? If yes, list out the same.

16.11 Securitization of Housing Loans

Securitization of housing loans has been one of the alternatives emphatically suggested to overcome the liquidity problem of the HFCs. Securitization of housing loans has been bogged down because of stamp duty restrictions. Stamp duty is levied on mortgage- backed securities (MBS) as the provisions of the Transfer of Property Act, 1881 consider such transaction as transfer of asset. That is, stamp duty needs to be paid when there is (i) a transfer of the securitized assets by the originator to the special purpose vehicle (SPV) and (ii) an undivided interest in the form of pass through certificates (PTCs) is transferred by the SPV to the investors. Though asset-backed securitization is possible to be routed to lower stamp duty states like Maharashtra, stamp duty cannot be avoided in securitization of house loans. This is because of the fact that mortgage-backed securitization (MBS) has to be necessarily registered through the place where the mortgaged property exists. However, with Karnataka and Tamil Nadu also reducing the stamp duty rates for such transactions to a low of 0.1%, there exists a possibility for securitization of housing loans in these states.

Activated by such announcements, the NHB is issuing "pass through certificates (PTCs)" for securitization of mortgage-backed assets on behalf of HFCs. In this mechanism, a pool of assets (mortgages) would be sold by the HFCs to NHB which would act as a special purpose vehicle. The NHB would resell these loans by breaking them into marketable securities that is the pass through certificates.

The securitization would be done on those assets in Maharashtra, Tamil Nadu and Karnataka due the low stamp duty. The securitized debt would have a time period of five to seven years. It will be issued to pension funds, mutual funds, financial institutions and commercial banks.

Example: MHP Relaxations for Residential MBS

In a boost to securitization of home loans, the RBI in its Master Directions of September 2021, relaxed the Minimum Holding Period (MHP) requirements for residential Mortgage-backed Securities (MBS). Unlike the earlier 12-month period, MHP got reduced up to 6 months along with the requirement of MHP linked to repayment frequency was changed to tenor of the loan - 3 months MHP for loans up to 2 years and 6 months for more than 2 years.

Source: https://www.legal500.com/developments/thought-leadership/new-directives-on-securitisation-of-standard-assets-revamping-the-securitisation-landscape/ February 1, 2022 & https://www.rbi.org.in/Scripts/BS_ViewMasDirections.aspx?id=12165 September 24, 2021

Accessed on September 10, 2022

16.12 Measures by RBI

RBI has removed some tough conditions imposed on housing loans by banks. The rules were regarding the property age (that the property cannot be more than 5 years old), the borrower's margin (that the margin of own funds brought-in should be at least 35%) and the repayment period (at least 15 years). Thanks to RBI removal of these conditions, borrowers' margin is coming down to the range of 20 to 25 per cent. The property age can go up to about seven to 10 years, and some repayment tenures have increased to 25 years.

RBI's Master Circular dated February 18th, 2022[26] consolidates the guidelines issued to banks for housing finance. Some important guidelines include:

- Bank finance can be granted only for purchase of a plot, provided a declaration is obtained from the borrower that he intends to construct a house on the said plot, with the help of bank finance or otherwise, within such period as may be laid down by the banks themselves.
- Banks may consider requests for additional finance within the overall ceiling.
- Banks may grant term loans to housing finance institutions taking into account (long-term) debt-equity ratio, track record, recovery performance and other relevant factors Banks can issue long-term bonds with a minimum maturity of seven years to raise resources for lending to affordable housing.

[26] https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=12243&Mode=0

The central government has stressed on the rural housing sector. It has raised the allocation for Indira Awas Yojana to ₹ 2,277 billion by 2021-22[27]. RBI will revise the norms of repayment of rural housing loans by banks so that installments coincide with crop cycles. The total houses completed under this scheme in 2021-22 were 43,75,051 units.

Pradhan Mantri Awas Yojana – Pradhan Mantri Awas Yojana (Urban) Mission was launched on 25th June, 2015. The scheme intends to provide housing for all in urban areas by year 2022. 2897001 units completed in 2021-22; total units completed are 2, 11, 45,962 up to 2021-22.

Example: Lower Risk Weightage on Housing Loans Extended by RBI

In April 2022, RBI extended the lower risk weightage on housing loans until March 31, 2023 which expired for March 31, 2022. This was to boost the credit flow to the housing loan sector. Earlier, the RBI rationalized the risk weights for housing loan sector by linking them only with loan to value (LTV) – 35% risk weight for LTV of 80% or lower and 50% for LTV between 80% to 90%.

Source: https://www.livemint.com/money/personal-finance/rbi-extends-lower-risk-weightage-on-home-loans-by-one-year-what-it-means-11649394534672.html April 08, 2022
Accessed on September 10, 2022

Check Your Progress – 2

6. Which of the following is not eligible for home improvement loans?
   a. External repairs
   b. Plumbing work
   c. Waterproofing
   d. Internal and external painting
   e. Construction of additional floor
7. In which year the wealth tax act got abolished?
   a. 2012
   b. 2013
   c. 2015
   d. 2017
   e. 2019
8. What is the advantage of securitization of housing loans?
   a. Solves solvency problem
   b. Solves liquidity problem

[27] https://rhreporting.nic.in/netiay/FinancialProgressReport/Allocation_PhaseWiseReport.aspx

   c. Reduces debt
   d. Increases revenue
   e. Increases profits

9. Which of the following entities are not eligible for refinancing scheme?
   a. Microfinance institutions
   b. Scheduled banks
   c. Regional rural banks
   d. Housing finance corporations
   e. Builders

10. Which of the following depicts capital adequacy ratio?
   a. Risk weighted capital
   b. Total capital
   c. Product of risk weighted assets and total capital
   d. Risk weighted asset over total capital
   e. Total capital over risk adjusted weighted capital

Activity 16.2

When the wealth tax got abolished in the year 2015, since then, how the tax on wealth is computed?

Answer:

16.13 Summary

- The Indian housing finance industry comprises Housing and Urban Development Corporation (HUDCO), National Housing Bank (NHB), co-operative housing finance societies, insurance companies, commercial banks, co-operative banks and 26 companies approved by NHB, the apex financial institution in India for housing loans.
- NHB was formed as a subsidiary of RBI, when national housing policy was announced in 1988 to regulate housing finance industry in India.
- Eligibility Criteria for refinance was fixed by NHB for Housing Finance Companies (HFCs), Scheduled Commercial Banks (SCBs) and other financial entities. Fresh guidelines were issued on 18-06-2022 and from time to time guidelines will be amended by NHB.

- The refinance may be available for a period of not less than 1 year and not exceeding 15 years subject to the maturity of the flagged loan list.
- Individual Housing Loan Portfolio of Primary Lending Institutions was registered at ₹ 24,30,775 crore in FY 2021-22 according to NHB Annual Report 2021-22.
- NHB prescribes regulatory guidelines for various HFCs relating to the capital adequacy norms, income recognition norms, loans/lending norms, interest rate ceilings for loans of various maturities, and the procedures for conducting general business.
- HFCs insist for two guarantors as sureties for the proposed loan. HFCs should consider lending to sound, healthy and viable proposals which satisfy all the eligibility criteria prescribed by NHB.
- HDFC is the leading HFC in India. It is offering various housing loans to individuals and NRIs. HDFC also offers Line of Credit (LOC) to corporates for their employees’ homes in two methods.
- The housing sector has been accorded with infrastructure status. There exist many concessions in the Income Tax and Wealth Tax Acts for individuals and companies engaged in this business. The Income Tax Act allows deduction of interest for individuals on the borrowed capital meant for housing purposes.

16.14 Glossary

ACHFS: These are Apex Cooperative Housing Finance Societies (ACHFS) at state level which provide financial assistance for construction of houses and composite housing scheme such as acquisition of land, development of site and construction of house.

Capital Adequacy Ratio: It is the prime indicator of capital adequacy, is calculated as risk weighted assets over total capital.

EMI: Installments are collected in the form of equated monthly installments (EMI) which provides for the payment of interest with principal.

Home Extension Loans: These loans are improvement loans provided by the bank.

Income Recognition Norms: Financing institutions do not recognize the income from non-performing assets on accrual basis. Income is booked only when they are realized.

NNPA: It refers to the gross non-performing asset less provisions made in these assets.

Non-Resident (External) Account: Is a savings account maintained in Indian currency in India by NRIs, with the foreign income earned outside India.

Non-Resident (Ordinary) Account: Hitherto maintained domestic operative accounts of the NRI will be converted to NRO accounts. The domestic credits and debits can be done in this operative account.

PLI: Primary Lending Institutions which include Aditya Birla Housing Finance, Adani Housing Finance, etc.

Refinance: Is a process wherein certain development financial institutions provide financial assistance to banks and NBFCs on their asset portfolios.

Rural Housing Fund: NHB has formulated Rural Housing Fund (RHF), 2008 scheme for lending towards rural housing undertaken by people falling under the weaker section category.

Securitization: It is the process of converting an illiquid pool of assets and transforming them into a tradable security.

16.15 Self-Assessment Test

1. What are the regulatory guidelines of NHB?
2. What are the salient features of rural housing fund 2008?
3. Write in detail the procedure for getting loans from NBFC?
4. What is the process of credit appraisal of an individual?
5. What are the various housing loan schemes available for NRI?
6. What are the documents that are required by the self-employed?

16.16 Suggested Readings/Reference Materials

1. Anthony Saunders, Marcia Millon Cornett, Anshul Jain (2021), Financial Markets and Institutions, 7th edition, Tata McGraw-Hill Education
2. Prasanna Chandra (2020), Fundamentals of Financial M, 7th edition, Tata McGraw-Hill Education.
3. Devie Mohan (2020), The Financial Services Guide to Fintech, 1st edition, Kogan Page Limited.
4. Siddhartha Sankar Saha (2021). Indian Financial System. 2nd edition, Tata McGraw-Hill Education
5. DR. R. Shanmugham (2020). Financial Services. 2nd edition. Wiley India

16.17 Answers to Check Your Progress Questions

1. **(c) NHB**

   NHB is the regulator of the housing finance institutions.

2. **(b) To provide home for all Indians by 2022**

   The National Housing Board aims at providing finance for housing and not for building houses.

   Venture capital investment is huge at the time of setting up of business.

3. (c) Minors

Minors are not eligible for home loans. Hence, they are not covered by the NHB.

4. (e) Loans to the weaker sections provided in urban areas

Because the loans are given to the weaker sections in rural area and are eligible for refinancing.

5. (e) ₹ 1 cr.

This is the minimum size of a refinance claim.

6. (e) Construction of additional floor

This does not necessarily come under improvement of assets.

7. (c) 2015

The wealth tax act got abolished in the year 2015.

8. (b) Solve Liquidity Problem

It helps solve the problem of cash crunch.

9. (e) Builders

Builders are not eligible for refinancing scheme.

10. (d) Risk Weighted Asset over total Capital

It depicts capital adequacy ratio.

Unit 17

Mortgages and Mortgage Instruments

Structure

"Step by step, place became property, property became a mortgage, and mortgages became derivative investments."

- Douglas Rushkoff, American author and documentarian

17.1 Introduction

To understand how a property becomes a mortgage, let's study mortgages and instruments made from mortgages in this unit.

The previous unit discussed upon the housing finance segment in India. The unit mainly discussed the functioning of National Housing Bank (NHB) and its role, objectives, schemes and regulatory guidelines concerning housing finance in India. The relevant Reserve Bank of India (RBI) measures are also discussed hereunder. Now, the present unit discusses upon another type of housing finance called mortgage and its instruments.

As per the Cambridge dictionary, a mortgage is defined as "an agreement that allows a person to borrow money from a bank or similar organization, especially to buy a house, or the amount of money itself".

It is a legal agreement that is mortgaged to a bank or any financial institution, which provides the money for the purchase of the house property. On repayment of the commitment (principal and interest), the title of the property is re-conveyed to the owner.

In this unit, we will discuss the features of the important mortgage-related securities that are prevalent in the United States and other countries across the Globe. We begin with a discussion of how mortgages operate to provide the necessary background for understanding and analyzing mortgage-related securities.

17.2 Objectives

After going through the unit, you will be able to:

- Recall the concept of mortgages
- Describe the various types of mortgages
- Differentiate between traditional and non-traditional mortgages
- Discuss the mortgage business in India and other countries

17.3 Mortgages - Meaning and Concept

A mortgage may be defined as creating charge over immovable property to secure a debt payment or obligation. Section 58 of the Transfer of Property Act, 1882 defines mortgage as –

"A mortgage is the transfer of an interest in specific immovable property for the purpose of securing the payment of money advanced or to be advanced by way of loan, an existing or future debt, or the performance of an engagement which may give rise to a pecuniary liability."

The transferor of the property is called a *mortgago*r, the transferee a *mortgagee*; the principal money and interest of which payment is secured for the time being are called the *mortgage-money*, and the instrument (if any) by which the transfer is effected is called a *mortgage-deed or instrument.*

Ingredients of Mortgage

From the above definition of mortgage, the following are the requirements of a mortgage:

i. There should be transfer of interest in the property by the mortgagor (the owner or lessor).
ii. The transfer should be to secure the money paid or to be paid by way of loan or a pecuniary obligation.

Three outstanding characteristics of mortgage are:

- The mortgagee's interest in the property mortgaged terminates upon the performance of the obligation secured by the mortgage.
- The mortgagee has a right of foreclosure upon the mortgagor's failure to perform.

- The mortgagor has a right to redeem or regain the property on repayment of the debt or performance of the obligation.

Let us understand the mortgage markets in emerging markets like in USA and India.

Example: Mortgage Loans by Bajaj Housing Finance

Bajaj Housing Finance, which was among the first HFCs (Housing Finance Company) to offer external benchmark-linked home loans, would offer mortgage loans to the tune of ₹ 5 crore or higher with a repayment tenor of up to 30 years. The hassle-free processing with an online application feature, minimal documentation, and doorstep pick-up service made it one of the preferred mortgage lenders in India.

Let's assume that Mr. Srinivasan had raised a 25-year housing mortgage for his villa for ₹ 2.5 crore.

Three outstanding characteristics of this mortgage would be

1. Bajaj Housing Finance's interest in the villa terminates upon the payment of the last instalment.
2. Bajaj Housing Finance would have a right of foreclosure upon Srinivasan's failure to pay the amount agreed.
3. Mr. Srinivasan would have a right to redeem or regain the villa on repayment of the debt or any other performance of the obligation agreed upon.

Source: https://www.moneycontrol.com/news/business/banks/bajaj-housing-finance-announces-home-loan-interest-rate-change-offers-one-of-the-most-competitive-rates-starting-at-7-20-8723251.html, dated: 22 June, 2022. Accessed on 16th August, 2022

17.4 Types of Mortgages in the USA

[28]The mortgage industry plays an integral role in the U.S. economy, as it is the major industry that provides employment and the greatest source of wealth and savings for Americans. As per the statistics in 2018, 80% of the homeowners have taken mortgage loans for acquiring their property.

[29]According to Fed Reserve Data, US mortgage market had shown an increase of $254 billion in the fourth quarter of 2022 and stood at $11.92 trillion at the end of December, 2022 marking a nearly $1 trillion increase in mortgage balances in 2022. There was $498 billion in newly originated mortgage debt in Q4 2022.

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[28] https://www.magnifymoney.com/blog/mortgage/u-s-mortgage-market-statistics-2018/ dated 21st December 2018; https://www.supermoney.com/studies/mortgage-industry-study/ dated 11th May 2019

Magnify money is maintained by lending tree. Lending Tree is an online lending marketplace headquartered in the United States. It is listed company on NASDAQ.

[29] https://www.newyorkfed.org/newsevents/news/research/2023/20230216#

https://www.bankrate.com/mortgages/largest-mortgage-lenders/

Rocket Mortgage was the biggest with more than 1.2 million loans worth $340 billion in 2021, according to HMDA data. United Wholesale Mortgage was next with 654,000 loans worth nearly $227 billion in 2021. Next was Loan Depot and it originated nearly 390,000 loans worth $137 billion in 2021. Wells Fargo originated 376,000 loans worth $159 billion in 2021. Freedom Mortgage originated 361,000 loans worth $89 billion in 2021. JPMorgan Chase Home Lending originated 274,000 loans worth $134 billion in 2021.

Most of the mortgage loans are on a fixed-rate unlike in India and other countries where it is on a floating basis.

The home loan scheme works differently in the USA. A person who applies for a mortgage loan typically deals with an underwriter who works for banks. There are also Mortgage brokers who normally do not provide loans but have relationships with a number of lenders. To get a mortgage loan, one has to submit to a credit check. This includes verification of employment and income, places of residence over the past two years, some documentary evidence on savings and other financial information and finally the copy of the purchase and sale agreement. Once approved, the client has to make a down payment of 20 percent. It is also possible to obtain 100 percent financing if one can qualify for it, which needs additional credit checks, etc.

In India and other parts of the world, mortgage/home loans are a long-term commitment to banks as they get committed to long-term repayment including the gestation period. This puts a strain on the liquidity of the banks and these loan portfolios grow at a steady rate of 10 to 15% p.a. However, in the US, it works a little differently. Mortgage loans are treated as commercial paper. The financial institutions bundle mortgage loans into securities that people can invest in. This system quickly frees up money for the financial institutions to lend out further mortgage loans.

Some of the government-sponsored enterprises, such as Freddie Mac and Fannie Mae, facilitate this system.

[30]Some Facts about Freddie Mac and Fannie Mae

Fannie and Freddie are regulated by the Federal Housing Finance Agency (FHFA), which currently holds the conservatorship for both companies. FHFA is part of the U.S. Department of Housing and Urban Development (HUD). The unwinding of the housing bubble in 2007 and the financial crisis that followed in 2008 hit Fannie and Freddie hard. To avoid a complete collapse, the FHFA seized the companies and put them into conservatorship on September 6, 2008 just days before Lehman Brothers filed for bankruptcy and sent the financial markets into a tailspin.

[30] https://www.forbes.com/advisor/investing/fannie-mae-and-freddie-mac/

In 2014, FHFA published a strategic plan for releasing Fannie and Freddie from conservatorship. The plan has three big goals:

– Prevent foreclosures and keep mortgage credit in a safe and sound manner to keep housing finance markets resilient, liquid, and efficient.

– Reduce taxpayer risk by encouraging more private capital in the mortgage market. This goal would decrease the role that Freddie and Fannie play in mortgages.

– Build a new infrastructure for securitizing single-family residential mortgages.

Fannie Mae and Freddie Mac have participated in the Covid 19 Mortgage Relief Program in 2020 and 2021.

Depending upon the terms of mortgage agreed upon between the lender and the borrower, mortgages can be classified into traditional and non-traditional mortgages.

Before discussing the features of the two mortgages, we will take a look at some of the important aspects of all mortgages. The lender usually examines the credit-worthiness of a borrower by eliciting information on the following:

- Details of the amounts outstanding on any other loans taken by the borrower.
- Details of monthly/annual income of the borrower from all sources; and the net worth of the borrower.

The lenders in the US follow two basic rules of thumb to adjudge the adequacy of the income for paying the obligations under mortgage:

Rule 1: The total mortgage payment (principal and interest) should not exceed 25% of the borrower's total income less all payments owed to other obligations.

Rule 2: Total mortgage payments plus other housing expenses such as taxes, insurance, utilities and normal maintenance costs should not exceed 33% of the borrower's total income less all payments owed to other obligations.

It must be understood that the above percentages are not always rigidly applied – the percentages may be lowered if the lender is otherwise convinced of the borrower's net worth and liquidity, and if the interest rates rise to a high level in tight money situations; lenders do lower the percentages to maintain a certain level of business.

[31]Some Facts about Mortgages in the United States

Lenders in the US insist upon some kind of mortgage insurance. There are broadly two types of mortgage insurance – one is originated by the borrower while the other by the lender. The borrower usually arranges the insurance with a life

[31] http://www.ey.com/Publication/vwLUAssets/ey-us-mortgage-banking-ma-trends-and-outlook/$FILE/ey-us-mortgage-banking-ma-trends-and-outlook.pdf - Nov2016

insurance company and such policy provides for continuing payment of the mortgage even after the death of the insured person. This kind of insurance is cheaper than ordinary life insurance because the death benefit, which is equal to the outstanding mortgage loan, declines over time. The other type of mortgage insurance is taken out by the lender and the premia are paid by the borrower.

This policy usually covers only a percentage of the loan amount, and the insurance company undertakes to pay the lender the amount insured or the loan amount in full, on default by the borrower. If the insurance company pays the loan amount in full, it has the right to seize the property, sell it and retain the sale proceeds.

Mortgage lenders send payment notices reminding borrowers about overdue payments; they record payments, keep records of mortgage balances, administer escrow accounts for payment of property taxes or insurance, send out tax information at year-end and initiate foreclosure proceedings in the event of a default. All functions the lender performs are collectively known as servicing the loans and the fee they collect to perform the function is known as the servicing fee. The mortgage rate usually includes the servicing fee. If a mortgage is sold to someone else, the original lender or the originator may continue to service the loan. The originator would collect the servicing fee from the second lender whose rate of return on the mortgage would be lowered to the extent of the servicing fees.

Lenders usually insist upon a down payment on the loan, which may range between 5-25% of the purchase price. The down payment creates a margin of safety for the lender and in case the borrower defaults and the property has to be sold, any shortfall in realization does not adversely affect the lender. The term Loan-to-Value ratio (LTV Ratio) is used by the lenders to indicate the percentage of down payment required by them. Thus, an LTV of 85% means that the borrower would have to make a down payment of 15% of the value of the property. Over a period, as the mortgage balance declines, the LTV declines too. High LTVs are quoted only for newer, readily marketable properties and in times of lower interest rates and easy money conditions.

A borrower may sometimes want to make a monthly payment that is higher than the agreed-upon monthly payment. The excess so paid, is towards repayment of principal and is referred to as a prepayment. When this prepayment is not for the entire amount, then it is known as curtailment. Due to these reasons, mortgages may differ in terms of timing and amount of cash flows.

As mortgages are sensitive to interest rates, like bonds, their yields, duration and convexity can be calculated even for a mortgage loan.

Latest Industry trends and outlook

The regulatory requirement such as Basel III norms and Dodd-frank act has pushed up the costs leading to an unsettled situation in the US mortgage industry.

[32]Fitch Ratings in its Global Housing and Mortgage Outlook 2023 expect nominal home price growth to decline or slow substantially in 2023 for most markets driven by cooling demand due to high mortgage rates. This will follow home price declines in 2H22 in Australia, Canada, China, Denmark, Germany, the Netherlands, the UK and the US. Higher mortgage rates will weigh heavily on demand and home prices through 2023 and into 2024. Effects may be felt well beyond 2023 if marginal demand is wiped out with a deeper recession sets in.

[33]As inflation was skyrocketing in mid-2021, the Federal Reserve raised rates at its February 2023 meeting also, the central bank's eighth straight increase in its efforts to halt inflation. The Fed's actions affect adjustable-rate mortgages (ARMs) and home equity products, and every time the central bank raises its key rate, variable home loan rates move in tandem. As a result, the benchmark fixed rate on 30-year mortgages in March 2023 was around 6.3 percent. Due to increase in Fed interest rates, the mortgage interest rates doubled in 2022, peaking at 7 percent in November 2022.

17.4.1 Traditional Mortgages

In the US, savings and loan associations constitute the major originating group of traditional loans. What types of properties can be mortgaged? Virtually all forms of real estate can be mortgaged, though they fall into several categories: Residential and non-residential, etc. The traditional mortgages exhibit the following features:

- A fixed-rate of interest is charged on the loan for its entire term.
- The loan is repaid in equated monthly instalments consisting of both principal and interest. At first, the mortgage payments are mostly interest payments. As the principal outstanding declines, the interest portion of the monthly payments also declines and the principal portion increases.

Consider a 30-year 10% traditional mortgage for a loan of $1,00,000. The monthly payment and the break up between principal and interest will be as under (Table 17.1):

Table 17.1: Traditional Mortgage (10% Interest Rate, 30-Year Term)

Month	Mortgage Balance at the end of the Month	Monthly Payment	Interest	Principal
0	1,00,000.00			
1	99,955.76	877.57	833.33	44.24
2	99,911.16	877.57	832.96	44.61
3	99,866.18	877.57	832.59	44.98
–				

[32] Source: FitcheRatings Global Housing and Mortgage Outlook 2023
[33] https://www.bankrate.com/mortgages/mortgage-rates/?mortgageType=Purchase&partner Id mortgage - industry-insights

Month	Mortgage Balance at the end of the Month	Monthly Payment	Interest	Principal
100	93,135.76	877.57	776.96	100.61
101	93,034.32	877.57	776.13	101.44
102	92,932.04	877.57	775.29	102.28
–				
300	41,303.22	877.57	348.60	528.97
301	40,769.84	877.57	344.19	533.38
–				
358	1,733.44	877.57	21.57	860.00
359	870.32	877.57	14.45	863.12
360	0	877.57	7.25	870.32

Source: ICFAI Research Center

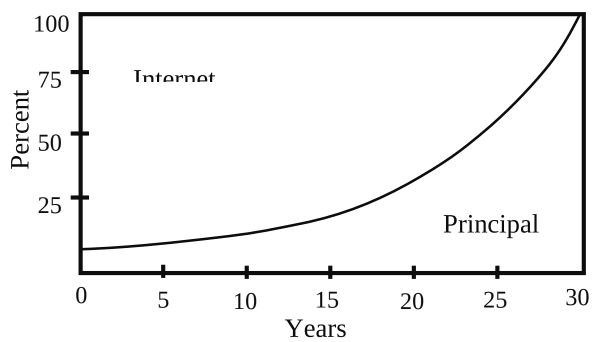
Note: Each month, the interest payment is 1/12 of 10% of the mortgage balance at the end of the previous month. The principal payment is the total payment minus interest. Total payment is the equated monthly payment calculated as 100,000 ÷ $PVIFA_{(10/12,360)}$.

Table 17.1 above illustrates the breakdown of interest and principal components. At first, the mortgage payment is mostly interest. It gradually decreases as maturity approaches. On maturity, the payment is entirely the principal.

The amount of principal outstanding at any time is referred to as the mortgage balance. The amount of a home's value that is owned is referred to as the homeowner's equity. The difference between the current market value of the home and the mortgage balance equals the homeowner's equity. As the mortgage balance declines, the equity rises.

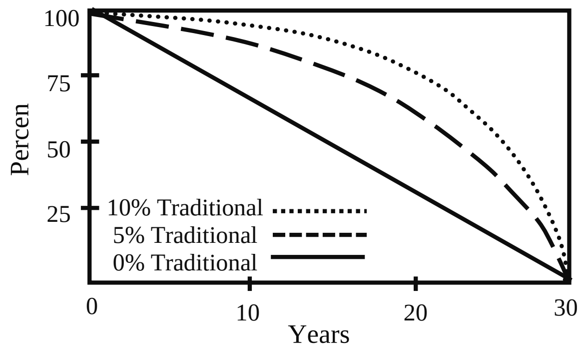
The contents of the Table 17.1 are graphically presented below in Figures 17.1 and 17.2.

Figure 17.1: Monthly Mortgage Payments – Interest/ Principal (30-year, 10% Conventional Loan)



Source: ICFAI Research Center

Figure 17.2: Examples of Mortgage Balances for Various Loans



Source: ICFAI Research Center

Figure 17.2 shows how the mortgage balance for several possible loans would decline over a period.

17.4.2 Non-traditional Mortgages

Non-traditional mortgages--also referred to as Alternative Mortgage Instruments (AMIs), do not have level monthly payments, but employ some other structure of payment. We will discuss in this section, the features of some of the popular forms of non-traditional mortgages.

Graduated-Payment Mortgages (GPMs)

The payments on GPMs unlike the payments on traditional mortgages are not equal. The payments under GPMs start at a relatively low level, rise for a specified number of years and then become equal after the specified number of years. The level of steps of increase, and the specified number of years after which the payments become equal, depend upon the plan indicated in the mortgage agreement.

The terms of five popular plans are given in the Table 17.2 below:

Table 17.2: Graduated-Payment Mortgages

Plan	Term to Maturity (in years)	Years that Payments Rise	Percentage Increase per year (%)
I	30	5	2.5
II	30	5	5.0
III	30	5	7.5
IV	30	10	2.0
V	30	10	3.0

Source: ICFAI Research Center

The comparison between monthly payments under a GPM based on Plan III, and those under a traditional mortgage for a loan of $1,00,000 at 10% interest is given below in Table 17.3:

Table 17.3: Comparison between GPM and Traditional Mortgage Monthly Payments

Year(s)	Monthly Payment under GPM ($)	Monthly Payments under Traditional Mortgage ($)
1	667.04	877.58
2	717.06	877.58
3	770.84	877.58
4	828.66	877.58
5	890.80	877.58
6-30	957.62	877.58

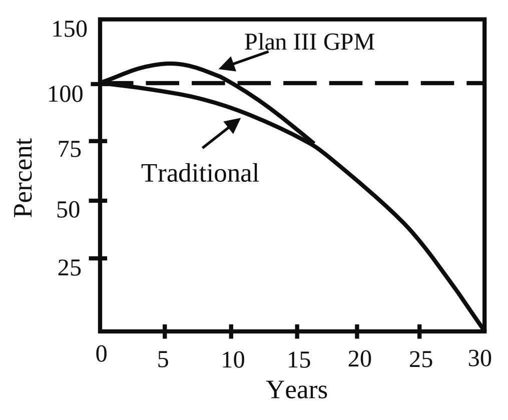
Source: ICFAI Research Center

GPMs are preferred by young first-home buyers whose current income is not sufficient to take on a large loan, but whose income is expected to increase rapidly in the near future.

As GPMs have smaller initial payments than traditional mortgages, they do not pay down their mortgage balances quickly. Another feature of GPMs is that the mortgage balance increases for a short period because smaller payments in the initial years do not even cover the interest, and the shortfall is added back to the mortgage balance. However, with the increase in the monthly payments, the mortgage balance gradually decreases and eventually reaches zero by the end of the term.

A graphical comparison of mortgage balance between plan III GPM and a traditional mortgage is illustrated in Figure 17.3 hereunder.

Figure 17.3: Comparison between Plan III GPM and a Traditional Mortgage



Source: ICFAI Research Center

Figure 17.3 shows the mortgage balance for a traditional and a plan III GPM. Under plan III GPM, mortgage balances increase for a particular period and then start declining.

Pledged-Account Mortgages (PAMs)

PAMs are so structured that the repayments resemble traditional mortgages from the lenders' point of view, and resemble GPMs from the borrowers' point of view. This is achieved as follows:

- Under PAMs, some portion of the down payment as required under a traditional mortgage is deposited in a savings account.
- The borrower then pays instalments that are lower than those under the traditional mortgage are. These instalments are increased at a specified percentage for a definite number of years and thereafter the borrower pays equal instalments. Thus, for the borrower, the payments resemble a GPM.
- However, the lender is paid equated monthly instalments by drawing the difference between the instalment paid by the borrower and the instalment due from the pledged savings account.

The difference between payments under the traditional mortgage and a PAM is explained below with the help of an illustration.

Assume that a loan is borrowed for an amount of $1,10,000 for 30 years at an interest of 10% per annum. The down payment required is $17,535.

Under a traditional mortgage, the borrower would pay the down payment of $17,535 and make an equated monthly payment of $811.46.

Under a PAM mortgage, the structure would be as follows:

- The borrower would make a down payment of $10,000 and deposit $7,535 in a pledged savings payment. Let us assume that this deposit earns an interest of 5¼%.
- The borrower would make graduated payments for 6 years increasing at a rate of 6% every year, and thereafter up to the 30th year, the payments would be equated.
- The lender would receive an equated monthly payment of $877.58 throughout the term of the mortgage.
- The gap between the amount payable to the lender and payment made by the borrower will be made up through withdrawals from the pledged savings account.

The amount of payment by the borrower and the amount drawn from the savings account for each year are given below in Table 17.4.

Table 17.4: Pledged-Account Mortgages Payment Structure

Year(s)	Graduated Monthly Payment made by Borrower ($)	Amount Drawn from Savings Account ($)	Payment made to Lender ($)
1	655.78	221.80	877.58
2	695.12	182.46	877.58

3	736.84	140.74	877.58
4	781.04	96.54	877.58
5	827.90	49.68	877.58
6-30	877.58	–	877.58

Source: ICFAI Research Center

PAMs are used by borrowers who have sufficient cash on hand but face an income or cash flow shortage for the first few years. With the cash on hand, the pledged savings is opened, as it subsidizes the monthly payment and lowers the cash outgo.

Buy Down Loans

The buy down loan is similar to the PAM; however, it is the seller of the property and not the buyer/borrower who places cash in a segregated account so that additional amounts required may be drawn and paid along with the mortgage payments made by the borrower. The pledged account is created by the seller out of his profits as in the absence of such a pledged account, the borrower may not be eligible for any kind of loan. The amount that the seller pledges is a direct reduction of the sale proceeds for him and the borrower uses the seller's money without himself having to repay this amount to the seller. Though theoretically, this cost incurred by the seller may be inbuilt in the price by increasing it, the mortgage lender may not allow it. Buy down loans are arranged by sellers who are anxious to sell their property.

Adjustable-Rate Mortgages (ARMs)

Different kinds of ARMs have originated with their own features with the result that not all ARMs are even referred to as ARMs. Terms such as VRM (Variable-Rate Mortgage), ROM (Roll-Over Mortgage), RRM (Renegotiated-Rate Mortgage) and the like are used to refer to different kinds of ARMs.

To understand the complex features of an ARM, the structure of a California VRM used by a savings and loan association is given below:

i. The mortgage interest is based on the weighted average cost of savings index published by the Federal Home Loan Bank of San Francisco. In general, the spread between the mortgage rate and the index rate is held constant; that is, when the index changes, there is an equal change in the VRM interest rates. However, there are other provisions that may prevent such equal changes taking place all the time.

ii. The mortgage interest may change (up or down) only once in any six-month period and may not change at all during the first six months.

iii. The mortgage interest may not change (up or down) more than 0.25% (25 basis points) at a time, no matter how much the index changes. Combined with the provision (ii) above, this means that the mortgage interest may not change more than 0.5% per year.

iv. The mortgage interest rate must change at least 0.1% (10 basis points) at a time, except to bring the rate to a level previously impossible because of the 25-basis-point limitation. For instance, if the index raises five basis points from the original level, the VRM rate would not rise. However, if the index raises 30 basis points from the original level, the VRM rate will rise by 25 basis points (the agreed-upon maximum) after six months and by the other five basis points in another six months.

v. The mortgage interest rate may not rise more than 2.5% (250 basis points) higher than its initial level, no matter how much the index rises.

vi. Increases in the mortgage rate are optional on the part of the lender, but decreases are mandatory.

vii. Within 90 days of any time the mortgage rate is increased, or at any time the mortgage rate exceeds its initial level, the borrower may prepay the loan in whole or in part without a prepayment penalty.

viii. Whenever the mortgage rate is increased to a rate higher than its initial level, the borrower may opt to keep his monthly payment constant by extending the maturity of the mortgage. However, there is usually a limit up to which the extension of the maturity period will be allowed. For example, a 30-year mortgage may give the option to the borrower to extend the term by 10 years, which means that the total term to maturity of the mortgage cannot exceed 40 years.

Thus, ARMs have many complex features:

- ARMs can have maturities as well as interest rates that vary. It is impossible to calculate in advance the exact amortization schedule for an ARM.
- Provisions (iii) and (v) listed as features of California ARMs are common features of almost all ARMs. The provision that in any period, the interest cannot change beyond a specified basis point is referred to as a ‘periodic cap’. The provision that the mortgage interest rate may not rise above 2.5% (250 basis points) during the term of the maturity is referred to as a lifetime cap.
- Another provision found in many ARMs is negative amortization. The borrower may be allowed to maintain a constant monthly payment after an interest rate increase by opting to add any interest shortfall to the outstanding mortgage balance. This process is allowed to continue until the mortgage balance reaches a maximum amount at which time payments must rise.

In spite of all these complexities, the ARMs became popular due to the following reasons:

i. ARM reduces interest rate risk for the lender. Hence, thrift institutions such as the Savings and Loans, ARMs, offer obvious advantages in spite of the lifetime caps.

ii. Borrowers accept ARMs because the lenders, by offering lower initial rates, express their preference for ARMs. Depending on the competition and aggressiveness of the lender, the initial interest rate on ARM could be 1/2 percent to 2 percentage points or more, below the rates being quoted for fixed-rate mortgages. ARMs tend to be most popular when interest rates are highest and buyers are hunting for arrangements that could lower initial outflows.

The disadvantage of ARMs is that they are difficult to be sold in pooled or security form as there are no standard clauses. It is difficult to find large quantities of any one kind of ARM, as there are diversities in initial interest rates, index, interest rate reset frequency, periodic or lifetime caps and so on.

Swiss Variable Rate Mortgages

A Swiss Variable Rate Mortgage (SVRM) is a version of ARM, which carries a coupon rate that a bank can change any time giving a notice of three months or so. This contract is allowed to be terminated by either of the parties with a notice period of three months. It is observed that the coupon rates for this instrument, change in the same direction as the market rates; however, the degree to which it can change is low. The reason behind the banks not adjusting the rates with those of the market is the political pressure. Since the maximum rent that can be charged is closely related to mortgage rates, a change in coupon rate is subject to high analysis in the market.

Banks are under pressure not to raise/lower their mortgage rates immediately when interest rates increase/decrease. In a decreasing interest rate scenario, the banks do not lower the mortgage rates by the same amount as a decrease in interest rates to break even. These factors make pricing understandably a comprehensive process.

One possible approach is to handle this mortgage like ARM. A prominent feature of this mortgage is that prices need not be equal to the face value. Further, the interest rate process determines whether the mortgage is valued above or below a hundred. However, the lowering or increasing the floating rate of an ARM will not have a symmetric effect on the value of the mortgage. Since the coupon rates do not correct totally, it means the price of the mortgage fluctuates, which increases when rates are low and decreases when rates are high.

As SVRMs come with mutual termination privilege, borrowers use their call option to prepay their loans when interest rates are low as they can refinance their property with a low coupon fixed-rate mortgage. Banks do not use their put option even when the option is deep in the money. However, in an increasing interest rate scenario, if banks call back their SVRMs and offer new SVRMs based on the current conditions in the market, the borrower will still be in the same economic situation, where the coupon rates are raised due to a rise in market rates. Therefore, as only a borrower’s call seems to hold any economic significance, SVRM can be modeled as a half-floater with a borrower call option.

Example: Demand for Adjustable Interest Rate Mortgages Surging in the USA

In the third week of June 2022, mortgage rates recorded the highest level since 2008, making that the biggest one-week jump in the preceding 13 years.

The share of Adjustable-Rate Mortgages (ARMs) among them jumped to over 10%. ARMs, compared to a 30-year-fixed mortgage, carry a lower rate in the loan's early years and then adjust at regular intervals based on certain indexes. The potential for significantly higher payments in the later years of ARMs made it riskier than fixed-rate mortgages. With the interest rate hikes, homebuyers in the USA were worried that the rates would move even higher and were opting for ARMs before such a rate hike could happen.

Sources: i) https://www.wsj.com/articles/three-reasons-home-buyers-are-considering-adjustable-rate-mortgages-11657078678, dated: 7th July, 2022. Accessed on 16th August, 2022

ii) https://www.cnbc.com/2022/06/22/demand-for-adjustable-rate-mortgages-surges-as-interest-rates-jump.html, dated: 22nd June, 2022. Accessed on 16th August, 2022

Share-Appreciation Mortgages (SAMs)

High interest rates in the early 1980s brought about this innovative mortgage arrangement. SAMs use inflation as a way of paying for the property. The lender agrees to charge a very low level of interest on the funds and in turn, the borrower agrees to share a part of the increase in the property value with the lender when the loan matures, or when the property is sold, or at some other specified time.

When SAMs came into existence, one-third participation was popular; the lender would agree to decrease the interest charged by about a third of the prevailing rate in return for one-third of the appreciation in the property value.

For the borrower, SAMs are attractive as he/she can purchase an otherwise unaffordable home. The lender has the potentially lucrative equity kicker, depending on the rate of inflation. However, the disadvantage with SAMs is that they are not standardized and hence cannot be pooled, packaged into units, and sold as securities.

17.4.3 EU Mortgage Market

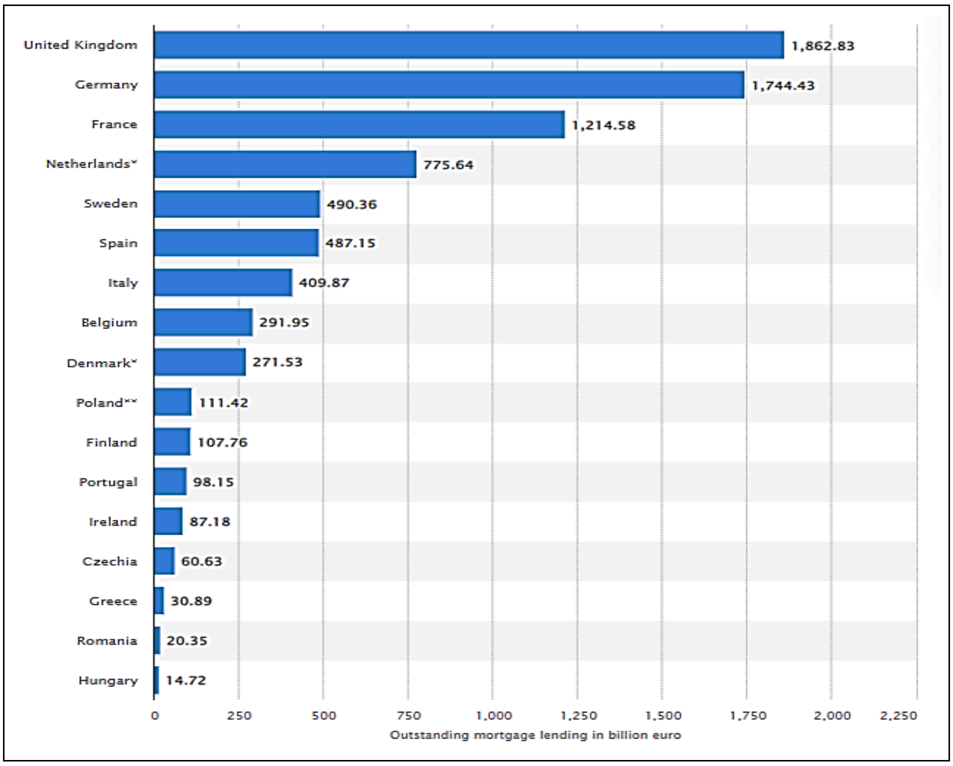
EU housing market plays an important role in the economic environment of the EU. It occupies a prominent place in the macroeconomic implications of the Union. From 2014, almost all of the countries of the EU have witnessed positive average growth in both residential investment and house prices and the European Union has been enjoying an upturn in the housing market after bottoming out in 2014**.** As of the first quarter of 2018, the annual growth rate of this sector is above long term averages. Further due to disposable real income in the hands of the people and favorable financing conditions, the story of upturn continues. As the housing sector is an important driver of the business cycle and that residential investment and house prices are leading indicator for future economic activity, the respective Governments are taking steps to maintain continuous growth and the future is also expected to be bright. The value of outstanding mortgage loans in the EU is over EUR 6.8 tn. and has been increasing around 2.4% year-on-year. The European Market federation, the institutional representative for mortgage loan products in the EU has been proactive to ensure maintaining the momentum.

Size of the EU mortgage market

Within the EU 28 countries, there is a wide variation in mortgage loans according to Eurostat and the Housing Finance Information Network (HOFINET). Only 25% of the homeowners lived in a house with a mortgage or housing loan while 45% were owner-occupants without a mortgage. In countries like Romania, Bulgaria and Croatia, less than ten percent of the population lived in an owner-occupied house with an outstanding mortgage loan of which and in Romania, it was just around one percent. In Poland and Italy, it stood at 11.1 and 13.6 percent. In the case of the Netherlands and Sweden, around 61% of the property owners were with outstanding mortgages.

Figure 17.4: Total Outstanding Residential Mortgage Lending in Selected European Countries as of 4th Quarter 2021

(in billion euro)



Source: © Statista 2022, https://www.statista.com/statistics/614792/outstanding-residential-mortgage-lending-europe-by-country

Check Your Progress - 1

1. Which one of the following provides the definition of a mortgage?
   a. Pledge of property documents to secure a debt payment
   b. Hypothecation of property documents to secure a debt payment
   c. Assignment of property documents to secure a debt payment
   d. Lien on the property documents to secure a debt payment
   e. Selling the property to the bank to secure a debt payment
2. Identify the principle that the lenders in the US follow to adjudge the adequacy of the income for paying the obligations under the mortgage.
   a. The total mortgage payment (principal and interest) should not exceed 33% of the borrower's total income less all payments owed to other obligations
   b. The total mortgage payment (principal and interest) should not exceed 25% of the borrower's total income less all payments owed to other obligations
   c. The total mortgage payment (principal and interest) should not exceed 55% of the borrower's total income less all payments owed to other obligations
   d. The total mortgage payment (principal and interest) should not exceed 50% of the borrower's total income less all payments owed to other obligations
   e. The total mortgage payment (principal and interest) should not exceed 15% of the borrower's total income less all payments owed to other obligations
3. Which one of the following is a feature of a traditional mortgage?
   a. A variable rate of interest is charged on the loan for its entire term
   b. A fixed-rate of interest is charged on the loan for part of its term and variable thereafter
   c. At first, the mortgage payments are mostly principal payments
   d. A fixed-rate of interest is charged on the loan for its entire term
   e. First, the principal component amount is recovered and then the interest component
4. Which one of the following is not a non-traditional mortgage?
   a. Graduated payment mortgage
   b. Pledge account payment mortgage
   c. Buy down loans
   d. Swiss variable rate mortgage
   e. Fixed-rate mortgage

5. What is the type of mortgage when the payments are relatively low level and rise for a specified number of years, and then become equal after the specified number of years?
   a. Graduated payment mortgage
   b. Pledge account payment mortgage
   c. Buy down loans
   d. Swiss variable rate mortgage
   e. Adjustable-rate mortgage

Activity 17.1

You are working in one of the home loan companies in California. Mr. Johnson approaches you to buy a house with home loan finance and needs to know the various types of loan mortgage facilities available with you. Explain him in brief on the various options.

17.5 Types of Mortgage Instruments in India

Before going into different types of mortgage instrument, let us understand the mortgage act -

Definition of the Mortgage as per TP Act

As per the Transfer of Property Act 1882- Sec 58, a mortgage is the transfer of an interest in specific immovable property for securing the payment of money advanced or to be advanced by way of loan, an existing or a future debt, or the performance of an engagement, which may give rise to a pecuniary liability.

The transferor is called mortgager, the transferee a mortgagee, the principle money and interest of which payment is secured for the time being are called mortgage – money and the instrument by which the transfer is effected is called mortgage deed.

The Transfer of Property Act contemplates six different kinds of mortgages.

1. Simple Mortgage-popularly known as Registered Mortgage
2. Mortgage by Conditional Sale
3. Usufructuary Mortgage
4. English Mortgage
5. Mortgage by Deposit of Title Deeds
6. Anomalous Mortgage

These are discussed in Table 17.5 below:

Table 17.5: Types of Mortgages

Simple Mortgage [Section 58(b)] of TPS Act.	The mortgager binds him personally to pay the mortgage-money without delivering possession of the mortgaged property. He agrees, expressly, that, in the event of his failure to pay according to his contract, the mortgagee shall have a right to sell and the proceeds of the sale to be adjusted.
Mortgage by Conditional Sale [Section 58(c)] of TPS Act.	The mortgager ostensibly sells the mortgaged property on condition that on default of payment of the mortgage money on a certain date, the sale shall become absolute. This also implies that on payment made as per the contract, the sale shall become void and the buyer shall transfer the property to the seller.
Usufructuary Mortgage [Section 58(d)] of TPS Act.	The mortgager delivers possession or binds him to deliver possession of the mortgaged property to the mortgagee, and authorizes him to retain such possession until payment of the mortgage money is made. He also authorizes the mortgagee to receive the rents and profits accruing from the property in lieu of interest or payment of the mortgage money. The mortgager binds him to repay the mortgage-money on a certain date, and transfers the mortgaged property absolutely to the mortgagee with a provision in the contract that he will re-transfer it to the mortgager upon payment of the mortgage money.
English Mortgage [Section 58(e)] of TPS Act.	The mortgager binds him to repay the mortgage-money on a certain date, and transfers the mortgaged property absolutely to the mortgagee with a provision in the contract that he will re-transfer it to the mortgager upon payment of the mortgage money.
Mortgage by Deposit of Title Deeds [Section 58(f)] of TPS Act.	Where a person, in any of the following specified cities/ towns, and in any other town which the state government concerned may, by notification in the official gazette, specify in this behalf, delivers to a creditor/ bank or his agent, documents of title to immovable property, with intent to create a security thereon.

Contd….

Anomalous Mortgage [Section 58(g)] of TPS Act.	A mortgage that does not fall under the purview of the other five types of mortgage. That is to say that it is a mortgage, which is not a simple mortgage, a mortgage by conditional sale, a usufructuary mortgage, an English mortgage or a mortgage by deposit of title deeds within the meaning of this section.

Source: ICFAI Research Center

Simple mortgage: Under this form of mortgage, there is no delivery of the possession of the mortgaged property by the mortgagor. He is committed to pay the loan amount, which is backed by the security of the mortgaged property. In the event of non-payment of the amount, the lender/ mortgagee will sell the property through a decree from the court and adjust the amount towards the dues.

Mortgage by conditional sale: In this type of mortgage, the owner of the property who is the mortgagor ostensibly sells the property to the mortgagee/ lender subject to the condition that it should be returned back to the mortgagor once the payment is made to mortgagee and the sale will be nullified. In the event of the mortgagor failing to repay, the mortgage will become a sale and the mortgagee will be the absolute owner of the property.

Usufructuary mortgage: This is a type of mortgage wherein the mortgagor will give rights to the mortgagee to collect the rent and other profits from the property so mortgaged and appropriate towards the interest and principal repayments. In this case, the possession of the property will be with the mortgagee until the loan amount is paid.

English mortgage: This mortgage is not common in India. In this type of mortgage, there are three essential aspects-

1. The mortgagor commits to repay the loan taken on the mortgaged property on a pre-determined date.
2. There is a transfer of the mortgaged property in favor of the lender/ mortgagee.
3. Once the payment is made on the specified date, the mortgaged property will be retransferred back to the mortgagor.

Mortgage by deposit of title deeds (also known as equitable mortgage):

This type of mortgage is most common in India. In this case, the mortgagor/ owner of the property deposits the title deeds of the property with a clear intention to create security at the notified place, which is normally a town as stipulated by the respective state governments.

For example- If the mortgage loan is given at a bank branch located in a village, the mortgagor has to deposit the title deeds of his residential property in the town nearest to the village in the branch of the bank from which he has taken the loan.

Anomalous mortgage:

Any mortgage that is not a simple mortgage or mortgage by conditional sale or usufructuary mortgage or English mortgage or equitable mortgage is anomalous mortgage.

Reverse Mortgage:

In all the earlier forms of mortgage, the mortgagor takes a loan in one lot against the property and makes payment as per the schedule whether in EMI format or a bullet form. In the case of a reverse mortgage, it is the reverse in the sense that the lender/ mortgagee will be providing monthly payment to the mortgagor.

There are two advantages to this type of mortgage.

1. The mortgagor can mortgage his property and get monthly amount from the mortgagee for his expenses instead of a bulk amount.
2. The amount so received is tax-free.

This type of mortgage is useful for senior citizens who have a house property but no monthly income for their sustenance. However, this type of mortgage is not popular in India, as the parents normally like to hand over the property to their children. There is also a sentiment attached to the house property.

The following illustrates the process for a reverse mortgage loan.

Process for Reverse Mortgage Loan

Reverse mortgage is mainly suitable for senior citizens to supplement their monthly income for sustenance. The property should have a clear title and should be free from any encumbrance.

Loan component

The loan amount sanctioned by the lender will be 50% of the market value of the property, which is mortgaged subject to the limit fixed by the bank.

Eligibility

A reverse mortgage is available to citizens of India who are over the age of 60. In case of a couple looking for a reverse mortgage, at least one of the participants must be over the age of 60, while the other has to be over 55 or 58 years of age, depending on the bank.

Repayment schedule

There is no EMI type of repayment in this type of loan.

The total amount (principle and interest) should be paid within six months after the death of the last surviving borrower or the couple leave the house and move to either an old age home or a relative's house.

An option is given to the legal heirs to make the total payment and claim the property or the bank will sell the property and adjust the loan amount.

> **Example: Reverse Mortgage Yet to Gain Popularity in India**
>
> It was not just a basic lack of awareness, but also the kind of emotional bonding people had with their homes, that have let reverse mortgages remain unpopular in India. In Indian culture, a house is identified as a family asset, which is generally passed on to the children. The way the reverse mortgage schemes were configured, also made them not palatable for the majority. When a scheme didn't have an answer/ solution for a simple question like 'what if I raise a reverse mortgage for 15 years but live for 20 years?', obviously it was not a complete retirement solution. The period of reverse mortgage required to be opted in advance by the customer was the reason behind this.

Source: https://www.moneycontrol.com/news/business/personal-finance/how-reverse-mortgage-helps-senior-citizens-increase-their-monthly-income-6319101.html, dated: 8th January, 2021. Accessed on 17th August, 2022

17.6 Essentials of Mortgage

The following are the essentials of a mortgage:

Transfer of Interest

In the case of a mortgage, there is a transfer of interest on the immovable property. The owner of the property (mortgagor) possesses the interest on the property, which he is going to transfer when he takes a loan against the property after mortgaging it to the lender (mortgagee). However, it should be noted that the mortgagor transfers only part of the interest in favor of the mortgagee since his interest is transferred to the mortgagee and his ownership of the property would be encumbered until he clears the loan amount taken on the property from the mortgagee.

Specific Immovable Property

Mortgage cannot be general. It should be on a specific property and the details of the property have to be distinctly mentioned in the mortgage deed.

Let us look at an example-

Mr. Suresh owns three immovable properties A, B and C and he mortgages property A. In case he fails to repay the amount, the court will grant a decree only on the sale of the mortgaged property A to repay the loan and cannot on B and C.

To Secure the Payment of a Loan

Mortgage on an immovable property can be created only if the mortgagor takes a loan and the property is offered as security in favor of the mortgagee for securing the repayment of the loan. Hence, mortgage on an immovable property is created in favor of mortgagor either for taking a fresh loan or a loan that is already granted as security.

Example: Essentials of a Mortgage with the Central Bank of India

The Central Bank of India (it is the name of the bank), in 2022, would offer a maximum mortgage of up to ₹ 1 crore for property in a rural area and up to ₹ 10 crore for property in other areas at MCLR (Marginal Cost of Funds Based Landing Rate) of 13.75%. Let's assume that Raman had 3 villas in the same colony in the urban area of Pune worth 7 crores each. If he was rising the mortgage on the first villa for ₹ 4 crore from the Central Bank, then ownership of the first villa would be encumbered until he cleared the loan amount taken from the Central Bank of India. The ownership of the remaining two villas would remain with Raman. Even on the first villa, only a part of the interest (equal to the indebted amount) would be transferred to the bank.

Source: https://www.centralbankofindia.co.in/en/Cent_Mortgage_msme, 2022. Accessed on 17th August, 2022

17.7 General Mortgage Lending Process Followed by Banks

There are four steps in the mortgage process. They are: a. Originating, b. Processing, c. Underwriting and d. Closing.

a. Originating

The credit officer in the bank takes the application from the customer who approaches for a loan against the immovable property. There are various ways that this can happen.

a. The customer may approach the bank branch in person.

b. Some banks may use other methods like mobile banking, Kiosks, extension counters in large malls or supermarkets, home personal computers, etc.

There has to be a face-to-face interaction between the customer and the bank official.

b. Processing

Processing of the proposal starts with the collection of information after the application is submitted. This is followed by a verification process by the bank official or the processor which comprises of the following:

a. The clear title of the property which includes the link documents to confirm the ownership title of the applicant.

b. Sources of income for the applicant to repay the loan (EMI).

c. Whether any guarantee is needed or not.

Loan-To-Value Ratio

For considering the loan, the borrower has to make a down payment, which may be a certain percentage of the loan component (normally 10 to 25%) of the cost of the property. This forms the Loan to Value Ratio (LVR). This is the size of the loan against the value of the property. For example- if the property is valued at 100 lakhs and the borrower is contributing 20 lakhs as a down payment, the LTV = 80.

c. Underwriting

This is a part of processing of the loan application based on the guidelines of the lending institution. For considering the loan, the bank officials will analyze the applicant on four parameters, which are called the 4 Cs of the borrower. They are

1. Character
2. Credit history
3. Capacity to repay the loan
4. Collateral (The value of the security, its condition. etc.)

d. Closing

This is the last stage in the mortgage process. After the mortgage is created, the documents are executed which is legally necessary evidencing the debt and the bank's security interest on the property and the loan is disbursed.

Example: Steps in the Mortgage Lending process followed by Axis Bank

1. Fill up the home loan application form
2. Pay the processing fee
3. Bank discussion (telephonic – within 5 days)
4. Document verification including checking of CIBIL score
5. Approval process
6. Sanction letter containing details of the loan amount, loan tenure, interest rate, and other terms and conditions
7. Property verification (legal check)
8. Loan disbursal (Cheque issued in favor of the applicant or the builder)

Source: https://www.axisbank.com/progress-witah-us/money-matters/borrow/step-by-step-guide-on-the-home-loan-application-process, dated 22nd January, 2021. Accessed on 17th August, 2022

17.8 Mortgage vs. Pledge vs. Hypothecation

Mortgage, pledge, and hypothecation are the various types of charges in favor of the bank to create the interest on the security.

Mortgage - This is the security interest (Charge) created on a specific and distinct immovable property created in favor of the lender for repayment of the loan (pecuniary liability) taken by the borrower for existing or future debt. The security is the documents of title of the immovable property.

Pledge - This is a kind of special bailment of goods where the security will be movable assets or pledged goods in the possession of the primary creditor or the lender. The goods are in the possession of the pledgee for repayment of the loan taken by the pledger. The pledged goods are returned to the pledger after the loan is repaid with interest as agreed upon.

The charge called pledge is based on the premise that upon the repayment of the debt, the goods will be returned to the pledger. It can also be disposed of as per the instructions of the pledger to secure the payment.

In the case of a pledge, the constructive, notional or physical delivery of the goods is a must by the pledger to the pledgee (the lender). It must be noted that the legal ownership or the title of the goods will be with the pledger though the procession of the goods will be with the pledgee.

As per Indian law, a pledge can be created only on documents of title on the movable property such as stock of goods, warehouse certificates, share certificates, fixed deposit receipts, gold or other precious metals, etc.

The most important factor to be noted in the pledge is that it can be created on existing securities and not those, which are going to be procured, as delivery is the precondition in the case of a pledge.

Hypothecation - This is a charge in favor of the lender where the goods will be in the possession of the primary debtor as against the primary creditor in the case of a pledge. This is also called a floating charge. This is the most common form of charge on security in India.

Example - Stocks of goods in a supermarket or materials in the factory against which money is taken by the borrower. There is no constructive delivery of security in case of hypothecation. It is a notional and equitable charge on the goods. In case of non-payment of loan by the borrower (hypothecator) to the lender (hypothecatee), the only way to recover is to file suit in the court for proceeding against the execution on the hypothecated goods.

The following Table 17.6 shows a distinction between a mortgage, pledge and hypothecation as follows:

Table 17.6: Mortgage vs. Pledge vs. Hypothecation

Particulars	Mortgage	Pledge	Hypothecation
Type of security	Immovable security	Movable security	Movable security
Possession of the security	Will be with the primary debtor (Documents of the title of the security will be with the lender/ mortgagor)	Will be with the primary creditor	Will be with the primary debtor

Examples	Flat/ land/ building, etc.	Stocks of goods, financial instruments, gold and precious metals	Stocks of goods, two and four-wheelers, transport vehicles, book debts, etc.

Source ICFAI Research Center

Example: Assets for Mortgage, Pledge, and Hypothecation

Ravi Prakash has a villa, a car, and 300 grams of gold in Hyderabad. After he acquired an Apartment in Amaravathi, he bought another car for commuting there and stored another 120 grams of gold in that new apartment. To meet some financial emergencies Ravi Prakash had to raise loans from BOB (Bank of Baroda) using all the three assets in Amaravathi. The particulars of his loans would be as follows.

Security	Apartment	Car	Gold
Type of loan	Mortgage	Hypothecation	Pledge
Possession of the Security	Ravi Prakash	Ravi Prakash	BOB

Sources: i) https://cevnews.in/2022/02/difference-between-pledge-hypothecation-mortgage-assignment-all-you-need-to-understand/, dated 13th February, 2022. Accessed on 18th August, 2022

ii) https://www.codeforbanks.com/banks/blog/pledge-vs-hypothecation-vs-mortgage-vs-assignment/, dated 14th February, 2018. Accessed on 18th August, 2022

17.9 Mortgage Financing in India

Mortgage financing in India is undertaken by banks and NBFCs like ICICI Bank, HDFC Bank, SBI, and Axis Bank, who are the major bankers providing mortgage financing. All other public sector and private sector banks also provide mortgage finance. The major NBFCs are HDFC, LIC Housing Finance, SBI Homes, etc. The type of loans, which is covered under mortgage finance, is Individual housing loans or home loans, and real estate loans.

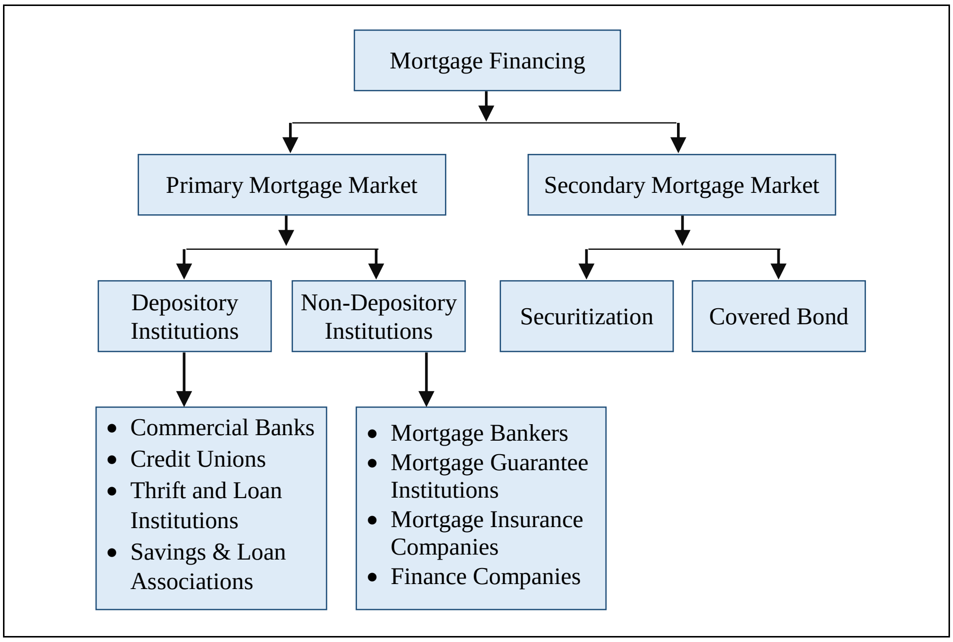
17.9.1 Primary Mortgage Market

Mortgage market in India can be broadly classified into two types - Primary Mortgage Market and Secondary Mortgage Market.

The primary market consists of depository and non-depository institutions while the secondary market comprises securitization deals and covered bonds.

Figure 17.5 will clearly explain the two mortgage markets.

Figure 17.5: Understanding Mortgage Financing Market in India



Source ICFAI Research Center

Commercial banks, credit unions, non-banking financial institutions are the traditional source for finance of housing loans. Subsequently, mortgage bankers, insurance companies, pension funds mortgage trusts, etc. have entered the fray.

The traditional model involves a sort of one-stop model where all the activities right from origination, servicing, and risk management functions are undertaken by one institution. This is also called portfolio lending, which is specialized by commercial banks, savings banks, European style banks, loan associations' building societies, etc. who form the part of the primary mortgage market.

Since home loans/ mortgage loans have large repayment terms such as 5 to 20 years or more, the participants of the primary markets get funds by selling the loans in the secondary market in the form of securitization, etc. The secondary market participants buy loans from the primary market and involve in buying and selling among themselves.

Depository Institutions

The depository institutions such as commercial banks, savings banks, European style banks, loan associations, building societies, etc. undertake all the functions right from origination, lending, risk management, monitoring, etc. Since these institutions undertake all the functions, they are also called bundling system. Sometimes each function is carried out by one specialist and this type is called an unbundling system.

Non-Depository Institutions

Insurance companies, pension funds, government-sponsored companies, finance companies, etc. are non-depository institutions. On a much smaller scale, institutions such as venture capital companies also undertake financing mortgage loans. These institutions may not directly involve in funding, but indirectly support mortgage financing through guaranteeing timely payments, issue mortgage-backed securities, buy mortgage loans, etc.

17.9.2 Secondary Mortgage Market

While the traditional primary mortgage market involves all the activities right from originating to recovery, which is termed as bundling of functions, in the secondary market, it is unbundling functions and activities associated with mortgage markets. It involves the sale and purchase of mortgage assets, securitization of mortgage loans and covered bonds.

While it is essential to have a well-developed primary mortgage market, it is also equally necessary to develop a secondary market as well for the following reasons:

a. Securing long-term funds in capital markets

b. To provide an avenue for fixed income securities for pensioners and insurance investors

c. To inculcate competition in the market

d. To develop off-balance sheet financing as a means of financing

The following showcases the advantages of having the secondary market for mortgages in India.

Advantages of having Secondary Market for Mortgage in India

An exciting secondary mortgage market in India will profit all the stakeholders in the mortgage chain. This includes issuers, investors, borrowers and the mortgage finance industry as a whole. It will also improve the housing and socio-economic scenario in the country. The introduction of Mortgage-Backed Securities (MBS) can improve housing affordability, increase the flow of funds to the housing sector and distribute the risks inherent in housing finance in a better way. It will also help many other industries that are dependent upon the housing sector in one way or the other.

Benefits to Issuers:

- Reduction in cost of funding
- Capping of credit risk – the risk in the case of securitization transactions is covered to the extent of credit enhancements provided by the originator
- Elimination of asset-liability mismatches, both in terms of maturities and interest risks

- Increase in liquidity and funding appetite by creating an additional avenue
- With the more efficient use of owned capital, the issuer is enabled to create higher effective leverage – which promotes Return on Equity (RoE), hence market capitalization.

Benefits to investors:

- Attractive rate of return on investment in a highly rated instrument, with an excellent track record of rating resilience and recovery rates
- Portfolio diversification both geographically and economically
- Socially responsible investing
- Ability to buy tranches that match their appetite
- Alternative to investment in government bonds and corporate bonds.

Benefits to Borrowers:

- Reduction in cost of mortgage finance
- Greater availability of funds
- Availability of funding for lower-income groups
- Creation of formalized credit scoring systems, which eventually yield into a decentralized, formula-driven approach to mortgage origination and make the process extremely fast
- On a higher level of development, integrating the origination process with the securitization process, whereby the mortgage originator develops into a mere originator-cum-servicer, for a much smaller agency cost, and therefore, much lower lending costs.

Benefits to Mortgage Industry:

- Specialization of mortgage-related service providers leading to reduction of costs and improvements in efficiency
- Lender access to alternative funding sources
- Improved sustainability of longer-term housing funding through long-term debt market with reforms of contractual savings institutions like pension funds and insurance companies
- Potentially larger investor-base
- Lenders are enabled to expand the target market, through risk-sharing
- Long term debt market funding can help smoothening housing cycles
- Improved standardization and supervision of real estate loans, improve transparency and security for borrowers and lenders.

17.9.3 Future of Mortgage Industry in India

To appreciate the growth in the mortgage market in India, we must have an idea about the growth in the real estate industry first. The Indian real estate industry ranks third among the 14 major sectors in terms of direct, indirect investments in the economy. Bengaluru, Ahmedabad, Pune, Chennai, Goa, Delhi and Dehradun are the most favored destinations for this industry. Real estate industry is expected to reach a market size of US$ 120 billion by 2030 and contribute 13 percent of the country's GDP by 2025.

Retail, hospitality and commercial real estate are also growing significantly. Commercial office space has crossed 600 million square feet by 2018 and is increasing by 26 percent year-on-year. The growth in co-working space across has touched 3.44 million square feet as compared to 1.11 million square feet in 2017. The government of India and the state governments have been taking several initiatives such as the 100 smart city project, providing an opportunity for the real estate companies. Some of the government initiatives in this industry are Pradhan Mantri Awaas Yojana (PMAY) Urban, creation of National Urban Housing Fund, etc.

One of the important factors in India is that the mortgage industry is under-penetrated coupled with the non-availability of loans to a prospective homebuyer, especially in unbanked regions. However, NBFCs and HFCs have been the biggest drivers of housing finance growth in the country over the past decade their last-mile connectivity in tier II and tier III cities are not fully up to the mark. The liquidity crisis faced by NBFCs and HFCs, their limitation in distribution and slower processing ability has been a major concern thus impacting the housing finance growth in tier 11 and tier III cities. However, with the liquidity situation now close to normalizing, NBFCs and HFCs are expected to restart disbursals and are expected to pick up pace.

The housing loans in India are provided by both Scheduled Commercial Banks (SCBs) and Non-Banking Financial Corporations (NBFCs) both regulated by RBI.

The road ahead

The favorable macroeconomic conditions coupled with demographic factors that are conducive, and increasing affordability augurs well for the housing sector.

Office leasing in India's top seven cities rose 46 per cent to almost 39 million square feet (msf) in 2022. As per property consultancy JLL India data, net absorption or leasing of office space rose to 38.25 msf this year from 26.2 msf in 2021. This increase may continue in view of the following factors:

- Rapid urbanization,
- Low mortgage penetration,
- Nuclearization of families,
- Larger population below 35 years of age.

Rate of interest is one of the major factors by housing loan companies and is likely to go down south in view of the steps taken by RBI in reducing repo rates. While the rates are expected to be stable in the short term, borrowers are expected to see that banks will determine interest rates linked to repo rates thus introducing volatility. However, in the long term, this will be a positive for home loan borrowers.

Another important aspect is that there has been a realization by the government that housing is also a key driver of economic growth in addition to its social aspects. Further, this sector is having the ability to create employment and its linkages to multiple other sectors. Being the fourth largest contributor to Indian GDP and an engine of domestic growth for the Indian economy one can expect the housing finance sector to play a pivotal role in the growth story of the country.

Home Loan Market in India

India’s home loan market, currently valued at about ₹24-lakh crore, is expected to double in the next 5 years, with mortgage to GDP ratio rising commensurately from current 11 per cent, according to State Bank of India’s economic research report “Ecowrap”. This will mirror the overall trend in the country’s aspirations to become a $5 trillion economy by then, the report said.

The share of ‘Housing Loans’ in ‘Bank Credit’ has increased to 14.4 per cent in June 2022 from 13.1 per cent in March 2020. Housing contributes around 50 per cent of the personal/retail loans.

SBI’s Economic Research Department (ERD) noted the total home loan portfolio grew by 10 per cent in FY22, with districts in tier-3 and tier-4 areas growing at a much faster rate than tier-1 and tier-2 districts, post pandemic.

The National Housing Bank (NHB) that is the regulator of housing has been encouraging the banks and NBFCs to promote the portfolio aggressively. With a low level of NPA’s, this portfolio has also been attractive for financial institutions.

Innovation using disruptive technology has become the order of the day by some of the newly licensed housing companies. The housing finance regulator NHB has given license liberally to ten new housing finance companies in addition to the existing public and private housing companies.

NHB also offers refinancing to the housing companies at a concessional rate of interest in the urban segment to the housing companies for further relending to clients wherein these HFC’s make a spread of 2.5% to 3%.

Housing & Urban Development Corp. Ltd. (HUDCO), under the poverty alleviation program has been actively involved in the urban and rural housing projects for the poor and many teachers were benefited under the scheme. This is illustrated below-

The Pradhan Mantri Awaas Yojana

A scheme has been introduced by the government under the name *Pradhan Mantri Awaas Yojna* for the promotion of affordable housing for weaker sections through credit-linked subsidy in 2015. This scheme is the most promising one, which is under a credit-linked subsidy scheme. Any person buying the first house, costing between ₹ 3 lakh and ₹ 6 lakh, will get a 6.5% interest subsidy. This is discounted upfront and credited to the customer’s account within 10 days of the disbursement of the loan, before the first equated monthly installment or EMI starts. Most of the financial institutions including commercial banks, cooperative and regional rural banks, and HFCs have signed up with the NHB to implement this scheme in all the states from mid-June 2015 to March 2022.

Housing Development Finance Corporation (HDFC)

HDFC established in 1977 is another exclusive mortgage lender and housing finance institution in India, with a customer base of over 5.7 million, and is the largest home loan provider in the country. It was promoted as a ‘development finance institution’ by the Industrial Credit and Investment Corporation of India Limited, the International Finance Corporation, Washington [IFC (W)] and His Royal Highness The Aga Khan. The company provides housing loans for individuals and corporates. Forbes listed HDFC at 561 in the world’s 2000 largest companies. The company has disbursed housing loans to the extent of ₹ 2.45 lakh crores as of March 2016, as against ₹ 2.13 lakh crores as of 2015, registering a growth of over 15%. This figure rose to ₹ 2 trillion in 2022. The loan segment mainly comprises housing and commercial estate constructions. The company also has an asset management segment comprising of portfolio management, mutual funds, and property investment management.

SBI Mortgage Loan

State Bank of India (SBI) the largest Public Sector Bank of India with over 16,000 branches all over India is the largest mortgage loan provider in the country in the banking industry.

State Bank of India (SBI) disbursed a record ₹ 1.12 lakh crore of loans to individual home buyers until January end in FY22 as demand for housing in the hinterland surged, helping it leapfrog specialist lenders in the mortgage business. This is a 20% growth over the corresponding period in FY21.

SBI provides mortgage loan for both salaried and self-employed individuals for buying a new property, home renovation, etc. SBI also offers an all-purpose loan against mortgage loan, which means the loan can be used for any purpose if the amount is below 25 lakhs. One such purpose is for acquiring machines by the business enterprise. The rates offered are normally the lowest with minimal documents and speedy approvals.

During FY2016, several initiatives were taken by the bank to give an additional thrust to its home loan portfolio such as Project Tatkal, Online Customer Acquisition Solution (OCAS), Griha Tara, Launch of XX Flexi Pay Home Loan, XX Corporate Home Loan, MOUs / Tie-ups with the Home Loan lead aggregators / Service Providers, etc.

Some of the other features of SBI Home loans are 1. Finance up to 100% is provided against property based on market valuation, 2. Take-over of existing loan from other institutions with additional finance, 3. Competitive rates of interest, 4. Service at Doorstep. Some of the popular products offered by SBI are Loan against Mortgage of Immovable Property, Property Loan Scheme, and State Bank Rent Plus.

Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act (SARFAESI Act) 2002

Recovery of overdue and NPA housing loans through the legal process can take decades. Before 2002, banks were struggling to get the recovery at a reasonable time. The Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act 2002, is a powerful instrument in the hands of the banks and financial institutions (FIs) as secured creditors. This Act helps them enforce securities held as collateral to loans disbursed by them. If such loans turn out as Non-Performing Assets (NPAs), Section 13 of the Act gives power to the secured creditor even to evict the tenant after giving notice as prescribed in the act. RBI’s timelines under this act are as follows:

1. If the borrower does not pay three installments continuously after 90 days but up to 12 months, the account becomes sub-standard and NPA.
2. Section 13(2) empowers the bank/ FI to serve a notice to the borrower for taking possession of the assets held as security for the money lent by it.
3. Banks /FI shall serve notice to the borrower to discharge his full liabilities within 60 days from the date of the notice.

Example: Mortgage Financing would Double in India in 5 years

According to Mr. Deepak Parekh, Chairman of HDFC, India’s biggest housing finance company, India should be able to double its home loans to around $ 600 billion during the five years from 2022 to 2027. According to him, this would contribute to the goal of India becoming a $ 5 trillion economy. But it was expected that India’s mortgage penetration would remain at around 13% of GDP which would be low compared to other Asian Economies, where the mortgage to GDP Ratios were ranging between 20% and 30%. If India could rise this ratio to 20% it would accelerate the economic growth of the country.

Source: https://www.businesstoday.in/real-estate/story/indias-mortgage-market-should-double-in-next-5-yrs-to-600-bn-hdfcs-deepak-parekh-336650-2022-06-07, dated: 7th June, 2022, Accessed on 17th August, 2022

17.9.4 Statutory Requirements for creation of charge under Companies Act 2013

As per Section-2 (16) Charge means- An

- Interest or lien,
- Created on the property or assets of a company, or
- Any of its undertakings or both as security and includes a mortgage.

Principle rule of Creation of Charge is that "Charge will be created on the Assets of the Company", which are defined in Schedule III of the CA-2013.

Provisions of Charge given under Chapter VI of Companies Act 2013 (Section- 77 to 87)

The need for creating a charge on the company's assets:

Almost all the large and small companies depend upon share capital and borrowed capital for financing their projects. Borrowed capital may consist of funds raised by issuing debentures, which may be secured or unsecured, or by obtaining financial assistance from financial institutions or banks.

The financial institutions/banks do not lend their monies unless they are sure that their funds are safe and they would be repaid as per the agreed repayment schedule along with payment of interest. In order to secure their loans, they resort to creating a right in the assets and properties of the borrowing companies, which is known as a charge on assets. This is done by executing loan agreements, hypothecation agreements, mortgage deeds and other similar documents, which the borrowing company is required to execute in favor of the lending institutions/ banks, etc.

Type of Charges to be registered:

Section 77 states that companies are required to register all types of charges**,** with ROC within 30 days of its creation:

- Within or outside India,
- On its property or assets or any of its undertakings,
- Whether tangible or otherwise, and
- Situated in or outside India.

For creation of charge form CHG-1 will be filed with fees prescribed under Act. Form should be signed by the company and the charge-holder and should be filed together with the instrument creating a charge.

Duty of Registration of Charge:

- As per Section 77, it is the duty of the company to create a charge.
- As per Section 78, if the company fails to file a form for registration of charge then, the person in whose favor charge is created will file a form for the creation of charge. The person is entitled to recover from the company the amount of fees.

However, before filling out the form person will give 14 days' notice to company. If the company does not register the charge or show sufficient cause then the person himself will file the form with ROC.

This is not the responsibility of the person (in whose favor charge is created) to file the form. Therefore, if the company fails to file a form for registration of charge and the person has also not filed the form then the person will not liable to pay any penalty.

Certificate of Registration of Charge:

After filling of creation of charge, ROC will issue a certificate of registration of charge in form CHG-2. The certificate issued by the registrar under CHG-2 shall be conclusive evidence that the requirements of Chapter VI of the Act and the rules made thereunder as to registration of creation of charge, as the case may be, have been complied with.

Check Your Progress - 2

6. Which one of the following is not a type of mortgage listed in the Transfer of Property Act 1882?
   a. Simple Mortgage
   b. Mortgage by conditional sale
   c. English mortgage
   d. Adjustable rate mortgage
   e. Mortgage by deposit of title deeds
7. Which one of the following is the type of mortgager when the borrower binds himself personally to pay the mortgage-money without delivering possession of the mortgaged property?
   a. Simple Mortgage
   b. Mortgage by conditional sale
   c. English mortgage
   d. Anomalous mortgage
   e. Mortgage by deposit of title deeds
8. Which one of the following is the type of mortgager that binds him to repay the mortgage-money on a certain date, and transfers the mortgaged property absolutely to the mortgagee with a provision in the contract that he will re-transfer it to the mortgagor upon payment of the mortgage money?
   a. Simple Mortgage
   b. Mortgage by conditional sale
   c. English mortgage
   d. Anomalous mortgage
   e. Mortgage by deposit of title deeds

9. Which of the following is the nodal agency for regulations in the housing sector in India?
   a. Housing Development Finance corporation
   b. Reserve Bank of India
   c. National Housing Bank
   d. Housing and Urban Development Corporation Ltd
   e. Housing Finance Companies
10. Which of the following act gives power to the lender to evict the tenant after giving notice as prescribed in the Act?
    a. TP Act
    b. NHB Act
    c. RBI Act
    d. SARFAESI Act
    e. HDFC Act

Activity 17.2

You are working in a public sector bank in a rural branch. Your zonal manager advises you to promote the housing loan portfolio in the nearby villages. You need to explain the various benefits that the bank can offer in availing of a housing loan. Explain the benefits that your bank can offer.

17.10 Summary

- A mortgage may be defined as a pledge of property documents to secure payment of a debt. Depending upon the terms of mortgage agreed upon between the lender and the borrower, mortgages can be classified into traditional and non-traditional mortgages.
- The buy down loan is similar to the PAM; however, it is the seller of the property and not the buyer/borrower who places cash in a segregated account so that additional amounts required may be drawn and paid along with the mortgage payments made by the borrower.
- As per the Transfer of Property Act 1882- Sec 58, a Mortgage is the transfer of an interest in specific immovable property for securing the payment of money advanced, or to be advanced by way of loan-- an existing or a future debt, or the performance of an engagement, which may give rise to a pecuniary liability.

- There is severe shortage of housing in urban and rural India. The government is aiming to ensure 100% housing to all by 2020, which is a tall order due to the large gap in housing. This in turn is going to create a huge opportunity for the housing sector and mortgage business as well, over the next decade.
- The mortgage industry plays an integral role in the U.S. economy, as it is the major industry that provides employment and the greatest source of wealth and savings for Americans. The home loan scheme works in a different way in the USA. A person who applies for a mortgage loan typically deals with an underwriter.
- Within the EU 28, there is a wide variation in mortgage loans. Only 25% of the homeowners lived in a house with a mortgage or housing loan while 45% were owner-occupants without a mortgage.
- According to Fed Reserve Data, US mortgage market recorded at $11.92 trillion at the end of December, 2022 marking a nearly $1 trillion increase in mortgage balances in 2022.
- Due to increase in Fed interest rates, the mortgage interest rates doubled in 2022 peaking at 7 percent in November 2022.
- Fitch Ratings in its Global Housing and Mortgage Outlook 2023 expect nominal home price growth to decline or slow substantially in 2023 for most markets and see lower demand for mortgages.
- The mortgage industry in India is under-penetrated. However, NBFCs and HFCs have been the biggest drivers of housing finance growth in the country over the past decade their last-mile connectivity in tier II and tier III cities are not fully up to the mark. This presents a huge opportunity for the mortgage industry.

17.11 Glossary

Mortgage: A mortgage is a debt instrument, secured by the collateral of specified real estate property, and the borrower is obliged to pay back with a predetermined set of payments.

Mortgage as per Transfer of Property act 1882: As per the Transfer of Property Act 1882- Sec 58, a Mortgage is the transfer of an interest in specific immovable property for the purpose of securing the payment of money advanced or to be advanced by way of loan--an existing or a future debt, or the performance of an engagement which may give rise to a pecuniary liability.

Pradhan Mantri Awaas Yojna (PMAY): Pradhan Mantri Awaas Yojna (PMAY)), is a social welfare program, created by the Indian government, to provide housing for the rural poor in India and for urban poor with the main objective of housing for all by 2022.

SARFAESI Act: The Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 allows banks and other financial institutions to auction residential or commercial properties to recover loans subject to certain conditions.

17.12 Self-Assessment Test

1. Explain in detail the differences between traditional and Non-Traditional mortgages.
2. Discuss briefly the various types of non-traditional mortgages.
3. What are the basic rules that the lenders in the US follow to adjudge the adequacy of the income for paying the obligations under mortgage?
4. Define Mortgage as per T P act 1882 and list out the various types of mortgages as described in the act.
5. Discuss the role of NHB in promoting the home loan market in India.
6. What is Pradhan Mantri Awaas Yojna? How does it help in providing affordable housing to the poor in India?

17.13 Suggested Readings/Reference Material

1. Anthony Saunders, Marcia Millon Cornett, Anshul Jain (2021), Financial Markets and Institutions, 7th edition, Tata McGraw-Hill Education
2. Prasanna Chandra (2020), Fundamentals of Financial M, 7th edition, Tata McGraw-Hill Education.
3. Devie Mohan (2020), The Financial Services Guide to Fintech, 1st edition, Kogan Page Limited.
4. Siddhartha Sankar Saha (2021). Indian Financial System. 2nd edition, Tata McGraw-Hill Education
5. DR. R. Shanmugham (2020). Financial Services. 2nd edition. Wiley India

17.14 Answers to Check Your Progress Questions

1. (a) Pledge of property documents to secure a debt payment

A mortgage may be defined as a pledge of property documents to secure a debt payment.

2. (b) The total mortgage payment (principal and interest) should not exceed 25% of the borrower's total income less all payments owed to other obligations.

This is the principle that the lenders in the US follow to adjudge the adequacy of the income for paying the obligations under the mortgage.

3. (d) **A fixed rate of interest is charged on the loan for its entire term**

    This is a feature of a traditional mortgage.

4. (e) **Fixed-rate mortgage**

    This is a traditional mortgage.

5. (a) **Graduated Payment Mortgage**

    The payments under Graduated Payment Mortgage start at a relatively low level, rise for a specified number of years, and then become equal after the specified number of years.

6. (d) **Adjustable Rate Mortgage**

    This is a non-traditional mortgage that is not listed in the TP Act 1882.

7. (a) **Simple Mortgage**

    In the case of a simple mortgage, the mortgagor binds himself personally to pay the mortgage-money without delivering possession of the mortgaged property.

8. (c) **English Mortgage**

    In the case of an English mortgage, the mortgagor binds himself to repay the mortgage money on a certain date and transfers the mortgaged property absolutely to the mortgagee with a provision in the contract that he will re-transfer it to the mortgager upon payment of the mortgage money.

9. (c) **National Housing Bank**

    It is the nodal agency for regulations in the housing sector.

10. (d) **SARFAESI Act**

    Section 13 of the SARFAESI Act gives power to the secured creditor even to evict the tenant after giving notice, as prescribed in the Act.

Unit 18

Real Estate Financing: Risk and Return

Structure

"Real estate investing, even on a very small scale, remains a tried and true means of building an individual's cash flow and wealth."

- Robert Kiyosaki

18.1 Introduction

Investment in real estate is a time tested formula to acquire wealth.

In the previous unit, we discussed the mortgage and mortgage instruments and how the mortgage industry is flourishing in the USA, EU and India.

In this unit, we shall be deliberating on real estate financing and the risk and returns associated with such activity. We will discuss the features of real estate financing in major mortgage markets where this form of asset-based financing has grown phenomenally witnessing a plethora of innovative financing strategies and a variety of instruments. Some of the instruments presented and discussions provided in the following pages may not be immediately relevant in the current Indian context, however, they do serve the purpose of providing a flavor of the possible developments that could take place in this area of asset-based financing in the future.

18.2 Objectives

After going through this unit, you should be able to:

- Discuss various aspects of the real estate industry in India
- Determine the various ways of financing the real estate industry
- Appreciate real estate as an investment vehicle
- Explain various risks associated with financing this industry

18.3 Real Estate Transaction

A real estate transaction involves the exchange of economic resources between a seller, buyer and, normally, a financial entity. Thus, the real estate transaction is, essentially, a tripartite agreement in which the financier has an important role to play. There could be variations to this basic theme. The seller himself may assume the role of the financier also as such an agreement would enable the seller to earn interest on the funding in addition to the gain on sale; the buyer may leaseback the property to the seller; the financier may also have an ownership or profit-sharing interest in the property and so on. With a number of entities coming together with various objectives, opportunities are created for structuring diverse methods of real estate financing.

The buyer is usually the borrower/user in a real estate transaction product. He is oriented as owner, lessor, trustee, developer, syndicator or property manager. The borrower who assumes control over the property derives economic reward through value appreciation, cash flow, tax benefits and management. The borrower also assumes the risk underlying the ownership of the property. The lender/financier provides a service and he would like to protect himself against the downside risk of direct ownership by extending an amount of loan that is lower than 100% of the value of the asset (say, loan to the extent of only 80% of the value of the property).

Unlike other assets, real estate, being a limited resource, typically holds its value or increases in value over the long run and hence, the lender’s risk of losing capital is minimized in this form of financing. The financing structures, which allow the lender also to share the long-term appreciation from the gain on a future sale further increases the returns accruing to the financier. Of course, in such participative arrangements, the financier may be willing even to increase his risk exposure by providing a very high percentage of the value of the asset as a loan.

18.4 Classification of Real Estate

All real estate (residential, commercial, etc.,) falls into three broad categories based on use. These categories are – purchaser occupied property, income-producing property and property developed for sale.

If the property is used by the person who has bought it, as his residence or as his business premises, then it is called as purchaser occupied property.

Income-producing property is that which a borrower builds or buys to rent or lease. Examples of income-producing property are apartment houses, light industrial parks, shopping centers, office buildings, etc. When these properties are purchased, it is usually for generating income for the owner on a continuous basis into the future.

Property developed for sale is a property that is either built or purchased for the purposes of selling for a profit to persons other than the owner. Examples of property developed for sale are residential tracts, condominiums, and other properties that will be sold as soon as they are completed.

Another way of classifying the types of real estate property is as follows:

- Residential real estate: This type of property includes both new construction and resale homes.
- Commercial real estate: These include shopping centres and strip malls, medical and educational buildings, hotels and offices.
- Industrial real estate: This type of property includes the land allocated for industries or already constructed industrial sheds etc.
- Land: This type of property includes house sites and agricultural land.

Example: Growth and Analysis of Commercial Real Estate market in India

There is an exponential growth in India's commercial property after the COVID-19 outbreak. There were lot of disruptions to business during 2020 and 2021 resulting in closure of many business establishments such as supermarkets, movie halls, restaurants. Commercial real estate market has steadily picked up during 2022 due to the rising demand for a variety of industries and businesses. The demand for commercial real estate sector appears to be consistent and steady.

Source: Commercial Real Estate Market India: Types, Trends (squareyards.com) dated 8th July, 2022, Accessed on 27.07.2022

18.5 Factors that distinguish Real Estate from Other Assets

Real estate differs from other assets in the following ways:

i. Real estate is fixed in location and each parcel of real estate is unique. Different parcels of real estate may be substitutes for a particular use but no two parcels are perfectly the same.

ii. The value of a real estate property is dependent on local and regional economic conditions. An office building that is in an area where office space is in excess supply cannot be moved to an area where office space is at a premium. In addition, the value of a property depends upon the use to which adjacent and nearby properties are put to.

iii. Real estate is a durable asset with a long economic life. A building once constructed at a site will remain for a number of years. Hence, the developer must not only take into account, at the time of construction, the immediate use of the building, but also the possible future use of the property.

iv. Real estate investments are made up of large not-so-easily divisible large economic units that require a substantial outlay of funds.

v. For many properties, especially those properties spanning a large area, there may be very few buyers and hence the market for such properties may not be very active at all. It is difficult to establish a market price for such investments. Since real estate is not traded on any national market, information on price is hard to obtain. Due to the above-mentioned factors, a sale of a real estate investment takes much longer time to complete than the sale of a security. In addition, we may conclude that the market for real estate is not very efficient.

vi. Theoretically, direct investment in real estate or ownership can be separated from the management of the property. However, the owner (in comparison with ownership of other assets) must closely watch over the person in charge of management. He must also have specialized knowledge of the local conditions in which the property is situated to assess how well the property is being managed.

vii. The transaction costs for real estate tend to be higher than that of many other types of assets, mainly due to difficulties associated with obtaining price information and the complicated legal procedures involved in the purchase and sale of real estate.

18.6 Real Estate: An Investment Vehicle

Real estate as an investment vehicle exhibits the following features:

- Real estate has always been found to be a reliable hedge against inflation.
- It has been established that the returns from real estate are not highly correlated with returns from shares and bonds. Hence, the inclusion of real estate in a portfolio serves to diversify the risk and enhance the risk-return characteristics of the portfolio.
- Direct investment in real estate entails tax benefits through deductibility of depreciation (on buildings). In addition, any debt financing used could lead to tax losses (as per US tax laws), which would be used to shelter other income.
- In India, investment in real estate is eligible for tax benefits under sections 80 C and 24, to individuals under the Income Tax laws.
- Real estate assets offer attractive total returns. Apart from the income stream of rental, the prospects for growth in both rental and value are attractive when compared to expected returns from financial assets.

18.6.1 Difficulties in Real Estate Investing

The difficulties in real estate investing are-

- Real estate investment is perceived as a high-risk investment area because of its complicated and unstandardized nature.
- Active management commitment is required to produce high returns.
- Data concerning the historical returns and risk of the various types of possible real estate investments is inadequate.

The following provides the types of risk that real estate investments can face.

Risks in Real Estate Investments

Risk is a natural part of any investment, and commercial real estate is no exception. Thus, it is essential that Investors must make their own call on risk, based upon their capacity to take risk if it is within an acceptable level. To understand the risk level, the first step is to understand the different types of risks that lead to a negative impact on a real estate investment. The following elements of risk need to be assessed before taking a call.

Sponsor risk: The ability of the developer, operator or lender can have a substantive impact on whether that sponsor can execute a business plan that includes asset management risk and property management risk.

Debt risks: Debt risks can lead to foreclosure due to either over-leverage or debt maturity or a combination of both.

Cap rate risk: A small movement in a cap rate percentage can have a considerable effect on the residual value of an asset and, in turn, the profitability (or loss) of a particular transaction.

Tenant risk: The creditworthiness, stability and number of tenants.

Leasing risk: The lease-up may not occur or may occur at a slower rate than the sponsor anticipates.

Physical asset risk: Aging assets tend to have more risk for unforeseen problems to surface, such as costly roof replacements or equipment failure.

Entitlement risk (new development only): Delay in obtaining municipal approval to construct the project.

Construction risk: The risks due to cost overruns, projects taking longer than anticipated to complete.

Market risk: The risk due to the top and down-market cycles.

Geographic risk: Neighborhood Job growth, population and demographics are some of the key ingredients. Primary markets such as New York, San Francisco, L.A. or Chicago have larger, more diverse economies, and a bigger population base, to insulate them from market downturns.

Check Your Progress - 1

1. Which of the following is a real estate transaction?
   a. The exchange of economic resources between a seller and a buyer
   b. The exchange of economic resources between the contractor and the buyer
   c. The exchange of economic resources between the real estate agent and the contractor
   d. The exchange of economic resources between a seller, buyer, and a financier
   e. The exchange of resources between a banker and a buyer
2. Mr. Ram Gopal has taken a housing loan to purchase a flat in Chennai where he wants to live. Which one of the following categories will the above-mentioned property be classified into?
   a. Property for investment
   b. Income-producing property
   c. Property developed for sale
   d. Commercial property
   e. Purchaser occupied property
3. Which one of the following is not a factor that distinguishes real estate from other assets?
   a. Real estate is fixed in location and each parcel of real estate is unique
   b. The value of a real estate property is independent of local and regional economic conditions
   c. Real estate is a durable asset with a long economic life
   d. Real estate investments are made up of large not-so-easily divisible large economic units
   e. The transaction costs for real estate tend to be higher than that of many other types of assets
4. Which one of the following is not correct regarding real estate as an investment vehicle?
   a. Real estate has always been found to be a reliable hedge against inflation
   b. Direct investment in real estate entails tax benefits through deductibility of depreciation
   c. The returns from real estate are highly correlated with returns from shares and bonds
   d. Real estate in a portfolio serves to diversify the risk and enhance the risk-return characteristics of the portfolio
   e. Investment in real estate is eligible for tax benefits under various sections

5. Which one of the following is not a reason to consider real estate investment as a high-risk investment?
   a. Investment in real estate is complicated and unstandardized
   b. Active management commitment is required to produce high returns
   c. Data concerning the historical returns of possible real estate investments is inadequate
   d. Data concerning the risk of the various types of possible real estate investments is inadequate
   e. The risk assessment is not possible due to the volatility of the valuation of the securities in the market.

18.6.2 Real Estate: Selection and Management

Office buildings, industrial warehouses and shopping centers are the three types of real estate that are included in most institutional portfolios. In selecting real estate, one should take care to analyze and inspect the property and make the purchase. A good real estate manager is one who has the expertise to distinguish between a good and mediocre property. Once the real estate is acquired, the management of the property becomes very important. An important objective of property management is inflation hedging. Short term leases are probably ideal for investor protection. Another important property management objective is to maximize a property's current income. To add to the rentability and value of the real estate, capital improvements should be made which makes the building look attractive to get the highest possible rent. Professional property management is increasingly being recognized by institutional owners of real estate. Financial institutions play an active role in the real estate sector through the creation of special purpose vehicle, which is discussed below.

SPV Route for transactions of Housing Sector

In fund-based housing finance services, an institutional player can purchase properties in bulk and get a bulk discount on the purchases. The discount could be to the extent of the intermediary charges paid by the actual purchaser to various brokers, consultants, etc. The entire transaction can be done by cheque so that the state government gets an additional income by way of increased stamp duty, since the contract price would be realistic or actual. It can form a separate Special Purpose Vehicle (SPV) for this purpose. The SPV can also finance corporate builders and monitor the progress of the construction until the building is transferred to the housing society. The assets, until then, remain in the books of the SPV and in case it is required, the dues can be recovered by the housing units directly to the consumers/purchasers. SPV can also be formed for the secondary mortgage market. The funds for these SPVs can be raised from debt instruments, which should be free from stamp duty.

The SPVs can then act as intermediaries between the primary lenders and investors of long-term and fixed income securities, by purchasing housing and other mortgage loans. SPVs can also help rebuild illegal constructions. The municipal authorities can first confiscate the unauthorized buildings and sell them to the SPVs for a nominal price. The SPVs, after some necessary and suitable alterations, can sell these to social institutions.

Example: REITs an Attractive Investment Vehicle?

Commercial real estate (CRE) was land that is used solely for business-related activities or as a workspace, as distinct from being occupied as a residence, which would fall under the category of residential real estate. Historically, Real Estate Investment Trust (REIT) portfolios have been performing very well. They should be part of any long-term diversified investment portfolio.

In April 2019 India's first REIT, Embassy REIT had been listed on the stock exchange. Since then the REIT structure had become a prominent feature Indian office market. Later Mindspace Office Parks had been listed and Brookfield Office Parks REIT listed in 2021.

Source: What Makes Reits An Attractive Investment Vehicle? (cnbctv18.com) dated 27th May, 2021; Accessed on 27.07.2022

Activity 18.1

You have joined India Real Estate Investments Ltd., a fast-growing NBFC in real estate investments, as an estate manager. Mr. Harvinder Singh, your boss has advised you to familiarize yourself with various aspects of real estate investments. Discuss the same.

18.7 Sources of Real Estate Finance

The risk underlying real estate financing varies with the stage in which real estate project is. The product life cycle of a real estate project comprises of three segments for which financing would be required:

i. Acquisition, development, or improvement financing

ii. Construction financing

iii. Permanent financing

Since the inherent risk characteristics are different in each segment, the sources from which financing may be drawn will also differ for each segment. For instance, construction financing is the most complex and risky phase in real estate development that is usually funded in the US by savings and loan associations and syndications. Other financing agencies like pension funds, financial institutions and mortgage companies seldom provide finance at the construction stage.

In this note, we will discuss the most prominent sources of real estate financing agencies in USA. These are:

- Commercial banks
- Savings and loan associations
- Life insurance companies
- Pension funds
- Real Estate Investment Trusts (REIT)
- Foreign investors
- Mortgage companies

Apart from borrowing from the above-mentioned sources, the buyer could also raise money from the seller or enter into a sale and leaseback arrangement with the seller.

We will discuss the features of various forms of finance provided by the above sources:

18.7.1 Commercial Banks

In the US, commercial banks have long been a large, diversified source of funds for real estate financing. The forms of real estate loans advanced by commercial banks to the borrowers directly are construction/development loans, business loans and residential mortgage loans. Indirect financing is provided by commercial banks through mortgage warehouse loans.

Construction/Development Loans

These loans are given to the developer of a project for financing the actual construction of the building. The loans are given for the period of construction that could extend over two to three years. The funds are advanced as progress payments based on the quantum of construction completed, less a retention amount which is payable only on completion of the entire construction. Floating interest rates are required to be paid with reference to a particular market interest rate. The borrower, on completion of the construction, raises funds from a long-term investor (say, a pension fund or life insurance company or even from the same commercial bank on different terms) and pays off the construction loan.

Since financing construction can be a risky lending activity for a commercial bank, only large banks are more active in lending to this segment. Smaller commercial banks may become involved in large projects through loan participations with large banks. Of late, pension funds, life insurance companies, savings and loan associations, which traditionally had provided the long-term finance on completion of the construction, have started competing with the commercial banks in offering construction/development loans. To survive the competition, commercial banks have started to offer construction loans with 'mini-perm' features. The mini-perm feature allows a borrower to borrow a medium-term loan from the commercial bank to pay off the construction loan taken from the same commercial bank on completion of the construction. The facility of the medium-term loan extends the time available to the borrower to scout for a lender who would be willing to fund the real estate on a permanent basis.

Commercial banks are also currently being allowed to a limited extent to participate in the equity financing of real estate.

Business Loans

The business loans given by commercial banks for real estate can be of many forms. The most predominant are business loans for financing of industrial properties and shopping centers. An industrial loan can be either extended as a conventional mortgage (which is secured only by the value of the property) or as a direct commercial loan (which is secured by the value of the property and additional assets or personal guarantee of the borrower). Financing industrial property is considered more complex than financing a residential or commercial property. The bank will have to review the borrower's credit-worthiness intensively. The bank must also have a comprehensive knowledge of the industrial location and industrial technology. In addition, given the nature of an industrial property, its alternative use value is more restricted than a commercial property. Hence, it is not uncommon for the commercial bank to ask for additional security, apart from the mortgage of the property while extending business loans for industrial property.

While extending shopping center financing, unlike other mortgages where the appraised value of the property is considered as the key factor, the commercial bank must do a detailed financial analysis of future cash receipts and disbursements, to assess the repaying capacity of the borrower. The credit of a shopping center may be enhanced, if the tenants enjoy a national reputation (for example, credit to a shopping center to be occupied by Sears Roebuck & Company or Walmart Stores, Inc. has a higher credit standing). Analyzing shopping center financing can be quite complex as it calls for an analysis of the economics of retailing, the use of forecasting techniques, and preparation of financial projections of operating results, to depict the sources and uses of cash flow, examination of the adequacy of the cash flows for debt, and a reasonable rate of return for investors.

Residential Loans

Commercial banks tend to be one of the major suppliers of residential mortgage loans. The types of residential loans extended by commercial banks are as follows:

i. A conventional real estate loan secured by a real estate and it does not carry any government insurance or guarantee.

ii. An FHA real estate loan is any loan secured by residential real estate in which the lender is insured by the Federal Housing Administration (FHA). The borrower, the property and the loan must comply with requirements that have been established by the FHA.

iii. A Veterans Administration real estate loan is any loan secured by real estate and made to an eligible veteran (say, a war veteran) in which a portion of the loan is guaranteed by the Veterans Administration (VA). The veteran, the property and the loan must meet the requirements of the VA.

iv. A real estate construction loan is any loan secured by real estate on which partial disbursements are made during the construction period. Such a loan may be arranged on a long-term conventional basis, on an FHA or a VA basis, or on a short-term loan basis.

Mortgage Warehouse Loans

These are lines of credit extended by the commercial bank to mortgage bankers, to facilitate the origination of mortgages on a short-term or medium-term basis, to facilitate the borrower to enjoy the credit until such time a more permanent form of finance is obtained. Mortgage warehouse loans are an indirect form of financing given by commercial banks.

The loans given to mortgage bankers can be one of the two types; (i) The Committed Technical, under which the mortgage banker has a prior commitment from an investor to purchase the property on completion of construction and (ii) The Uncommitted Technical, under which there is no prior commitment from a permanent investor to finance.

18.7.2 Savings and Loan Associations

S&Ls are akin to 'benefit funds' and 'nidhis' in India and were founded on the principle of promoting savings habit among the working class and thereby build a capital base from which loans are extended for the purchase of the family home. S&Ls from the savings deposits mobilized extended long-term and fixed-rate mortgage loans.

S&Ls were highly profitable until the late 1970s. The volatile economic environment that developed in the late 1970s rendered many of these S&Ls unviable. While the market interest rates were rising, the S&Ls found themselves locked to fixed interest income from long-term mortgages that had been extended at much lower levels of interest. The spread for S&Ls is becoming negative certain regulatory changes were effected to revive the S&Ls and enabled them to adapt themselves successfully to the changing economic environment. A major part of the changes was directed at removing the restrictions on the kinds of business that the S&Ls could engage in and providing them with more avenues of income. As a result of the changes, S&Ls can invest in non-residential real estate. Although there are still some limitations on savings and loan activities in commercial real estate and real estate development, these institutions can now participate in such development in a variety of ways. Thus, S&Ls are moving into areas of finance that had previously been dominated by commercial banks.

S&Ls offer real estate financing in the following forms:

- Land acquisition and construction loans
- Direct joint ventures
- Direct development and Syndications
- Bow ties and Mini-perms
- Gap loans

Land Acquisition and Construction Loans

Some of the larger S&Ls enter into land acquisition and construction loans with the developers. Some of the financing structures adopted by the S&Ls for these loans are equity participation loans, profit participation agreements and direct joint ventures.

To lend an equity participation loan, the S&L usually forms a service corporation subsidiary that enters into a joint venture or a limited partnership with a real estate developer. The service corporation makes a nominal contribution of say, $1000 to the capital of the partnership and limits its liability to the contribution so made. The S&L lends the loan to the partnership and takes a first lien on the property. Usually, the partnership makes no payments to the S&L, either on the principal or the interest, until the project is complete. When the project on completion is sold, a balloon payment of the principal and accrued interest is paid to the S&L. The developer and the service corporation then divide (usually equally) the gain, arising on the sale of the project. Thus, the S&L not only acts as a financier but also acquires an equity stake in the property developed through the service corporation subsidiary.

Some larger S&Ls that do not want to form the service corporation subsidiary try to participate in the profits of the developer by including profit participation clauses to standard loans. The greater the financial contribution of the developer to the project, the lower is the S&L’s share in the profits. Some of such agreements provide for a share to the S&L from the project’s operating cash flow (say, a part of the rentals earned on completion), while others provide for a share to the S&L in the capital gain at the time of sale of the property. The loan terms invariably provide that principal and interest must be paid in full before calculation and payment of any profit.

Direct Joint Ventures

S&L could fund real estate development by entering into a direct joint venture with the developer. In some cases, the S&L may not advance funds directly to the joint venture but will guarantee the repayment of a loan from an interim financier, say, a commercial bank. During the construction period, the S&L will actively seek a buyer for the property and offer financing for a longer duration to the buyer. Normally, in joint ventures, profits from the sale of property are divided equally between the developer and the S&L.

Direct Development and Syndications

Larger S&Ls also directly engage themselves as developers of single independent family homes and apartments. In the case of multi-family apartments, S&Ls may form syndicates to develop the property. S&Ls normally do not enter as developers or form syndicates, for the development of commercial and industrial properties.

Bow Ties and Mini-perms

A bow tie arrangement is designed to protect both the borrower and the lender against volatile interest rates. While an interest rate may be stated in the documentation (which is usually the maximum rate supportable by the cash flow from the property), an additional amount may be payable if the market rate of interest exceeds a ceiling rate agreed upon. This additional amount will be added as a balloon payment to the principal at maturity.

As we have seen earlier, a mini-perm is a short-term loan extended at the time of completion of the project to provide bridge finance, until the developer can obtain financing of a more permanent nature.

Gap Loans

These loans lent by both larger and smaller S&Ls are loans extended to the developer to cover the difference or gap between the bank construction loan and the total cost of the project. The gap loan is at an interest that is much higher than the prime lending rate. An origination fee is usually charged for the grant of the loan and most often, an equity participation clause is added. The gap loan is secured by a second lien on the property. The main advantage to the developer is that 100% financing for the real estate development is obtained without the need to bring in personal funds or to form a partnership and in addition, the developer is entitled to the usual percentage of profits.

18.7.3 Life Insurance Companies

The life insurance companies have traditionally provided permanent or long term financing for both residential and commercial properties. Such loans, popularly referred to as take out loans, would allow a developer to pay off or 'take out' the construction debt. The long term loans or mortgages would be for a fixed rate of interest and have a term to maturity of 25 to 30 years.

However, in the 1980s when interest rates were very volatile and started rising, the life insurance companies realized the vulnerability of their loan portfolios to interest rate risk and have shifted their lending to loans of shorter maturities. Some major insurance companies have formed their own construction lending departments and are providing both construction and takeout financing (on a short term basis). Generally, insurance companies are moving towards shorter duration loans and away from traditional long term mortgages.

The insurance companies are also engaging in real estate financing with some equity participation arrangement. Such financing forms are convertible debts, participating mortgages, joint ventures with developers and syndications.

While entering into mortgages with equity participation clauses, the insurance companies insist on a first lien on the property and require that the title must be good, marketable and insurable on such a basis. Most life insurance companies also insist upon the assignment of important leases to the lender as additional security. Adequate fire and other hazard insurance coverage for the property must also be ensured. Life insurance companies may be willing to advance funds even in excess of the normal loan-to-value ratio of 75 to 80 percent if the property is leased to a tenant with a strong credit rating.

18.7.4 Pension Funds

A pension fund is one that receives contributions from corporations, government agencies, unions and workers for the eventual repayment to former employees in the form of retirement benefits. The funds of a pension fund are normally entrusted by the manager of the fund to a trustee for investments in income earning assets. The return so generated should be adequate to guarantee payment of future benefits to retirees without risking the loss of assets. The trustee has a fiduciary responsibility to safeguard and prudently invest the assets.

The asset liability structure of pension funds is such that these funds can ideally finance long term mortgages on real estate. The inflow of funds is continuous and stable for the pension funds and the payment of obligations are actuarially determinable. In the past, pension funds had predominantly invested only in stocks and bonds; and only with the unprecedented inflation in the 1970s, did the pension funds move into real estate financing to hedge against inflation.

In general, pension funds seek to finance income-producing properties of four types: (i) office buildings, (ii) industrial buildings, (iii) shopping centers, (iv) apartment buildings.

[34]Allocation of funds by pension funds in Real Estate Investment Trusts (REITs)

Of the $ 9 trillion funds of pension, endowment, and foundation funds, $800 billion is invested in real estate in the US. Most of these investments are done through a combination of REITs and private real estate investment. This ensures proper diversification to cover the risk. In the United States, the third-largest asset class is the investments in real estate houses and is an important component of a diversified investment portfolio. There has been an increase of pension fund allocations to real estate over the past several years which is around 7 to 10% of the average target weight to real estate which is still less than the other models.

Real estate investments can be compared to equity and fixed income investments as it is considered a matured class of assets. Investors can take exposure to real estate through public market investments as well as through private market investment. Investment through REITs is one of the best ways for investors to take exposure in this market as it provides the most cost effective and efficient way to gain exposure. Though REITs and private real estate are complementary investments within a portfolio, historically it is observed that REITs are comparatively stronger in performance.

The investment pattern by the REITs is 46% in bonds, 35% in equities, 16% in real estate and 3% in cash.

As regards India, REITs invests a minimum of 80% in completed and rental yield assets and a maximum of 20% in various other investments such as:

- Under construction properties that are not rent-generating,
- Listed or unlisted debt/equity of real estate companies whose operating income is more than 75 percent from real estate activity.

18.7.5 Real Estate Investment Trusts (REITs)

An REIT is a vehicle that pools the capital of a large number of individual investors and issues of debt, and then either invests the capital in the ownership of real estate (equity trust) or lends the capital to real estate borrowers on the security of mortgages (mortgage trust). Now a days, most REITs are a combination of equities and mortgages. They are creatures of the US Tax Laws and must comply with specified conditions to retain their special tax status. This special status enables a REIT to distribute its income to its shareholders (at least

[34] https://www.reit.com/news/blog/nareit-developments/role-real-estate-pension-funds dated 8th July 2019
https://economictimes.indiatimes.com/markets/stocks/news/income-from-office-property-through-reit/articleshow/69659498.cms?from=mdr dated 5th June 2019

95%), without the REIT itself paying any federal income tax. If a REIT fails to comply with the conditions specified in the Internal Revenue Code, it becomes taxable on its income as if it were a regular business corporation.

REITs can acquire property in any of the following ways:

i. Purchase of existing improved properties as part of their investment portfolios.

ii. Hiring independent contractors to construct improvements on land that REITs own.

iii. Investing in a joint venture with developers- Usually, in a joint venture, the REIT is a passive partner with most of the capital for the project being supplied by the developer.

iv. Owning the land under buildings owned by others- The REIT leases the land to the owner of the building on a long term basis.

The most predominant form of mortgage lending by REITs is construction/development lending. Some REITs even offer a package of construction and stand by financing. Other financing arrangements offered by REITs are sale/leasebacks, second mortgages with equity participation for developers, and warehouse financing (establishing lines of credit) for mortgage bankers.

Recently, finite-life REITs are being established. These trusts have specific life spans between 5 and 15 years and at the end of the specified life span, the trusts must be liquidated. The finite life is intended to reduce the disparity between the market price of the REIT shares and the underlying value of its real estate assets, thus warding off hostile takeovers. Also, mortgage REITs are increasingly including many of the equity features formerly reserved for equity REITs. In the new form of mortgage, REITs seek participation in the appreciation of the property and in cash proceeds, acquisition of a portion of gross income generated by the property above a certain amount, conversion rights and options to purchase.

Real Estate Investment Trusts (REITs) is a new concept in India and Securities and Exchange Board of India (SEBI) framed the SEBI (REITs) 2014 regulations, which were subsequently amended in 2016.

Latest guidelines on REITs

SEBI guidelines on IPO and other aspects:

- Vide its circular dated 19th December 2016 has come out with the guidelines for public issue of units of REITs.
- It later issued a couple of circulars on the financial disclosure in the offer document and continuous disclosures and compliances on the 26th and 29th of December by REITs.

- In July 2017, to facilitate ease of operations for applying for registration and compliances of various reporting's, SEBI has introduced an online system for filings related to REITs.
- Vide its circular dated 13th April 2018 SEBI issued a circular clarifying that REITs can issue debt securities.
- On 15th January 2019, SEBI issued amendments on Guidelines for public issue of units of REITs.

One of the major issues in India has been the duping of homebuyers by unscrupulous developers. Though belated, the Real Estate Act 2016 has brought in some discipline amongst the developers.

[35](REITs in India) (Key Aspects of REIT Regulations)

2018 Amendments in REITs Regulations, 2014

1. The definition of controlling interest from more than 50% of voting right or interest that was necessary for acquiring controlling interest to not less than 50% voting rights.
2. The definition of holding company means the company in which REIT holds fifty percent of equity share capital or interest, which in turn has made investment in other SPV that holds the property.
3. The definition of Real Estate Assets includes both leasehold and freehold property, whether held by REIT directly or through holding company or through special purpose vehicle.
4. Either the sponsor must have an interest in assets or he must be holding units of REIT on post-issue basis or his experience must be utilized for meeting the eligibility criteria.
5. Dispute resolution mechanism in shareholder or partnership agreement in SPV for any investment to be made in properties through SPV is made mandatory.
6. For investment in properties by REIT through SPV, the manager has to appoint the board of director or the trustee in proportion to their shareholding or interest in REIT or SPV.
7. As per the present regulation, REIT should invest 20% of its asset in unlisted equity shares of companies that derive not less than 75% of their operating income from real estate activities. The minimum post paid-up capital required for small-cap and large-cap company to be listed on stock exchange shall be ₹ 3 crores.

[35] http://www.mondaq.com/india/x/771958/Commodities+Derivatives+Stock+Exchanges/Analysis+Of+Effect+Of+Amendments+Pertaining+To+Real+Estate+Investment+Trust+Regulation dated 15th January 2019

Latest amendment by SEBI in March 2020

In Regulation 14, in sub-regulation (11), the following new proviso shall be inserted after the first proviso, namely,-

"Provided further that the REIT shall not be required to file draft offer document with the Board in case of a fast track rights issue, subject to the fulfillment of the conditions as specified by the Board from time to time."

Further modification dated 16th June 2020

The Security Exchange Board of India vide its notification dated 16th June 2020, has published the Securities and Exchange Board of India (Real Estate Investment Trusts) (Second Amendment) Regulations, 2020. The amendments deal with the provisions governing the sponsors of Real Estate Investment Trusts.

Through this amendment, new regulation 7A has been inserted relating to De-classification of the status of the sponsor.

De-classification of the status of a sponsor(s) of a REIT whose units have been listed on the stock exchanges for a period of three years shall be permitted upon receipt of an application from the REIT and subject to compliance with the conditions that the unit holding of such sponsor and its associates have taken together do must not exceed 10% of the outstanding units of the REIT and the investment manager of the REIT must not be controlled by such sponsor or its associates. Further, the maximum subscription under Regulation 14(2) (ba) from any of the sponsors shall not be more than 25% of the unit holding.

Amendment in Taxation Regime of REIT through Finance Bill, 2018

1. The Finance Bill, 2018, has deleted the exemption available on the transfer of long term capital assets that is now taxed at a 30% rate.
2. The short term Capital Gain on the transfer of units of business trust on which Securities Transaction Tax (STT) is paid at the rate of 15% as per Section 111A.

No tax breaks are available under Sections 80C to 80U for both short and long term capital gains.

Income from Sale of REIT Units

i. Capital gains from sale of Indian REIT units are subject to short-term capital gains tax at 15% if held for less than one year.
ii. Units held for more than three years (36 months) are subject to LTCG tax at 10% if they result in an income over ₹ 1 lakh.
iii. Additional points on taxation:
    a. Interest income from REITs is taxable.
    b. Dividend income from REITs is taxable depending on the REIT's special tax concession status.

c. If special tax concession has been obtained, dividend income is taxable in the hands of the investor.

d. If not, dividend income is not taxable.

e. Income from amortization of SPV debt is not taxable in the hands of the investor.

18.7.6 Foreign Investors

In the United States, foreign investment in real estate has been growing as a source of real estate capital, mainly due to limited legal restrictions on such foreign investment. Foreign investors focus on existing commercial and industrial property in or near major US cities. *Ab initio,* development projects are avoided by foreign investors for financing. These investors look for shopping centers and office buildings let out to 'Triple A' rated tenants. Foreign investors prefer high-quality buildings in the best locations and avoid properties subject to long-term leases.

Real estate sector has received a big boost in India, which is discussed below-

Indian Real Estate Sector

Indian real estate sector can be broadly classified into housing, retail, hospitality, and commercial sectors. The size of this sector in 2017 was approximately 120 billion USD and it is expected to reach $1 trillion by the next decade (2030) and is expected to contribute around 13% of the country's GDP by 2025.

The real estate construction industry ranks third among various major sectors and the growth story is well supported by the demand for office space, urban and semi-urban accommodations with significant growth registered in retail, hospitality and commercial real estate. There is a 30% increase in new housing launches across top cities in India that is effectively 1.95 lakh units.

Demand for Warehousing:

There is a sharp increase in demand due to e-commerce with the liberalization of FDI policy. The electronic and white goods segment is the key driver to boost the demand for warehouses in urban and semi-urban areas and this segment will witness investments of ₹ 50,000cr by 2020.

Technology to propel the growth

The various facets of Proptech supported by technological developments of digital tools by creating virtual experiences for the buyers, chatbots, BIM, drones and next-gen innovations will be the game changers for this industry.

Emerging concepts in the reality sector:

The emergence of concepts such as co-living, student housing, senior living, co-working, will witness stronger growth in 2019. There is a growing number of youth willing to go for co-living spaces in big cities. Co-living and student housing will boost the rental housing segment due to high housing prices in metros and tier 1 cities.

Road Ahead

- Real Estate Investment Trust (REIT) platform is expected to propel the industry by creating an opportunity worth $ 20 billion over the years.
- There has been a shift from family-owned businesses to that of professionally managed ones.
- Real estate developers are also investing in centralized processes for sourcing material and organizing manpower in areas like project management, architecture and engineering.
- There is increased transparency in the system. To attract funding, the companies have revamped their accounting and management systems to meet due diligence standards.

18.7.7 Mortgage Companies

Mortgage companies originate loans with their own funds and credit resources. Unlike other financing agencies, they sell the mortgage loans originated by them to other investors and then take on the servicing of the loans for those investors. Mortgage companies are the most diversified of all the financial institutions that serve the real estate market. Mortgage companies in addition to origination, sale and servicing of residential mortgages, also provide insurance, purchase land, extend development/construction loans, and perform property management. However, the number of mortgage companies has remained small as compared to other financing agencies.

Before originating and selling packages of mortgage loans to investors, the mortgage companies must obtain the necessary funds. Usually, these funds are obtained through warehousing loans, or lines of credit provided by the commercial banks. Banks have been willing to extend lines of credit for mortgage companies because the mortgage companies usually have commitments from permanent investors to purchase the loans in inventory. The construction loans that they are lending and the single independent family mortgages in inventory are mostly insured or guaranteed by the government. To reduce the cost of borrowings, some mortgage companies also issue commercial paper, so that short-term funds can be availed in tight money conditions.

18.7.8 Seller Financing

In seller financing, the seller accepts in lieu of cash, the buyer’s note for the unpaid price secured by a mortgage on the property being sold. While such an arrangement provides immediate financing for the buyer, it also creates an investment for the seller, which is secured by a property with which the seller is already familiar. In addition, the return to the seller is at a higher rate than what would be normally available.

A seller financing can also take the form of a second mortgage or junior mortgage to make up the difference between the price demanded by the seller and the cash available with the buyer.

The negotiations between the seller and the buyer revolve around:

- Loan-to-value ratio (what percentage of value will be provided as a loan by the seller)
- The interest rate
- Mortgage terms such as duration and instalments to be paid (whether equated instalments or stepped or ballooned)
- Prepayment option (so that the buyer can switch over to cheaper credit if available and the seller gets back the money to invest in more profitable ventures)
- Right to assign the mortgage (if the buyer wishes to sell the property within a short-term, the seller would agree to such subsequent sales, only if the new buyer's credit standing is high and/or the original seller is offered better terms for the balance mortgage)

18.7.9 Sale/Leaseback

In this type of transaction, the real estate is sold to a buyer who at the same time enters into a long term lease of the property with the seller. The seller-lessee retains possession of the property and pays a net rental to the buyer-lessor. The seller-lessee is also responsible for payment of all operating expenses, insurance and real estate taxes. The seller-lessee loses the right to set off depreciation (in the case of a building) and foregoes the appreciation in the price of the property. However, for a land and building property, if the sale/leaseback is only for the land, the seller-lessee retains the right to deduct depreciation for tax purposes. Most sale/leaseback transactions occur between a corporation (owner/seller/ lessee) and a prospective buyer (for example syndication, pension fund or insurance company).

Example: 67% Exposure of Banks and FIs to Real Estate was Safe

As of 2021, banks and other FIs had a real estate exposure of $100 billion. Out of this exposure around 67% was safe and rest of the exposure was under pressure according to real estate consultant Anarock. Around 15% of this exposure was under some sort of pressure but there is scope for resolution, at least the principal amount. Rest of the 18% exposure was under severe stress with poor visibility of servicing of debt.

Source: Real estate: Exposure of banks, financial institutions to real estate at $100 billion; 67% loans safe: Anarock, BFSI News, ET BFSI (indiatimes.com) dated 26th July, 2021, Accessed on 27.07.2022

18.8 Forms of Real Estate Investment

Real estate investments can be equity investments in which the investor acquires the ownership or equity interest in the property. They can also be debt investments that simulate a fixed income security. Some real estate investments can be a hybrid of both equity and debt investments. Both the equity and debt investments can be classified as either direct or indirect. In direct investments, there is no intermediary through which the investment is made and the investor may either actively manage the asset or delegate such management to an expert for a fee and assume a passive role. The distinctions between debt and equity investments and direct and indirect real estate investments will become clearer from a detailed discussion of the features of the various forms of investment available.

18.8.1 Debt Investments

Mortgage is a legal agreement by which a bank, building society, etc. lends money at interest in exchange for taking title of the debtor's property, with the condition that the conveyance of title becomes void upon the payment of the debt. Let us discuss debt instruments that deal with mortgages.

Mortgage loans are investments made in real estate through the provision of debt capital to the owner in return for a claim on the income stream from the financed property or the income of the owner of the property (in the form of interest and principal repayments). The debt capital is secured by a lien on the same property for which the funds are provided. This lien is referred to as mortgage and it empowers the lender to have the property sold on default of payments by the borrower and insist on the application of the sale proceeds towards payment of the unpaid mortgage balance.

Mortgage lendings are subject to default risk, interest-rate risk and inflation or purchasing power risk. Default risk is the uncertainty associated with the receipt of interest and/or principal. It consists of payment delinquency risk, or the risk arising from the non-timely payments by the borrower, and the risk that the borrower may become insolvent and the outstanding amount on the mortgage loan, which may become totally or partially irrecoverable. Interest-rate risk is the risk that at some point in time in the future, the market interest rates may rise well above the actual interest charged under the mortgage.

Mortgage-backed Securities

The mortgage-backed securities have created a secondary market for mortgages in well-developed countries. These securities allow investors to invest in mortgage assets without having to become involved in the cumbersome procedures of mortgage origination. A mortgage-backed security represents a *pro rata* and undivided claim, which is evidenced by a certificate. Investors receive periodic payments consisting of interest and principal amortization from a pool of mortgages with very similar characteristics. The mortgages in the pool serve as collateral for the mortgage-backed securities. The manner in which payments are made from the pool to the investor depends on the type of mortgage-backed security issued.

The popular forms of mortgage-backed securities available in the US are Government National Mortgage Association (GNMA or 'Ginnie Mae'), Pass-Through Security, the Federal Home Loan Mortgage Corporation (FHLMC) Participation Certificates, FHLMC Guaranteed Mortgage Certificates (GMCs), privately insured Pass-Through Securities and Tax-Exempt Mortgage Revenue Bonds.

There are broadly two categories of mortgage-backed securities: Mortgage-backed bonds and Mortgage-pass-through securities. Mortgage-backed bonds closely resemble conventional bonds with principal characteristics such as (i) semi-annual payments of interest and annual repayment of principal and (ii) minimum annual principal-reduction payments as per a predetermined schedule. Some mortgage-backed bonds such as the GMCs carry an unconditional guarantee by the Federal Home Loan Mortgage Corporation in respect of both interest payments and collection of principal.

Pass-through securities pass through to the ultimate investor, a fractional share of monthly payments received on the underlying mortgages in the pool, consisting of principal amortization and interest, as these are received or scheduled to be received (including prepayments on those mortgages), minus a small fee retained by the issuing entity (originator) for servicing. A unique feature of pass-through securities is that the cash flow received each month by investors is uncertain due to the unpredictable nature of prepayments by the mortgagor.

The following attributes of mortgage-backed securities must be closely examined by the investor while evaluating the risk-return profiles of alternative mortgage-backed securities:

i. Safety of the issue with respect to risk of default and loss of payments
ii. Difficulty or ease associated with the saleability of the issue
iii. Payment characteristics
iv. Relative yield of the issue
v. Denominations in which the security can be purchased
vi. Tax status of the issue
vii. Expected maturity (life of the loan) of the issue

18.8.2 Equity Investments

Real estate equity investments confer the following benefits to their holders:

i. Tax shelter
ii. Cash flow (income component of total return)
iii. Price appreciation
iv. Diversification

While the tax shelter benefits are of importance to high-bracket taxpayers, the diversification benefits are of importance to investors seeking to reduce the risk of their overall portfolios.

In a nutshell, the value of the benefits of tax shelter, cash flow, price appreciation and diversification to a particular investor depends on:

- The investor's overall tax and financial position;
- The degree of investor's risk aversion;
- The composition of the investor's overall portfolio;
- What the investor is looking for from the real estate investment.

In the United States, real estate equity investments are often structured so that investors can receive different proportions of tax shelter, cash flow or price appreciation. That is, the three components of return are packaged individually or in various combinations to various investors with differing investment objectives.

Real estate equity investment can be either direct or indirect. In a direct equity investment, the investor must address the following issues:

i. Whether he must make the investment and take the management decisions or hire a real estate agent to manage the property on his behalf.

ii. The types of properties and which particular properties to purchase.

iii. The quantum of property to be purchased.

iv. Whether a combination of debt and equity should be used.

v. What are the benefits to which weightage should be given – tax shelter, cash flow, appreciation, diversification or elements of all four.

vi. Whether he must himself use or develop the property or lease it to others.

The direct real estate equity investment can take any of the following forms:

i. Ownership of personal residence/commercial property.

ii. Limited partnership, joint ventures or syndications entered into with others to participate in the income generated or in future appreciation in value.

The indirect real estate equity investment is done predominantly through equity Real Estate Investment Trusts (REITs). In a loose sense, REITs can be viewed as mutual funds that invest in real estate properties and/or mortgages instead of securities such as bonds and shares. REITs essentially are financial intermediaries specializing in real estate investments. They channel funds from financial markets to the real estate sector. REITs raise the funds required for investment in properties through the issue of shares of beneficial interest (analogous to equity shares), borrowings from institutions such as banks and insurance companies, and the issue of a variety of debt instruments. The REITs provide an opportunity to investors (who subscribe to the shares of beneficial interest and the debt instruments) to participate in the gains of a professionally managed portfolio of diversified real estate assets. Many REITs list their shares on the stock exchanges or their shares are traded in the over-the-counter markets. The greatest advantage that the REITs, in comparison with other forms of real estate investment offer is the liquidity of the investment. Another benefit is that the REITs, like the mutual funds, do not have to pay tax on the income received by them. That is, the income (including the capital gain) distributed is taxed only in the hands of the shareholders and hence double taxation is avoided. Moreover, the capital gain realized and distributed to the shareholders is taxable as a capital gain for the shareholders, at the usual differential rate of tax.

REITs can be broadly classified into equity REITs, mortgage REITs and hybrid REITs.

Equity REITs primarily acquire ownership of various categories of income generating properties. The main source of income for the equity REITs is the rentals. Capital gains are realized by equity REITs on the sale of properties. Mortgage REITs are predominantly engaged in mortgage lending. Their sources of income are interest earned on mortgages, commitment fees, accretions of discounts on mortgages priced below face or maturity value, and commissions earned on mortgage purchases. The mortgage REITs obtain capital gains mainly from selling mortgages above their cost whenever longer term interest rates drop. These REITs also concentrate on construction and development loans (on a first mortgage basis) which are high risk and high yielding real estate investments.

The hybrid REIT is one that combines the features of both equity and mortgage REITs. A mortgage REIT whose loan contains an income participation clause and whose shareholders are provided participation in the income streams or cash flow of mortgaged properties is an example of a hybrid REIT.

The following provides an overview of a real estate industry.

[36]Real Estate Industry – An Overview

- Real estate sector in India is expected to reach US$ 1 trillion in market size by 2030, up from US$ 200 billion in 2021 and contribute 13% to the country's GDP by 2025. By 2040 the real estate market will grow to ₹ 65,000 crore from ₹ 12,000 crore in 2019.
- As per ICRA estimates, Indian firms are expected to raise more than ₹ 3.5 trillion (US$ 48 billion) through infrastructure and real estate investment trusts in 2022, as compared with raised funds worth US$ 29 billion to date.

[36] https://www.ibef.org/industry/real-estate-india
ibef compiled the data from Media Reports, Press releases, Knight Frank India, VCEdge, JLL Research, CREDAI-JL, Union Budget 2021-22

Government of India along with the governments of respective states has taken several initiatives to encourage development in the sector. The Smart City Project, with a plan to build 100 smart cities, is a prime opportunity for real estate companies.

- Around 40 million square feet were delivered in India in 2021. It is expected that the country will have a 40% market share in the next 2-3 years. India is expected to deliver 46 million square feet in 2022. In 2021-22, the commercial space is expected to record increasing investments.
- According to the Economic Times Housing Finance Summit, about 3 houses are built per 1,000 people per year compared with the required construction rate of five houses per 1,000 population. The current shortage of housing in urban areas is estimated to be about 10 million units. An additional 25 million units of affordable housing are required by 2030 to meet the growth in the country's urban population.
- FDI in the sector (including construction development & activities) stood at US$ 55.18 billion from April 2000-September 2022. Between January-July 2022, private equity investment inflows into the real estate sector in India stood at US$ 3.27 billion. Indian real estate is expected to attract a substantial amount of FDI in the next two years with US$ 8 billion capital infusion by FY22.
- The Securities and Exchange Board of India (SEBI) has given its approval for the Real Estate Investment Trust (REIT) platform, which will allow all kinds of investors to invest in the Indian real estate market. It would create an opportunity worth ₹ 1.25 trillion (US$ 19.65 billion) in the Indian market in the coming years.
- The residential sector is expected to grow significantly, with the central government aiming to build 20 million affordable houses in urban areas across the country by 2022, under the ambitious Pradhan Mantri Awas Yojana (PMAY) scheme of the Union Ministry of Housing and Urban Affairs. Expected growth in the number of housing units in urban areas will increase the demand for commercial and retail office space.
- Under Union Budget 2021-22, tax deduction up to ₹ 1.5 lakh (US$ 2069.89) on interest on housing loan, and tax holiday for affordable housing projects have been extended until the end of fiscal 2021-22.

Example: Gain of 2% in listing of Brookfield India REIT Shares

On 16th February 2021 shares of Brookfield India Real Estate Investment Trust were listed and gained a premium of over 2% on NSE. Earlier the shares were issued at ₹ 275.

Contd….

Brookfield REIT had become the third listed REIT in India.

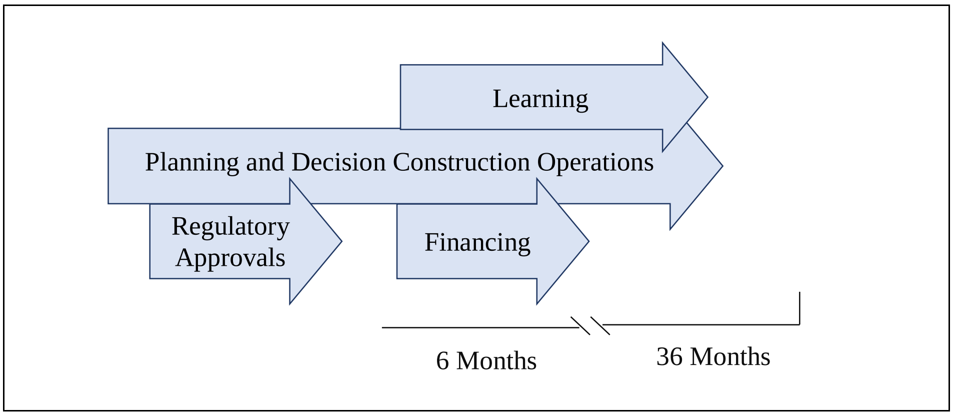
The aim of REITs was to attract investment in the RE sector by monetising rent-yielding assets. The listing of REITs enabled to unlock the huge value of real estate assets. It also enabled retail participation.

Source: Brookfield India REIT: Brookfield India REIT shares list with over 2% premium, Real Estate News, ET RealEstate (indiatimes.com) dated 16th February, 2021, Accessed on 28.07.2022

18.9 Risk-Return Profiles of Real Estate Investments

An analysis of risk and rewards in real estate development requires one to know the process of development of real estate, which is outlined in Figure 18.1.

Figure 18.1: Process of Real Estate Development



Source: ICFAI Research Center

The first stage is planning and design. This requires market analysis to study the supply and demand consideration and some pro forma representations of expected performance. In this stage, one assesses the profitability of the investments, given the market conditions. The second stage involves obtaining regulatory approvals that may take either a few weeks or a few years. The elements of financing, construction and leasing are next. Last but not the least is the operational phase. Most investors get involved only in the last stage, i.e., they buy the complete leased building. However, some take different risk positions in different markets at different times by backward integration, along with the development process.

The risk and return characteristics of a particular form of real estate investment depend on whether such investment is more in the nature of debt or equity and whether it is a direct or indirect mode of investment.

The direct real estate equity investments such as proprietorships, joint ventures and limited partnerships can provide a higher-than-normal return like the equity shares if the concept of leveraging (partly financing by debt) has been used in financing the underlying asset and the return on the property is much higher than the cost of debt.

Real estate equity investments also offer tax shelter. However, the returns are exposed to risks created by inefficient management of the property and relative lack of liquidity. In addition, to enjoy the benefits of diversification, huge amounts would have to be invested across various geographic locations and types of properties.

Indirect equity investments in real estate such as participation in equity REITs provide the investor with the much-needed liquidity and assured efficient management of the property. The equity REIT also usually holds a well-diversified portfolio of properties and hence even with a small amount of investment, the investor can obtain benefits that flow from such a diversified portfolio. Since the investments in equity REITs reduce the investor's exposure to risk, they tend to be efficiently priced and hence the return on such investments would be low.

A direct debt investment in the form of a mortgage has all the risk-return characteristics of a fixed-income security. However, the mortgage is less liquid than fixed-income securities. In comparison, indirect mortgage investments such as mortgage REITs or mortgage-backed securities provide a higher degree of liquidity to the investor and lend geographic diversification to the mortgage portfolio.

18.10 Salient Features of RERA and the Investor Protection

Let us discuss the few points on RERA and the investors are protected through this regulatory authority:

Real Estate Regulatory Authority (RERA)

[37]RERA Act, 2016 that was passed by the Parliament in the year 2016 and came into effect in March 2017, is a strong regulatory body in the real estate sector with the sole aim of protecting the home purchasers. It also boosts the real estate investments, enhances accountability and transparency with respect to housing transactions and real estate.

Salient Features

The salient features of RERA are-

- Real Estate Regulatory Authority has to be established in every Indian state to monitor, adjudicate and arbitrate any disputes in real estate projects in the concerned state.
- Establishment of a fast-track mechanism for settlement of disputes through appellate tribunal and dedicated adjudicating officers.
- All real estate projects must be registered with RERA and no property can be sold if not registered with RERA. The promoters have to upload the details of the project on the RERA website.

[37] https://www.bankbazaar.com/home-loan/rera-act.html

- A project's registration can be cancelled if RERA receives any complaints and are found to be true after an inquiry.
- A promoter's application will be approved or rejected within 30 days.
- Not more than 10% of the cost can be taken as advance payment from the buyer at the time of application. Additional amounts can be collected only after a written agreement with the buyer is executed and the sale of the property is registered.
- Insurance on the title of the building, the land, and the construction of each project to be obtained.
- 70% of the amount collected from the buyers needs to be deposited in a separate account. It can be withdrawn after the receipt of certification from an architect, a chartered accountant, and an engineer.
- Prior written consent from two-thirds of the allottees to be obtained if the promoter wants to transfer or assign a majority of his rights and liabilities in the project to a third party after obtaining the written approval of RERA.
- Any default from the side of the promoter or the buyer will attract equal rate of interest.
- If the promoter causes any losses to the buyer due to defective title of land etc., he will have to compensate the buyer.
- If the promoter violates the provisions of the law, the buyer or an agent can file a complaint with RERA.
- RERA can stop an agent, promoter, or buyer from continuing any activity against which a complaint has been raised.
- The aggrieved party can submit an appeal before the appellate tribunal if he is not satisfied with the decision of RERA.
- If the promoter fails to follow RERA's orders, they will have to pay a penalty of up to 5% of the cost of the property.
- If the Appellate Tribunal's orders are not complied with, a penalty will have to be paid. It can be imprisonment for up to 3 years or a fine up to 10% of the cost of the project or both.
- No civil court will have any jurisdiction with respect to any matter that comes under RERA or the appellate tribunal's jurisdiction.

RERA and its Role in Protecting Investors

Some of the malpractices committed by builders are abnormal delay in completing the projects, providing false information about the construction, diversion of funds, poor quality construction, keeping blank the date of possession in the sale agreement or altering the structure without consent of the buyers, etc.

RERA has been formed to protect the investors from such malpractices. The rules are framed in such a way that it will be difficult for the builders to get away. Some of them are:

1. All commercial and residential real estate projects where the land is over 500 square meters or eight apartments have to register with RERA.
2. The builders have to get all the clearance before they could advertise or sell any property.
3. They have to publish the sanctioned plan, layouts, location with clear demarcation of land, carpet area, number and area of garage, etc.
4. The builders have to upload the quarterly progress in the project on their web site.
5. 70 percent of the money received from customers has to be transferred into an escrow account to ensure that they do not divert their funds to other projects.
6. The sale agreement should be in the standard model to ensure equality and protection.
7. Advance payment to be received from the buyers cannot be more than 10% before entering the sale agreement.
8. In case of any structural defect or poor quality, it will be the responsibility of the developer to rectify such defects for a period of five years.
9. It is mandatory for the developers to disclose the size of their apartments, based on carpet area.
10. Clear title over the property and project has to be disclosed to buyers.
11. The buyer has the right to ask for a refund of the amount if the promoter has given false information.
12. If there is a delay in giving the possession on time then, the buyer can cancel the agreement or demand to be paid interest for every month of the delay until the date of possession.
13. The builder cannot transfer the majority rights and liabilities to a 3rd party without the prior written consent from two-thirds of buyers subject to a written approval of the RERA.
14. Complaints with respect to the project can be filed with state-level RERA that will be resolved within 60 days. If not satisfied with the resolution, one can file in the next authority (appellate tribunal) and the next authority (High Court).

In this context, the following is given below as an example.

[38]RERA - UP Derecognizes the Noida Project, the First of its Kind

Unnati Fortune's Aranya, located in Noida's Sector 119, has been the first builder to be de-recognized by RERA (UP state) after they detected severe financial irregularities and funds diversion committed by the builders. The regulatory authority de-registered Aranya phases 3, 4 and 5, a project of ₹ 1,500 crores under section 5 of the RERA Act after the developer failed to come with a satisfactory response to the notices issued by UP RERA.

Example: Builders Discouraged to Challenge RERA Orders: SC Ruling

In November 2021, the Supreme Court upheld a provisions in the real estate law. As per this provision, it is compulsory for builders to deposit full compensation plus interest ordered by the regulator or at least 30% of the penalty. This is a pre-requisite for challenging any order before the appellate authority. This judgement of the Supreme Court came as a big relief for homebuyers and prevent builders getting into a protracted legal battle by challenging the orders of the RERA authorities. The other provision wherein the appellate authority can increase the mandatory deposit beyond 30% had also been upheld by the apex court.

Source: SC ruling may deter builders from challenging Rera orders | India News - Times of India (indiatimes.com) dated 15th November, 2021, Accessed on 28.07.2022

18.11 Indian Scenario

Indian investment in real estate falls into many categories – single-family residences, multiple-family residences, commercial shopping centers, commercial storefronts and raw land.

The real estate sector in India is on the rise. The main growth thrust is coming due to favorable demographics, increasing purchasing power, existence of customer-friendly banks, housing finance companies, professionalism in real estate and favorable reforms initiated by the government, to attract global investors. India is facing a shortage of 18.8 million (revised to 10 million) fresh supply of houses in its urban pockets of which 15 million are LIG category by 2018.

Finance for residential buildings (single or multiple) is provided in the form of mortgage loans. The suppliers of house mortgage loans are Housing and Urban Development Corporation, central and state Governments, the Apex Co-operative Housing Finance Societies, housing boards in different States, LIC, commercial banks, private housing finance companies, financial institutions, etc. Equity

[38] https://timesofindia.indiatimes.com/city/noida/a-first-rera-cancels-projects-registration/articleshow/69489962.cms dated 25th May 2019

investments in residential properties are generally made by the corporates in India. Lured by the huge amount of capital appreciation in real estate investments, many cash-rich corporates have also joined in the business of developing residential properties.

Investments in commercial shopping centers and others are generally made by the corporates in the form of equity investments. Cash-rich companies that have unlimited access to funds are developing commercial complexes too. GE Shipping Company that has been in the property development business has many commercial cum shopping projects underway.

Investment in these projects is made either for self-use or for sale. For instance, all the housing loans are provided for the borrower’s self-use. Citibank and Hoechst have acquired units for the accommodation of their expatriate staff. Contrary to these, investments by corporates are made for sale. The major impediment in this market is the lack of long-term finance. However, with the boom in the real estate market, India may witness many financing strategies and instruments in real estate financing.

The market size of the real estate in India is likely to be to the tune of US$ 180 billion by the FY end 2020 and is expected to contribute six percent to the GDP of the country. The industry has been experiencing a CARG of over 11% over the last 8 years, it will continue to grow at a similar rate in the near future and the major reason is the tremendous opportunity for the real estate sector. There has been an increase of 26% in the private equity investments in real estate and has registered an increase of nearly ₹ 40,000 crore (US$ 6.01 billion) in 2016 alone. Sectors such as IT and ITeS, retail, consulting and e-commerce have registered high demand for office space in recent times. In the year 2016 alone, office space absorption was over 34 million sq. feet in the top eight cities of the country especially Bengaluru, Mumbai, and NCR.

Real estate sector in India is expected to reach US$ 1 trillion in market size by 2030, up from US$ 200 billion in 2021 and contribute 13% to the country’s GDP by 2025. Retail, hospitality, and commercial real estate are also growing significantly, providing the much-needed infrastructure for India's growing needs.

18.11.1 Housing Finance Companies in India - An Overview

NBFCs play an important role in providing funds to individuals and builders apart from banks. The notable NBFC’s are HDFC, LIC Housing Finance, L&T Housing Finance, CAN FIN Home Loans Ltd., PNB Housing Finance Limited, etc.

HDFC – This company has been associated with the Indian housing sector for the last four decades and a pioneer in housing mortgages. Started in 1977, the company has set high standards in home loans. The company has a wide range of product portfolios that includes loan offerings for purchase/construction of a home or office, renovation, extension, rural housing loans, loan against property, etc. HDFC has provided technical assistance in Bangladesh, Sri Lanka and Egypt and has undertaken consultancy assignments in various countries across Asia, Africa and East Europe. The sources of funds for the company are Deposits, loans, equity, refinance from NHB and repayments from clients. As of January 2023, Housing Development Finance Corporation has a market cap of $57.84 billion. In fiscal year 2020, the HDFC of India reported outstanding gross loans worth 77.43 billion U.S. dollars.

LIC Housing Finance Ltd (LIC HFL)

LIC HFL is a subsidiary company of LIC of India and is one of the largest housing finance companies with its registered and corporate office in Mumbai. Set up in the year 1989, the main objective is to provide long term finance to individuals for the following purposes-

- Purchase or construction of house or flat for residential purpose
- Repair and renovation of existing flat/houses
- Provide finance on existing property for business/personal needs
- Provide loans to professionals for purchase/construction of clinics/nursing homes/diagnostic centers/office space
- Provide long-term finance to builders for construction of houses or flats for residential purposes

The asset base of the company is ₹ 2.47 lakh crores.

Can Fin Home Loans Ltd.

Can Fin Homes Ltd., a subsidiary of Canara Bank is another important player in the housing finance sector. The company has completed 32 years of operation in the field of home finance and has been making profits and paying dividends since its inception in 1987. The company has a network of over 159 branches, 21 housing loan centers & 14 satellite offices spread across the country of which 70% of its branches are located in southern India. The total loan book of the company is ₹ 28,887 crores.

PNB Housing Finance Limited

PNB Housing Finance, the fifth largest housing finance company by loan assets is a subsidiary of PNB. The company focuses on retail home lending and has an asset base of ₹ 60,912 crore. The company provides housing loans for construction, purchase, repair and upgrade of houses, as well as the purchase of residential plots. It also provides loans against property (LAP) and loans for commercial property with a focus on the mass organized retail segment. On the wholesale side, it provides construction finance, lease rental discounting (LRD), and corporate term loans (CTL), mainly to real estate developers. The company has a strong distribution network of over 13,000 channel partners across India.

Apart from the above companies, there are other notable players in home loan finance such as India Bulls Housing Finance Ltd., Aditya Birla Housing Finance Ltd., SBI Home Finance, Shriram Housing Finance Home Loans, etc.

18.11.2 Government Initiatives

Government of India along with the governments of respective states has taken several initiatives to encourage development in the real estate sector. The Smart City Project, with a plan to build 100 smart cities, is a prime opportunity for real estate companies.

- On October 27, 2020, the government announced the application of Real Estate (Regulation & Development) Act, 2016 in the union territory of Jammu & Kashmir. This has paved the way for any Indian citizen to buy non-agricultural land and property, as opposed to the eligibility of only local residents earlier.
- Under Pradhan Mantri Awas Yojana (Urban) (PMAY (U)), 1.12 crore houses have been sanctioned in urban areas, creating 1.20 crore jobs.
- The decision to allow foreign institutional investors to subscribe to REITS and INVITs
- [39]Pradhan Mantri Awas Yojana – Urban (PMAY-U) was launched on 25th June 2015 to address urban housing shortage among the EWS/LIG and MIG categories including the slum dwellers by ensuring a pucca house to all eligible urban households by the year 2022.
- Affordable Rental Housing Complexes (ARHCs) for migrant workers/ urban poor as a sub-scheme under Pradhan Mantri Awas Yojana - Urban (PMAY-U) to provide ease of living to urban migrants / poor in industrial sector as well as in non-formal urban economy to get access to dignified affordable rental housing close to their workplace. The ARHC scheme will be implemented through two models:
  i. Utilizing existing government funded vacant houses to convert into ARHCs through public private partnership or by public agencies
  ii. Construction, operation and maintenance of ARHCs by Public / Private Entities on their own vacant land

[39] https://pmay-urban.gov.in/about

- A comprehensive and Robust MIS System is in place that helps all stakeholders to seamlessly manage information pertaining to physical and financial progress.
- CLSS Awas Portal (CLAP) is a common platform for all stakeholders in real time environment to facilitate processing of applications along with tracking of subsidy status by beneficiaries.

Example: ₹ 48,000 crore Allocated under Union Budget 2022 for Real Estate Sector

The Union Budget 2022-2023, presented by the FM Nirmala Sitharaman, was a progressive booster shot for the real estate sector. The FM stated that 80 lakh houses will be completed in year 2022-23 under PM Awas Yojana. In this budget ₹ 48,000 crores had been allocated for building the houses under PMAY. This allocation is expected to provide a boom to the real estate sector.

Source: Union Budget, 2022: Govt. Allocates Rs. 48,000 Crore For Real Estate Sector (PMAY) - Goodreturns dated 1st February, 2022, Accessed on 28.07.2022

Activity 18.2

You are working for Bright Real Estate Investments Pvt. Ltd., as an investment advisor. One of their clients approaches you for guidance on the possibility of investments in the real estate sector. Discuss the various options available.

<u>Check Your Progress -2</u>

6. Which one of the following will not be an important segment in the product life cycle of a real estate project for which financing would be required?
   a. Asset acquisition financing
   b. Asset development/Improvement financing
   c. Construction financing
   d. Bridge financing
   e. Permanent financing

7. Which of the following institutions is akin to savings and loan associations in the Indian scenario?
   a. Commercial Banks
   b. Non-Banking Financial institutions
   c. Benefit Funds and Nidhis
   d. Cooperative Banks
   e. Land Development Banks
8. Which of the following is a short term loan extended at the time of completion of the project to provide bridge finance, until the developer can obtain financing of a more permanent nature?
   a. Gap loans
   b. Mini perms loans
   c. Bow and ties loans
   d. Land acquisition and construction loans
   e. Syndication loans
9. Which of the following institutions generally extend the take out loans that are normally considered for developers to pay off the construction debt?
   a. Insurance companies
   b. Commercial banks
   c. REITs
   d. Savings and loan associations
   e. Pension funds
10. Which one of the following minimum criteria has to be satisfied for real estate projects to register with RERA?
    a. Where the land is over 100 square meters, or four apartments
    b. Where the land is over 500 square meters, or eight apartments
    c. Where the land is over 300 square meters, or six apartments
    d. Where the land is over 1000 square meters, or ten apartments
    e. Where the land is over 750 square meters, or eight apartments

18.12 Summary

- Real estate financing is predominant in the west, which is done in the form of asset-based financing.
- A real estate transaction is a tripartite one, involving an exchange of economic resources between a seller, a buyer, and in most of the cases – a financial entity.

- Three types of property exist for financing. They are: (a) Property occupied by the purchaser (b) Property developed to provide for continuous income and (c) Property developed for sale.
- Real estate differs from other assets in many ways. Some of the aspects of real estate are (a) Durability, (b) Require substantial outlay of funds, (c) Transaction cost tends to be higher, (d) Takes a large physical space, (e) Value of the real estate depends on various parameters concerning local and regional economic conditions, (f) A good hedge against inflation, and (g) Tax treatment is favourable for real estate investments.
- Real estate financing may be done essentially in three broad segments: (a) Acquisition development or improvement financing (b) Construction financing and (c) Permanent financing.
- Prominent sources of real estate financing in the US are (a) Commercial Banks (b) Savings and Loan Associations (c) Life Insurance Companies (d) Pension Funds (e) Real Estate Investment Trusts (f) Foreign Investors (g) Mortgage Companies.
- Real estate sector in India is expected to reach US$ 1 trillion in market size by 2030, up from US$ 200 billion in 2021 and contribute 13% to the country's GDP by 2025.
- Pradhan Mantri Awas Yojana – Urban (PMAY-U) was launched in 2015 to address urban housing shortage among the EWS/LIG and MIG categories including the slum dwellers.
- Affordable Rental Housing Complexes (ARHCs) for migrant workers/ urban poor as a sub-scheme under Pradhan Mantri Awas Yojana - Urban (PMAY-U) was another big initiative to meet the demand of housing. The ARHC scheme will be implemented through two models.

18.13 Glossary

Commercial Real Estate Property: There are three types of real estate properties and commercial real estate is one of them, the other two being, namely, residential and industrial properties. Commercial real estate is used in commerce/ business and the purpose is to make a profit out of the asset.

Mortgage: Mortgage is a charge on immovable property. It is a legal agreement that conveys the conditional right of ownership on a property as a security for the loan taken by its owner, who is called mortgager, to a lender, who is referred to as the mortgagee.

Property Manager: A property manager or estate manager is a person or firm who is entrusted with the responsibilities of managing a real estate property for a fee. This happens when the owner is unable to attend personally to such details or is not interested in doing so.

Real Estate Investment Trust (REIT): A REIT is a vehicle that pools the capital of a large number of; individual investors and issues of debt, and then invests the capital in the ownership of real estate (equity trust), or lends the capital to real estate borrowers on the security of mortgages (mortgage trust).

Real Estate Developer: A person who is engaged in real estate or property development. This activity is a business process that includes activities such as renovation and re-lease of existing buildings to the purchase of raw land and the sale of developed land or parcels, to others.

Real Estate: Real estate is an asset that consists of property such as land and buildings with natural resources on it. They are immovable.

Trustee: Is a person to whom something is entrusted with the supervision of a trust or legal person, to whom property is legally committed to be administered for the benefit of a beneficiary who can be another person or a charitable organization. A trustee is also a person (a corporate director) occupying a position of trust and performing functions comparable to those of a trustee. In short, a trustee is a person or member of a board given control or powers of administration of property, in trust with a legal obligation to administer it solely for the purposes specified.

18.14 Self-Assessment Test

1. Discuss the various classifications in the real estate sector.
2. What are the factors that differentiate the real assets from other types of assets?
3. Discuss the various types of risks in real estate investments.
4. Discuss the various sources of finance for real estate acquisition.
5. Discuss the concept of real estate investment trusts with specific reference to the Indian context.
6. Analyze the various forms of Real Estate Investments.

18.15 Suggested Readings/Reference Material

1. Anthony Saunders, Marcia Millon Cornett, Anshul Jain (2021), Financial Markets and Institutions, 7th edition, Tata McGraw-Hill Education
2. Prasanna Chandra (2020), Fundamentals of Financial M, 7th edition, Tata McGraw-Hill Education.
3. Devie Mohan (2020), The Financial Services Guide to Fintech, 1st edition, Kogan Page Limited.
4. Siddhartha Sankar Saha (2021). Indian Financial System. 2nd edition, Tata McGraw-Hill Education
5. DR. R. Shanmugham (2020). Financial Services. 2nd edition. Wiley India

18.16 Answers to Check Your Progress Questions

1. **(d) The exchange of economic resources between a seller, buyer and a financier**

   A real estate transaction involves the exchange of economic resources between a seller, buyer, and a financier.

2. **(e) Purchaser Occupied Property**

   Properties can be broadly classified into purchaser occupied property, income-producing property, and property developed for sale. Since Mr. Ramgopal wants to live in the flat that he purchased, it is purchaser occupied property.

3. **(b) The value of a real estate property is independent of local and regional economic conditions**

   The value of a real estate property is dependent on local and regional economic conditions.

4. **(c) The returns from real estate are highly correlated with returns from shares and bonds**

   It has been established that the returns from real estate are not highly correlated with returns from shares and bonds.

5. **(e) The risk assessment is not possible due to the volatility of the valuation of the securities in the market**

   Normally, the value of real estate security is not influenced by the market movements but is influenced by other factors.

6. **(d) Bridge financing**

   It is not an important segment in the product life cycle of a real estate project for which financing would be required, as it is short term financing and not a long term, which real estate financing needs.

7. **(c) Benefit funds and Nidhis**

   Savings and Loan Associations are akin to 'Benefit Funds' and 'Nidhis' in India.

8. **(b) Mini-Perms Loans**

   Mini-Perm is a short-term loan extended at the time of completion of a project to provide bridge finance until the developer can obtain financing of a more permanent nature.

9. **(a) Insurance Companies**

   The life insurance companies have traditionally provided the permanent or long term financing, for both residential and commercial properties popularly referred to as take out loans, which would allow a developer to pay off the construction debt.

10. (b) Where the land is over 500 square meters, or eight apartments

All commercial and residential real estate projects where the land is over 500 square meters or eight apartments have to register with RERA.

Unit 19

Securitization

Structure

"Much of the securitization took the form of collateralized debt obligations (CDOs) with senior credit tranches certified by rating agencies as AAA. It was the failure to properly price such risky assets that characterized the crisis."

- Alan Greenspan

19.1 Introduction

Risk management is the key in securitization and appropriate pricing of the asset is the cornerstone for securitization.

In the previous unit, we discussed various aspects of the real estate industry in India and various ways of financing the real estate industry and the risks involved in financing this industry. This unit deals with securitization, one of the new instruments introduced in the financial markets.

Securitization refers to the conversion of illiquid assets to liquid assets by converting longer duration cash flows into shorter ones. Securitization denotes the process selling of assets by the person holding them, to an intermediary who in turn will break such assets into marketable securities. The assets may virtually be anything ranging from future sales of cinema tickets and airline. In this unit, we discuss various aspects of securitization and the way it is evolving in Indian financial markets.

19.2 Objectives

After reading this unit, you should be able to:

- Discuss the process of securitization
- Describe various benefits of securitization
- Appreciate the risk management process in securitization
- Discuss various deals that can be done through securitization
- Visualize the landscape of the Securitization market in India

19.3 Meaning of Securitization

Securitization is a financial innovation born out of the necessity faced by savings and loan associations of the United States of America to save them from impending bankruptcy. When inflation began to rise and the market interest rates rose in step with it in the 1970s, these thrift (savings) institutions found that their spreads were turning negative. It is because they had to pay high market rates to attract short-term deposits (to compete with money market mutual funds and commercial banks offering money market accounts), and these rates were higher than the rates they were earning on the long-term mortgage loans, which had been sanctioned years before. While mismatched assets and liabilities became a primary problem for the thrift institutions, another problem was excess demand for loans compared to the deposits collected by S&Ls, banks, etc. The solution to this problem was found in the securitization of debt.

The securitization of residential real estate in the United States was begun based on the deeply ingrained principle, that the American family needs a home and will maintain that home over most other possessions; hence, the concept of using mortgage loans to support investment-grade securities, or the process of securitization took root. The statistical research also showed that the default rates on residential real estate loans were both minimal and predictable. Investment bankers saw this as an opportunity to generate liquidity. By ‘packaging’ hundreds of individual real estate mortgages into one large security, great confidence can be achieved in terms of the financial characteristics of the group. While it would be impossible to guess the probability and timing of the default of any individual mortgage, one could frame reliable predictions regarding average default for a group of mortgages based on historical studies of other similar large pools of mortgage loans.

The definition as per RBI on securitization is reproduced hereunder.

Securitization is the process of pooling and repackaging homogenous illiquid financial assets into marketable securities that can be sold to investors. The process leads to the creation of financial instruments that represent an ownership interest in or that are secured by a segregated income-producing asset or pool of assets. The pool of assets collateralizes securities. These assets are generally secured by personal or real property (e.g., automobiles, real estate, or equipment loans), but in some cases are unsecured (e.g., credit card debt, consumer loans).

The steps involved in the process of securitization are:

i. Transfer of assets by the originator (the person who holds the assets) to a Special Purpose Vehicle (SPV). An SPV is a separate entity formed exclusively for charting this deal and providing funds to the originator. An SPV can be either a company or a trust.

ii. The SPV divides this pool of assets into marketable securities called Pass-through certificates and resells them to various investors. Here, the investors may be banks or mutual funds or central, state governments or even the parent company of the SPV.

iii. The issue of securities is managed by a merchant banker or a syndicate of merchant bankers who also underwrite the issue. Normally, a trustee is also appointed to oversee the process of securitization.

19.4 Process of Securitization

The process of securitization involves the following steps:

i. Transfer of assets by the originator (person holding the assets) to a person (company or a trust) specially created for the purpose called special purpose vehicle (SPV). Special purpose vehicle is a separate entity formed exclusively for charting this deal and providing funds to the originator. SPV may be formed as a company under the Companies Act or a trust formed under the Indian Trusts Act.

ii. The assets transferred should preferably be homogenous in nature in terms of the risk attached to them and/or maturity such that the pooling of such assets would be convenient. SPV divides this pool of assets transferred by the originator into marketable securities called Pay or Pass-Through Certificates and resells it to various investors.

iii. Investors may be a bank, mutual fund, state or central government. The investors may even be the parent company or the financier of the originator

iv. The issue of securities is managed by a merchant banker who may underwrite the whole issue or it may be a syndicate of merchant bankers. The originator continues to administer the loan portfolio for some fee and he passes the collections to the trust that services the securities.

Apart from the SPV, a trustee is normally appointed to oversee the process of securitization. An escrow account is created for distributing the receivables to the investors in the deal. Such an escrow account is maintained by the trustee.

Theoretically, any resource with predictable cash flows can be securitized as follows:

i. Future rentals of a fishing boat
ii. Remuneration that is paid to a movie star
iii. Bills that are made at a five-star hotel
iv. Tickets that are to be sold at a cinema hall
v. Future billings for an airline
vi. Dues that have to be paid by the state electricity boards to the power generating companies
vii. Credit card receivables
viii. Loans that are to be paid to the housing finance company
ix. Mortgages in lieu of future payment
x. Hire purchase receivables
xi. Non-performing assets of a financial entity

19.4.1 A Typical Example

The process of securitization can best be understood by an example of a hire purchase company. Assume that there exists a company, an NBFC, which has hire purchase as its major business. Being into hire purchase, the company will definitely have a pool of assets of different maturities spanning a few years. In addition, obviously, these assets would be represented as lease receivables in the balance sheet of the company. That is, the company has now, its funds locked-up for maturities spanning over long years facing a liquidity problem and constrained by capital adequacy norms in increasing its scale of business and hence has to raise capital. In such a situation, Securitization will help in the transfer of such illiquid lease rentals to the SPV created for that purpose thereby offloading them from its balance sheet. The SPV will buy all these lease rentals with 'credit enhancement' clauses at a time and will take care of the receivables when they come.

The following explains about the securitization transaction in a bank in question and answer format.

Securitization Transaction in Bank

1. What is securitization?

   A. Securitization is the process of pooling and repackaging homogeneous illiquid financial assets into marketable securities that can be sold to investors. The process leads to the creation of financial instruments that represent ownership interest. These instruments are often secured by segregated income-producing assets, which collateralize securities.

2. Why do we need securitization?

   A. Banking sector needs securitization for a variety of reasons like: -

   Enhancing liquidity, attainment of capital adequacy ratio without augmenting capital and generally for increased operating efficiency.

3. Which sector could be the ideal target in India for securitization?

   A. There are indeed many: There are many sectors like urban infrastructure, power, telecom, roads and ports, whose development can be accelerated through securitization route. The housing finance and auto finance sectors are also ideal candidates.

4. Who are the parties to a securitization transaction?

   A. There are indeed many:

   Primarily, there are three parties namely, the originator, the Special purpose vehicle (SPV), and the investors. There are also other parties like obligor, the rating agency, administrator (servicer) agent and trustee and structurer.

5. What are the important roles of these parties?

   A. **The Originator:** Normally he is the banker. It is in his book of accounts the assets to be securitized exist. It sells the assets (on a true sale basis) on its books and receives the funds generated from such a sale. True sale here refers to the transfer of both legal and beneficial interest in the assets to the special purpose vehicle (SPV). The funds he thus gets enhance his liquidity.

   Special Purpose Vehicle: The SPV buys the assets from the originator. It makes the payment to the originator. This way, the securitized assets will no longer appear in the balance sheet of the originator and hence, the capital adequacy requirements of the originator will be less to the extent of the securitized assets. Now onwards, the SPV holds the assets in its books. The SPV has independent trustees and or directors.

   Investors: Normally, the investors are financial institutions, mutual funds, provident funds, pension funds, insurance companies, etc. They buy a participating interest in the total pool of receivables and receive repayment in the form of interest and principal as per the agreed terms.

   The role of other parties are as follows:

   Obligor: He is the original borrower who has raised the loan from the originator. This outstanding loan amount is transferred to the SPV.

   Rating Agency: The credit standing of the obligator is of great importance in the transaction. The investors take on the risk of the asset pool rather than the originator. The rating agency, therefore, would assess the strength of the cash flow and the mechanism designed to ensure full and timely repayment by the process of selection of loans of appropriate credit quality, the extent of credit and liquidity support provided and strengths of the legal framework.

Administrator (Servicer): It collects the payments due from the obligor and passes it to the SPV, follows up with defaulters and peruses legal remedies against them, if necessary.

Agent and Trustee: It accepts the responsibility for overseeing that all the parties to the securitization deal perform in accordance with the trust agreement. An agent is appointed, essentially to look after the interests of the investors.

Structurer: Generally, investment bankers act as structurer. Their role is to bring together all the parties to the deal and structure the deal.

6. What is credit enhancement?

A. Investors in securitized instrument take a direct exposure on the performance of the underlying collaterals and have limited or no recourse to the originator. Investors, therefore, require additional comfort in the form of credit enhancement. Various techniques of credit enhancements are as follows:

i. **External Credit Enhancement:**

Insurance: Full insurance is provided against losses on the assets. This tantamount to a 100 percent guarantee of the transaction's principal and interest payments. The issuer of the insurance looks to an initial premium or other support to cover credit losses.

Third-Party Guarantee: This method involves a limited/full guarantee by a third party to cover losses that may arise on non-performance of the collateral.

Letter of Credit: For structures with credit ratings below the level sought for the issue, a third party provides a letter of credit for a nominal amount. This may provide either full or partial cover of the issuer's obligation.

ii. **Internal Credit Enhancements:**

Credit Trenching (senior/subordinate structure): The SPV issues two (or more) trenches of securities and establishes a predetermined priority in their servicing, whereby first losses are borne by the holders of the subordinate trenches (at times the originator itself).

Apart from providing comfort to holders of senior debt, credit trenching also permits targeting investors with specific risk-return preferences.

Over-collateralization: The originator sets aside assets in excess of the collateral required to be assigned to the SPV. Cash flow from these assets must first meet any overdue payments in the main pool, before they can be routed back to the originator.

Cash Collateral: This works in much the same way as over-collateralization. However, as the quality of cash is self-evidently higher and more stable than the quality of assets yet to be turned into cash, the quantum of cash required to meet the desired rating would be lower than asset over-collateral to that extent.

Spread Account: The difference between the yield on the assets and the yield to the investors from the securities is called the excess spread. In its simplest form, a spread account traps the excess spread (net of all running costs of securitization) within the SPV up to a specified amount sufficient to satisfy a given rating or credit quality requirement. Only realizations in excess of this specified amount are routed back to the originator. This amount is returned to the originator after the payment of principal and interest to the investors.

Triggered Amortization: This works only in structures that permit substitution (for example, rapidly revolving assets such as credit cards). When certain pre-set levels of collateral performance are breached, all further collections are applied to repay the funding. Once amortization is triggered, substitution is stopped and the early repayments are an irreversible process. Triggered amortization is typically applied in future flow securitization.

The following explains about the future flow securitization in a question and answer format.

What is Future Flow Securitization?

Future flow securitization is different from asset securitization. In the case of asset securitization, the pool of income producing assets collateralizes securities. These assets are generally secured by real property like automobiles, real estate or equipment.

A future flow securitization, on the other hand, raises funds based on expected future cash flows that have not, at the close of the transaction, been generated. These transactions can be subdivided into two: long-term contract receivables and future cash flows.

Examples of long-term contract receivables are term off-take agreements for the supply of goods (like oil, coffee or steel) or services (like payment for clearing services). Volumes are generally prefixed, but the price of receivables may be variable. Generally, there will be provision for some type of price floor using hedging instruments.

The future cash flow category would include receivables that are not only subject to price variations, but also to variations in volumes. Examples are ticket receivables, telecom receivables, etc. In such cases, a 'base case' for the volume of receivables is presumed. Generally, the base case cash flows are progressively reduced over a number of years. The nature of that cash flow, along with a string of other structural credit enhancements, generally ensures that the transaction is rated above the unsecured debt rating of the borrower. This way, the borrower is able to secure finer pricing and longer tenures in comparison to the terms of the other funding agencies.

What are the advantages of Future Flow Securitization?

There will be a lesser cost of funds for the borrower, due to the higher rating. It is also possible to have a diversified source of funding. Securitized transactions, being of higher quality, attract investor interest, even during periods of the credit crunch.

Securitization can serve to extend the tenure of financing available to borrowers.

What are the risks associated?

Performance Risk: Future flow transactions rely on the future generation of cash flow to repay investors. Therefore, the continued existence and performance of the borrower throughout the tenure of the transaction are critical considerations to investors. Should the borrower become insolvent, no creditors of the borrower would be able to make a claim against the receivables sold to investors. So long as the borrower continues to operate, investors will receive payments. In terms of mitigating this risk, there is very little that can be done structurally, without obtaining the support or guarantee of a rated third party.

Generation Risk: There is still another risk related to the sustained generation of the receivables at certain levels from a host of factors outside the control of the borrower, e.g., anticipated reserves may not materialize or seasonal variations in the anticipated levels of receivables may occur. This risk is mitigated through adequate over-collateralization. Further, in order to protect investors against more sustained long-term declines in the levels of receivables generated, early amortization triggers are usually built into the transaction that will trigger repayment of the securities on an accelerated basis if a predefined trigger level is breached.

Price Risk and Off-take Risk: These refer to likely price variations or the concern that the obligors in the future cease buying or reduce their purchasing level of the goods or service from the seller.

What is the scope of securitization in India?

The scope indeed is very large. Residential mortgage loans may be brought under mortgage-backed securitization. Auto loans may be brought under asset securitization. Infrastructure finance can be expanded through this route. Export receivables, credit card receivables, air-line ticket receivables, lease rentals can all become subject matters of securitization.

What are the impediments to securitization?

There are many impediments to securitization in India. An underdeveloped security market for securitized assets lacking liquidity is one problem.

Regulatory change is needed to facilitate investment in the securitized paper by financial institutions. The risk weightage norms for these instruments are to be defined. Asset classification norms also need to be defined.

Adequate disclosure about the assets needs to be made to facilitate the investor to take a view on the security.

Foreclosure norms have to be simplified to facilitate a speedy recovery.

Stamp duty exemptions have to be in place. Clear accounting norms and taxation norms have to be prescribed.

19.4.2 Credit Enhancement

To obtain an investment credit rating and make the transaction attractive to the investors, some type of credit enhancement procedure is usually necessary. In order to cover the possibility that the loan portfolio will generate an insufficient payment to fund payments of notes interest when due, some form of liquidity support is provided, usually by a credit facility from a third-party lender. The credit enhancement part will take care of the risk involved in such receivables that will protect the SPV against potential default in respect of the receivables acquired.

Since this process of securitization often involves dealing with the backing of assets, it is referred to as Asset-Backed Securitization (ABS). There is another form of securitization that deals with mortgages instead of assets called as Mortgage-Backed Securitization (MBS).

In MBS, securitization will be done on a pool of mortgages that are placed with the originator. Say, in the case of a housing finance company that finances construction/acquisition of dwelling units in return for mortgaging of such dwelling units, the housing finance company may securitize the mortgages thereby seeking the advantages of securitization. Most other factors remain the same as in ABS.

Though it was stated earlier that any resource with predictable cash flows could be securitized, the investment bankers perceive that to make a resource attractive as a raw material for securitization, the following features must be presented:

i. The asset portfolio must have a documented history showing loss and delinquency experience.

ii. The historical loss on the portfolio must have been modest.

iii. The assets must have originated from standardized contracts.

iv. The asset portfolio must have been so structured that the risk is well diversified.

19.4.3 Asset-Backed Securitization Vis-Á-Vis Mortgage-Backed Securitization

Asset-Backed Security (ABS) was a later development after Market Backed Security (MBS) was fully evolved and achieved maturity in the market. Asset-backed securities (ABS) are created by buying and bundling loans – such as residential mortgage loans, commercial loans or student loans – and creating securities backed by those assets, which are then sold to investors. Often, a bundle of loans is divided into separate securities with different levels of risk and returns. Payments on the loans are distributed to the holders of the lower-risk, lower-interest securities first, and then to the holders of the higher-risk securities.

The market for non-mortgage Asset-Backed Securities (ABS) was established in the United States in 1985. The ABS market is dominated by securities backed by automobile loans and credit receivables. Other assets used include computer and automobile leases premia, insurance, corporate trade receivables, credit card receivables and even computer leases.

Asset-backed securities are structured as a trust or a company, similar to mortgage-backed securities. Unlike in India under the Uniform Commercial Code of the United States, there is no need for a trustee to take physical possession of any account documents to perfect a security interest in the receivables, as is required with mortgage securities.

The forms in which the ABS is issued may be broadly divided into two: installment contract ABS and revolving credit ABS. The installment contract ABS bears a close structural resemblance to mortgage pass-through securities. These ABS offer investors an undivided interest in a trust formed by the issuer. All the loans on automobiles, trucks and other assets are pooled to create trust. The loan agreements in the pool may have various final maturities, usually not extending beyond five years from the date of issue of ABS. Interest rates on the ABS would be typically lower than the loan interest. All installment contract ABS calls for full amortization of principal over the term-to-maturity through virtually equal monthly payments. Investors receive monthly interest on the outstanding balance. Each investor receives a pro-rata portion of principal and interest each month. The amount of principal included in each payment will depend on the amortization and prepayment rate of the underlying collateral. Faster prepayments will shorten the average life of the issue.

The revolving credit ABS is usually backed by likes of credit card receivables. For a specified period (the revolving period) these ABS do not amortize principal. The principal from the receivables is retained by the trustee to reinvest in additional receivables. Interest on revolving credit ABS is paid every month. Most ABSs carry a fixed rate of interest. Principal payments are distributed monthly with the interest payment during the amortization period, which follows the end of the revolving period.

Table 19.1 depicts the commonalities and differences between MBS and ABS vividly.

Table 19.1: Commonalities and Differences between MBS and ABS

	Mortgage-Backed Securitization		Asset-Backed Securitization
i.	Evolution and development of Securitization is slow due to several legal hassles involving mortgaging.	i.	It is difficult to identify homogenous assets of the same quality.
ii.	Also backed by easily traceable immovable property like real estate.	ii.	Backed by movable that may not be easily traceable.
iii.	Mortgage has to exist necessarily at the time of securitization.	iii.	Asset need not exist at the time of securitization such as future cash flows that can also be securitized.
iv.	Process takes into consideration appreciation in the value of assets.	iv.	Process takes into consideration depreciation in the value of assets.
v.	Legal hassles in recourse to the originator in case of default in receivables. Also, mortgage property can only be taken control of but not disposed of by the originator, SPV or the trustee without the intervention of a court of law.	v.	Legal hassles are relatively less as compared to MBS.
vi.	Stamp duty is levied based on the rates specified in the state where the deal is struck.	vi.	Stamp duty may vary irrespective of the location, as the assets may not be based in one place.
vii.	Low yields to the investor.	vii.	High yields to the investor.

Source: ICFAI Research Center

Example: India Bulls Housing Finance - Securitization Route

Indiabulls Housing Finance was intending to raise ₹ 5000 crores in Q4 of FY 20-21 through securitisation route. They raised ₹ 2000 crore in Q3 of FY20-21. Deputy MD Ashwini Kumar Hooda said that they intend to raise ₹ 3000 crores from wholesale book and another ₹ 2000 crore through the retail route in Q4.

Homogenous illiquid financial assets will be converted into marketable securities after pooling and repackaging.

Source: Indiabulls Housing Fin to raise Rs 5,000 cr from securitisation in current quarter|The Financial Express dated 14th February, 2021; Accessed on 31.07.2022

Activity 19.1

You are working in a Smart bank as manager in home loans department. The bank has a huge portfolio of home loans. Your Vice President advises you to put up a note for the securitization of the home loan portfolio. List out the steps to initiate the Home loan securitization process.

Check Your Progress - 1

1. Which of the following statements fits into a Special Purpose Vehicle in the securitization process?
   a. Subsidiary of the originator for charting the deal and providing funds to the originator
   b. Separate entity was formed exclusively for charting the deal and providing funds to the originator
   c. Group concern of the originator for charting the deal and providing funds to the originator
   d. Foreign company promoted by the originator for charting the deal and providing funds to the originator
   e. The originator himself for charting the deal and providing funds to his company
2. Which one of the following cash flows cannot be securitized?
   a. Credit card receivable
   b. Loans that are to be paid to the housing finance company

c. Mortgages in lieu of future payment

d. Hire purchase receivables

e. Future sales in a supermarket

3. Which one of the following is not a party to a securitization transaction?

   a. Originator

   b. Special Purpose vehicle

   c. Regulator

   d. Investor

   e. Obligor

4. Which of the following will lead to credit enhancement?

   a. Providing additional securities by the third party

   b. Credit facility from third party lender

   c. Providing collateral from a third party

   d. Providing guarantee from a third party

   e. Providing a letter of comfort from a third party

5. Which one of the following is not a characteristic of an asset-backed security?

   a. It is backed by the assets that are traceable

   b. Not many legal issues in this type of security

   c. It is difficult to identify homogenous assets of the same quality

   d. Asset need not exist at the time of securitization

   e. Provides high yields to the investor

19.5 Benefits of Securitization

The attractions of securitization have led to a widespread application of the technique to the residential mortgage loans, the easiest class of financial assets to securitize and to a growing volume of structured offerings of consumer receivables such as automobile loans, lease rentals, credit card receivables. While the benefits of securitization would depend on individual situations, the state of the assets, the state of the borrower and capital market conditions, certain key factors stand out:

i. The loan originators can raise money as soon as they create loans. They need not hold their asset portfolios until their maturity. This will help in multiple asset creation thereby helping routing of funds into business thereby increasing the profitability.

ii. The investor benefits in that the security he buys is of a good quality debt (usually rated AAA as it is credit enhanced) at higher yields and good liquidity. In most cases, the deal is underwritten by a merchant banker. Also, the deal will have a trustee to oversee the operation of the transfer of receivables to the investors in due course.

iii. Normally, securitized debt can be cheaper than other forms of funding as the securities enjoy a wider investor base and certain liquidity. It also improves returns on equity and assets besides eliminating the problem of mismatching by transforming the credit assets of the lending institutions into more liquid and marketable instruments and selling it to investors.

iv. Securitization deals help the originator beat the rating given to the company. Rating given to the company is based on all the items present in the balance sheet with a reasonable judgment on the quality of these assets. With the securitization deal taking place on a particular class of assets present in the balance sheets there is a case of the originator getting funds at a rate cheaper than what would have been possible on its own.

v. Not only securitization helps in getting funds at low cost but also enables the originator to take advantage of more profitable investment opportunities with the revenue generated through securitization.

vi. Securitized assets give originators the ability to pass on or eliminate credit, interest rate and lending risks associated with balance sheet funding. This improves asset management and is an effective means of diversifying credit risk.

vii. By transforming an illiquid asset on the balance sheet into cash, the originator minimizes the accounting leverage as measured by the debt ratio and thus enables raising more funds without impairing its borrowing ability.

viii. The advantage derived by the originator by securitization in increasing the capital adequacy is tremendous. Capital adequacy norms are very rigorous especially for NBFCs. Capital Adequacy Ratio is the ratio of the sum of Tier I and Tier II capital to the risk-weighted assets. An NBFC may increase its capital adequacy ratio by securitizing some of its homogenous assets by decreasing the risk weightage of the assets. This will help the NBFC in continuing with its business at the same time fulfilling the regulatory guidelines of the land.

Securitization of Future Flow Receivables: A Useful Tool for Developing Countries

Risk Mitigation

Securitization is a fairly recent financial innovation. The first securitized transactions occurred in the United States in the 1970s and involved the pooling and repackaging of home mortgages for resale as tradeable securities by lenders.

Since then, securitized markets have grown in sophistication to cover a wide range of assets. In developing countries, particularly in Latin America, some borrowers have raised financing by securitizing future flow receivables in hard currency.

In a typical future flow transaction, the borrowing entity (originator) in a developing country sells its future products (receivables) directly or indirectly to an offshore Special Purpose Vehicle (SPV), which issues the debt instrument. Designated international customers (obligors) are directed to pay for the goods they import from the originator directly into an offshore collection account managed by a trustee. The collection agent makes principal and interest payments to lenders. Any funds leftover are forwarded to the originator.

ILFS Debacle

The debacle of ILFS has created a negative sentiment amongst the investors in NBFCs, which are facing a crisis of confidence that in turn has led to a liquidity crunch. To sort the liquidity crisis, the Indian apex bank, Reserve Bank of India (RBI), has eased the norms of selling (securitizing) the loan books for Non-Banking Financial lenders (NBFCs). The latest guidelines on the securitization of loan book by NBFCs are

- NBFCs can now securitize loans of more than five-year maturity.
- This is subject to holding those loans for six months on their books.
- They should retain a minimum of 20% of the book value of these loans.

The above relaxation will be applicable till the end of December 2019 thus benefiting the housing finance companies and NBFCs, offering mortgage loans by enabling them to raise more funds through the securitization route and easing their liquidity problem.

In this context, to avoid such debacles RBI took some initiatives as below-

Measures of RBI

As against 26 NBFCs that lost their licenses in 2018, the licenses of 1701 NBFCs were canceled by RBI in 2019 due to non-compliance of maintaining minimum CAR which is 15% of the RWA. As per RBI data, the gross NPA of NBFC’s in FY 2019 has increased 0.8% from 5.8 to 6.6% as the percentage of total advance while the net NPA declined marginally by 0.1% from 3.8 to 3.7%.

RBI is now empowered to regulate NBFCs from April 2019 and supersede the board of NBFCs. RBI may also consider a resolution of financially-troubled NBFCs through a merger or by splitting them into viable and non-viable units called bridge institutions. RBI can also change or remove auditors and can have a say in the compensation of senior management. These changes are expected to make NBFCs more transparent and improve their financial strength.

Example: NHPC, HDFC Bank Agreement - Securitization of Return on Equity

National Hydroelectric Power Corporation (NHPC) has a power plant in the state of Himachal Pradesh, known as Chamera-1 power station. On 24th February, 2022, NHPC signed an agreement with HDFC Bank to securitise return on equity of Chamera-1 power station. This is done under the scheme of National Monetization Pipeline. Against 10 years of future cash flows of Chamera-1 power station, the monetization deal fetched a present value of ₹ 1016.39 crore.

In this process ownership of assets remain with NHPC and at the same time it can raise resources to meet capital expenditure. It is a tax-efficient, economical and quick mode of asset monetization.

Source: NHPC, HDFC Bank signs Agreement for Securitization of Return on Equity (psuconnect.in) dated 25th February, 2022; Accessed on 26.07.2022

19.6 Risk Management in Securitization

The various risks involved in securitization are given below:

Credit Risk: The risk of non-payment of principal and/or interest to investors can be at two levels: SPV and the underlying assets. Since the SPV is normally structured to have no other activity apart from the asset pool sold by the originator, the credit risk principally lies with the underlying asset pool. A careful analysis of the underlying credit quality of the obligors and the correlation between the obligors needs to be carried out to ascertain the probability of default of the asset pool. A well-diversified asset portfolio can significantly reduce the simultaneous occurrence of default.

Sovereign Risk: In the case of cross-border securitization transactions where the assets and investors belong to different countries, there is a risk to the investor in the form of non-payment or imposition of additional taxes on the income repatriation. This risk can be mitigated by having a foreign guarantor or by structuring the SPV in an offshore location or have a neutral country of jurisdiction.

Collateral Deterioration Risk: Sometimes the collateral against which credit is sanctioned to the obligor may undergo a severe deterioration. When this coincides with a default by the obligor then there is a severe risk of non-payment to the investors.

Legal Risk: Securitization transactions hinge on a very important principle of "bankruptcy remoteness" of the SPV from the sponsor. Structuring the asset transfer and the legal structure of the SPV are key points that determine if the SPV can uphold its right over the underlying assets if the obligor declares bankruptcy or undergoes liquidation.

Prepayment Risk: Payments made in excess of the scheduled principal payments are called prepayments. Prepayments occur due to a change in the macro-economic or competitive industry situation. For example, in the case of residential mortgages, when interest rates go down, individuals may prefer to refinance their fixed-rate mortgages at lower interest rates. Competitors offering better terms could also be a reason for prepayment. In a declining interest rate regime, prepayment poses an interest rate risk to the investors, as they have to reinvest the proceedings at a lower interest rate. This problem is more severe in the case of investors holding long-term bonds. This can be mitigated by structuring the tranches such that prepayments are used to pay off the principal and interest of short-term bonds.

Servicer Performance Risk: The servicer performs important tasks of collecting principal and interest, keeping a tab on delinquency, maintains statistics of payment, disseminating the same to investors and other administrative tasks. The failure of the servicer in carrying out its function can seriously affect payments to the investors.

Swap Counterparty Risk: Some securitization transactions are so structured wherein the floating rate payments of obligors are converted into fixed payments using swaps. Failure on the part of the swap counterparty can affect the stability of the cash flows of the investors.

Financial Guarantor Risk: Sometimes external credit protection in the form of insurance or guarantee is provided by an external agency. Guarantor failure can adversely impact the stability of cash flows to the investors.

19.6.1 Credit Rating

Credit rating forms an integral part of the securitization deal. After identifying the homogenous pool of assets that are to constitute a securitization deal, rating is sought by the originator to rate the securitization deal based on the tentative parameters on other parts of the deal. Credit rating agency considers that part of assets that are to be securitized without considering the assets in the balance sheet. By this, as mentioned above, there exists a possibility of securitized assets having a higher rating than the rating of the company itself. The entire credit rating agencies rate securitized instruments. CRISIL, Fitch India, CARE and ICRA have rated securitized deals. All such ratings will have a 'SO' suffixed to the deal to indicate that the rated instrument is of 'Structured Obligation', which essentially means that the deal has met all the parameters of credit rating and has been structured for the purpose of credit rating and marketing of the instruments.

Credit rating helps the investors to gauge the risk in investing in the deal. It also helps the originator to beat its own company's rating thereby enabling it to borrow funds at a cheaper rate. For example, at present NBFCs with a rating of A – and below are not allowed to borrow money through fixed deposits. These companies may securitize their pool of hire purchase receivables or any other assets that have a stream of future cash flows, which will give them a better rating for the deal, thereby achieving liquidity and enabling cheaper borrowing.

The parameters considered by the credit rating agency while rating a securitized deal are similar to the parameters used for rating any other similar borrowing instrument like the fixed deposits. The variance will be in consideration with the pool of assets.

19.6.2 Credit Rating of Pass-through Securities

The mortgage pass-through securities were also sought to be made more attractive to capital market investors by subjecting these securities to credit rating. In the United States, each rating agency has defined a series of criteria that must be adhered to obtain its designated ratings. The rating of the pass-through securities in reality is not a rating of the instrument but a rating of the 'pass-through' process. That is, high importance is attached to the rightness and security of cash flow from the mortgagor's hands to the hands of the ultimate pass-through certificate holder.

Credit rating of these securities tries to give an opinion of the credit exposure (loss of both principal and interest) to the pass-through certificate holder. The rating agency reviews in addition to other aspects, the flow of payments as outlined in the pooling and serving agreement, which is the operative document for pass-through security. The focus will be on the timely payment of principal and interest to certificate holders and on the mechanism established to cover any shortfalls that may arise due to deficiencies in the collateral. The shortfalls that may usually arise are sought to be covered through pool insurance or a senior/subordinated structure. While the pool insurance involves taking out an insurance policy that covers losses equal to a defined percentage of the pool, the senior/subordinated structure (or senior/junior structure) involves over-collateralization (that is, offering a value of mortgages that is much higher than the amounts payable on the pass-through securities) and subordinating the cash flows of a class of junior securities to those of senior class of securities. The senior class through this process gets protection comparable to a pool insurance policy.

19.7 Securitization of Residential Real Estate

In this section, we will discuss the process of securitization of residential real estate and the features of the instruments created by securitization. As mentioned before, securitization of mortgages may also be done to convert underlying longer maturity loans into short-term marketable securities. These are called mortgage-backed securities.

19.7.1 Whole Loans

In a whole loan sale, all rights and responsibilities connected with a mortgage loan are transferred to the purchaser. The rights so transferred include the right to collect monthly principal and interest payments, the right to seize and sell the property if payments on the underlying loan are not made on a timely basis and the right to amend the terms of loan to correct a delinquent status. The whole loan sale is a sale whereby the originator, the mortgagor or any subsequent mortgagor finds a willing buyer who would provide liquidity to the seller for the right acquired under the sale to take over the mortgage loan. Thus, each loan or a number of loans are sold to individual buyers. The seller ceases to have any right on the mortgage loan subsequent to the sale.

The other features of whole loans are as below:

- A whole loan sale may be with recourse or without recourse to the seller.
- The seller may retain the right to service the loans; that is, the seller may collect the monthly principal and interest payments, deduct a servicing fee, remit the balance to the buyer of the loan, and correct delinquent loan payment situations and initiate foreclosure proceedings on default. The seller may also not retain the right of servicing the loan under a whole loan sale.
- Before buying a whole loan, the buyer would inspect the files connected with the mortgage loan under sale. The buyer may take on the loan only on the seller making specific representations and warranties with respect to the loan – such as the amount of loan, coupon rate and maturity of each loan, the type of property, the status of ownership and the like. The loan documents and trust deeds are transferred to the buyer with a proper assignment deed.

The whole loans were not highly useful as a medium of liquidity, because the buyer had to inspect each loan assigned to him individually and this meant that only a buyer with proven expertise in the assessment of mortgages (such as other thrift institutions and mortgage bankers), could invest in the whole loans. Since the whole loans market circulated the same funds available with the thrift institutions and mortgage banks, it was felt that a different kind of security that would draw diverse investors was necessary.

19.7.2 Mortgage Participation Certificates

These certificates were designed to reduce the amount of loan-by-loan review that needed to be performed by a purchaser of a pool of whole loans. The seller brought together a pool of mortgage loans that were inspected and reviewed by a third party known as the custodian. Representations and warranties on a particular pool were made by the seller, who took upon the obligation to repurchase any loan in the pool, which did not conform to such representations and warranties. These certificates were not very popular, since the purchaser was fully exposed to all the risks and losses associated with the pool of loans. In addition, investors investing in capital market securities could not fully comprehend these certificates, as the loans were difficult to analyze. The presence of peculiar features such as prepayment options with the borrower to repay the principal at any time, the monthly periodicity of the cash flows and the weak financial positions of the thrift institutions themselves (which made even loans with recourse to the seller appear risky) deterred the growth of the market for the mortgage participation certificates.

19.7.3 Mortgage Pass-Through Securities

When mortgages are pooled together and undivided interests in the pool are sold, pass-through securities are created. The term 'undivided' in the context of pass-through securities means that each holder of the security has a proportionate interest in each cash flow generated in the pool. When a pass-through security is sold, it is to be construed as a sale of assets and not as an issuance of debt obligations of the originator of the mortgages. That is, the obligation to pay continues to be that of the borrowers collectively and the originator has no obligation to pay. The pass-through securities promise that the cash flow from the underlying mortgages would be 'passed through' to the holders of the securities in the form of monthly payments of interest, principal and prepayments. When the holder of an individual mortgage prepays the whole or part of the principal before the scheduled date, prepayments are said to occur.

The most active issuers of mortgage pass-through securities are the mortgage originators such as savings and loan associations, commercial banks and mortgage companies. The originator can either issue private pass-through security or file the necessary documents with a guarantor for the issue of pass-through security backed by the guarantor. From the investor's point of view, securities backed by guarantors are safer investments than private pass-through securities as in the former timely payment of interest and principal is guaranteed.

The cash flows from pass-through security will be exactly equal in magnitude to that of cash flows from a mortgage directly financed by the investor, if the elements of servicing fees and prepayments were not there. However, there would still be a time lag in the receipt of cash flows from the pass-through securities. All originators do collect a servicing fee that is structured as a direct deduction from the interest on the mortgage and compensates the originator for the cost of collecting the payments, and ensures that the originator has a continuing interest in monitoring the status of the loans. When servicing fees are deductible and no prepayments occur, even the cash flow from a pool of traditional mortgages derived through the pass-through securities will not be equated, as the deduction in the form of servicing fee, declines over time. This is because the servicing fee is charged (like interest) on the outstanding balance of the principal amount. Table 19.2 provides the comparison of features of Mortgage securities and alternate instruments.

Table 19.2: Comparing the Features of Mortgage Securities and Alternative Investment Instruments

Feature	Mortgage Pass Throughs	Mortgage-Backed Bonds	CMOs	Corporate Bonds	Treasury Bills
Use of Collateral	More efficient use of collateral but credit enhancement required for private issuers	Inefficient	Relatively efficient	N/A	N/A
Certainty of Cash flow	Relatively uncertain	More predictable	More predictable still	Usually callable only after 5 to 10 years	Non-callable except for longest maturities
Frequency of Payments	Monthly payments of principal and interest	Quarterly or semi-annual payment of interest with bullet repayment of principal on maturity	Semi-annual payment of interest with bullet repayment of principal on maturity	As with CMOs (although many eurobonds pay interest annually)	Issued at discount to face value
Average Life	Depends on the prepayment experience of underlying mortgages	As with mortgage pass-throughs	Predictable for the fast pay bonds: less so for the slow pay bonds	Predictable minimum average life and pre-payment penalties increase return if called	Very predictable as the majority are non-callable
Liquidity	Good, especially for GNMAs	Adequate	Good	Limited for many bonds	Excellent
Credit Risk Spectrum	Range from government guaranteed to A-rated private pass-throughs	Most AA or AAA	Most AAA	AAA to speculative	All backed by the full faith and credit of the US government. In the Indian context, it is not

					applicable as they are not guaranteed by government
Investor Spectrum	Mainly with traditional mortgage market participants. Limited capital market investor base	As for pass-throughs plus medium/ long-term capital market investors	Wide investor spectrum across mortgage and capital markets	Wide capital market investor spectrum	Limited capital market investor spectrum

The mortgage pass-through securities were designed to serve the following purposes:

i. To enhance the creditworthiness of the sale of mortgage loans, so that a better insulation from the possibility of loss could be offered to the investors who have not traditionally invested in mortgages.

ii. To create a security that would be more freely treatable and transferable.

iii. To create a security that would not necessarily involve the inspection of each loan, as done in the case of whole loan sales.

To create a pass-through security, the loans or pieces of collateral are placed into a trust estate created and held by an independent trustee and proportionate ownership interests in the pool are sold. The rights to all cash flows associated with the mortgage loans – principal and interest payment, insurance payment, insurance proceeds, prepaid principal are assigned to the trustee for the benefit of the pass-through certificate holders. These securities are normally designed to distribute cash receipts on the 25th of the month following expected receipt of the mortgagor's payment so that sufficient time is allowed for processing the payments.

19.7.4 Standardization

In spite of the mortgage pass-through securities offering the holders the advantage of free tradability and transferability, the market for these securities did not flourish as there needed to be some form of standardization in the mortgage market as well as a major clearinghouse for the purchase and sale of mortgage securities. In the late 1970s and early 1980s, three institutions were established in the United States to address these problems. Different characteristics of the loans that could be securitized were announced by three government-backed agencies – Government National Mortgage Association (GNMA), the Federal National Mortgage Association (FNMA) and the Federal Home Loan Mortgage Corporation (FHLMC). The agencies were authorized to take mortgage loans from the thrift institutions and create pass-through securities that could be sold in the secondary market. Due to the large purchasing efforts on the part of these agencies, the characteristics spelt out became the standards of loan packages in the secondary market. The process of credit rating further helped in popularizing the mortgage pass-through securities.

19.7.5 Mortgage-Backed Bond

The mortgage-backed bonds, another form of asset securitization, were evolved to address a weakness inherent in a mortgage pass-through security, namely, lack of call protection and poor predictability of cash flow. Under the mortgage pass-through security, if the borrower wished to prepay his mortgage loan due to change of job, refinancing, death, or buying a new home, such prepayment would be accepted and the cash flow would be passed on to the holder. Thus, the maturity of the pass-through security instead of the expected term of say, 30 years, could also be cut short to a term of say, 30 days.

A mortgage-backed bond is a collateralized term-debt offering. It is secured by mortgages that have a market value of 110 to 200 percent of the principal amount of the bond. Unlike the pass-through certificates, the mortgages are not sold to the holder of the security but are used only as collateral for the bonds that are issued to raise finance. The terms of these bonds are like the bonds floated in the capital market – semi-annual or quarterly payments of interest at a fixed rate or floating rate and final bullet payment of principal.

The savings and loan associations and other thrift institutions have been the predominant issuers of mortgage-backed bonds. Since the issuer does not assign the mortgage loans to the investor, but only offers them as collateral, the rating of the bonds will consider the financial strength of the issuer. These bonds are over-collateralized so that even when some of the borrowers under the mortgage have made prepayments well ahead of the maturity of the bonds, there would be sufficient protection offered to the bondholders in respect of the bullet payments of the principal on the date of maturity of bonds.

The collateral offered under these bonds is pledged to an independent trustee. This pledging ensures that a smooth liquidation takes place in the event of default on the part of the issuer of bonds. Although the mortgage-backed bonds could protect the investor from prepayments, they involved over-collateralization and resulted in inefficient utilization of eligible collaterals and restricting the power of the originator of the mortgages from borrowing to the fullest possible extent against the market value of the mortgages.

In the case of traditional mortgage-backed bonds, when a default occurs, the collateral would be liquidated by the trustee to repay principal and accrued interest and the investor will have to bear the risk only for the price paid on purchase which is in excess of the par value of the bond.

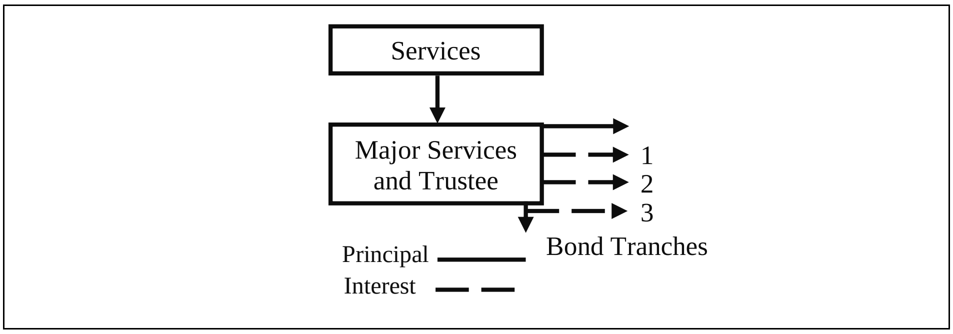
From 1987 onwards, mortgage-backed bonds with a defeasance structure are being issued. Under the defeasance structure, when there is a default on the bond, the traditional accelerated payment is not done but the trustee is given powers to effectively defease the issue with a portfolio of government securities. In other words, the issuer is required to maintain sufficient collateral to enable the trustee to purchase a portfolio of government securities whose cash flow would satisfy the payment of principal and interest on the mortgage-backed bonds. The defeasance structure provides maximum protection to the bondholder against loss and premature call of the bond.

19.7.6 Collateralized Mortgage Obligations (CMO)

To create a securitized mortgage that incorporated the mortgage-backed bond's cash flow predictability and improved the use of collateral for the issuer cash flow bond (or pay through security) and the collateralized mortgage obligation was created. Cash flow bonds looked very similar to normal pass-through securities in that the cash flows arising out of the underlying pool of mortgages were dedicated to the servicing of the bond. However, it was similar to mortgage-backed bonds in that the collateral was placed in the hands of trustees. The variant of cash flow bond widely used is the collateralized mortgage obligation.

CMOs were created to protect the investors from prepayment risk. The CMO takes the same cash flow that a conventional pass-through security generates and then carves them into discrete maturities or tranches. Thus, under a CMO there could be class A bonds maturing in 7 years, Class B bonds maturing in 15 years and so on. Cash flows generated by the underlying collateral (to the extent that it exceeds the amount required to pay interest) is used to retire bonds. Only one class or tranche of bonds at a time receives principal. All principal payments, as stipulated by the prospectus are made for the 'fastest pay' tranche of bonds. Once the retirement of this tranche is completed, the next tranche in the sequence is repaid along with the principal amount. This sequential process continues until the last tranche of bonds is retired. The CMO innovatively uses the cash flows of long maturity, monthly pay collateral to create securities of differing – short, intermediate and long – final maturities and expected average lives. (Refer Figure 19.1).

Figure 19.1: Cash Flows



Source: ICFAI Research Center

The process by which cash flows are got from the collateral to the bondholders in different tranches is depicted in Figure 19.1. In this example, whilst interest is paid to each of the three tranches, any excess cash flow generated by the collateral is paid exclusively to the first tranche of bonds until this is fully repaid. Thereafter, excess cash flow is applied solely to the second tranche and so on.

Cash Flow Apportionment under a CMO Structure

For investors seeking low exposure to interest rate risk, the shorter tranche CMOs are best suited. Since the shorter tranches must be retired before longer tranches receive principal payments, the longer tranches have a form of call protection. For long-term investors who want to avoid the call and reinvestment risk, the longer tranche CMOs are ideal investment vehicles.

Benefits of CMO

The benefits of CMO are-

To the Investor:

- CMOs are considered to have a high-level of credit quality, because of the quality of the underlying collateral. To be assigned a high credit rating a bond should be structured in such a way that the cash flow generated is at least sufficient to support the amount of bonds in issue even under the most conservative prepayment nature.

To the Issuer:

- Compared to pass-through securities, funds can be raised more cheaply due to segmentation.
- Wider diversification of investor base can be achieved.
- More efficient use of collateralization than mortgage-backed bonds.

19.7.7 Comparing the Different Mortgage Securities

Table 19.2 compares the features of the three main classes of mortgage securities (pass-through, mortgage-backed bonds and CMOs) with each other and with two of the main alternative investments (corporate bonds and treasuries). Mortgage-backed bonds and CMOs in particular, have developed many of the characteristics of the two other main capital market instruments examined, corporate bonds and treasuries. By so doing, they have been able to tap a wider investor base in the capital markets than have pass-through securities, which are still generally held by participants active in the US primary mortgage market.

19.7.8 Interest only/Principal only Securities

These securities are referred to as STRIPs (Separate Tranche Interest and Principal). The STRIP security is created by taking the cash flows from the underlying collateral and splitting them into two or more classes that have the same maturity as the underlying collateral. Certain classes will receive more interest than other classes while the other classes will receive more of principal than those classes entitled to receive more interest.

The purchaser of the Interest-Only (I/O) portion of the STRIP invests in a security with a yield potential of high coupon collateral. The expectation of this investor is that the interest rates will remain the same or will continue to rise, which would result in slower prepayments. This is because the borrower of the mortgage loan in order to prepay would have to raise funds at equal or increased interest rates and hence would be better off paying the interest stipulated in the mortgage.

The purchaser of the Principal-Only (P/O) portion of the STRIP expects the interest rates would continue to fall and the borrowers of the mortgage loans would resort to large-scale prepayments. This is because when market interest rates are falling the borrowers would be induced to replace the higher interest obligations under the mortgages with lower interest loans. P/O is bought at a discount and any faster return of principal accelerates the yield to the investor.

Both the I/O and P/O are extremely volatile and sensitive to small changes in interest rates and the resulting prepayment rates. The returns to the investors of I/O and P/O move in opposite directions.

Example: Loan Assets Securitized by NBFCs

Non-banking Finance Companies (NBFCs) including Housing Finance Companies (HFCs) are in the forefront in securitisation of loan assets. The amount of loan assets securitised by NBFCs grew by 43% in FY 21-22 to ₹ 1,25,000 crores thanks to quick economic recovery and a low base effect. The same figure stood at ₹ 87,300 crores in FY 20-21.

Source: NBFC: Loan assets securitised by NBFCs jump 43 pc to Rs 1.25 lakh crore last fiscal: Report - The Economic Times (indiatimes.com) dated 18th April, 2022; Accessed on 27.07.2022

19.8 Pay-Through Securities (PTS)

In a pay-through arrangement, there are broadly three parties involved. They are a seller, an SPV and a board of trustees. The seller (who undertakes the pay through initiative) transfers (sells) the assets to a third party, known as the special purpose vehicle (SPV). The SPV then issues notes that are collateralized by the assets or receivables. The debt issued by the SPV bears interest at a specified rate. Since the SPV is used for affecting a pay through transaction, the SPV should have some equity component in its capital structure. This is because the law in the US does not permit companies to be financed entirely through debt. The investors, who subscribe to the notes issued, may not be very sure of the credibility of SPV. Therefore, the issuer constitutes a trust, managed by a board of trustees for liaison between the investors and the SPV.

19.8.1 Procedures Involved in a Pay-Through Mechanism

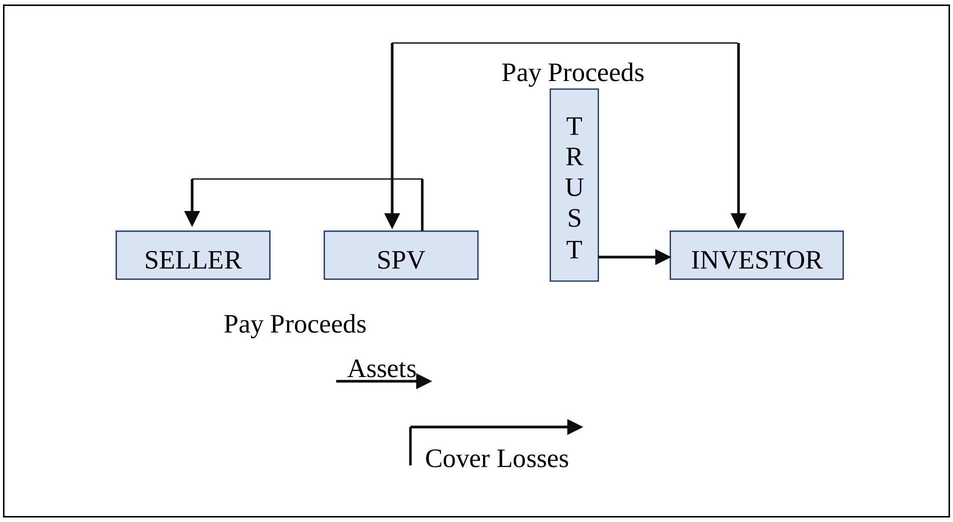
A pay-through structure revolves around a special arrangement known as the special purpose vehicle (SPV), which comes into existence only for the purpose of structuring the deal. The SPV is brought into existence by the issuer himself. The issuer identifies receivables or other assets suitable for securitization, sells those assets to the SPV and simultaneously does credit enhancements. The SPV purchases the issue and issues notes to the investors, which bear a specific rate of interest. The SPV then receives the funds from the investors and pays back to the securitizing company. This way, the liquidity needs of the company are met. Later, when the inflows from the receivable start coming in, the trustees receive those inflows and appropriate them to the investors. To attract more and more investors to participate in this process and to provide a cushion to the investor, the issuer undertakes credit enhancements. Let us now understand what the process of credit enhancement is all about.

Even though credit enhancement is frequently talked about in the context of asset-backed securities, it has been in practice in other forms in different contexts. The practice of personal guarantees, etc., is just the variations of the process under discussion. The credit enhancement provides cushion to the investors of the security by providing over-collateralization or by way of third-party credit enhancements. The guarantor or the credit enhancer provides a guarantee up to the full value of the issue, which makes the issue marketable on this implied protection. Overall, the process of credit enhancement aims to fulfill the objectives of eliminating the credit risk for the investor as much as possible. Broadly, there are two forms of credit enhancement practices; they are Issuer Provided Enhancements and Third-Party Enhancements. The Third-Party Enhancement is further bifurcated into Full Enhancements and Partial Enhancements.

19.8.2 Pay-Through Structure

The pay-through structure is explained in the following Figure 19.2.

Figure 19.2: Pay-through Structure



Source: ICFAI Research Center

19.8.3 Issuer Provided Enhancements

The issuer can provide credit enhancements to the portfolio either by over-collateralization or by way of direct recourse. Either way, the objective is to minimize the risk exposure of the investors. Over-collateralization is the act of providing more collateral than required to meet the obligations. In direct recourse, the company going for the securitization of its assets undertakes to make good all the shortfalls in the cash flow required to service the issue of securitization.

19.8.4 Third-Party Enhancement (Full)

Third-party credit enhancement is good if the third party is of high credit quality. In this case, the debt repayment capacity of the party, who is extending the credit enhancement facility, is evaluated. If the party is found sufficiently creditworthy, the securitization is considered to be fully credit enhanced by a third party.

19.8.5 Third-Party Enhancement (Partial)

As the name suggests, the guarantee given by the third party against the portfolio is less than 100% of the value of the underlying assets. The partial and the full enhancement by the third party are generally provided by the financial institutions. Since the credit quality of the guarantor is different from the credit quality of the assets, it is difficult to ascertain the extent of credit risk reduced due to the enhancement.

Example: ICRA Assigned Rating to PTCs

Shriram Transport Finance Company Ltd. (STFC) had issued Pass-through Certificates (PTCs) under a securitisation transaction. The PTCs were backed by a pool of vehicle loan receivables worth ₹ 1,083.58 crores. ICRA in September 2021 had assigned provisional ratings to these PTCs taking the cash flows from the pool of contracts, STFCs track record in the vehicle loan business and credit enhancement available into consideration.

Source: https://www.icra.in/Rationale/ShowRationaleReport/?Id=106796 dated 29th September, 2021; Accessed on 31st July, 2022

19.9 Hindrances for Securitization in India

Securitization is a new concept in India. The first deal of securitization was made in 1992 between ICICI and Citibank to securitize ICICI’s seller line of credit bills of exchange. The following provides an explanation to this.

Asset-Backed Securitization in India

What do you call the procedure that enables an entity to get money before it is due? Plainly put Securitization of the marvel of finance that gave more money to be famine-stricken entities, securitization is simpler and convenient.

Securitization deals essentially with the breaking of locked-up long-term assets into marketable short-term securities – enabling the company to obtain and recycle its locked money into its business. Though securitization has taken its root more than a decade ago, Indian markets are, as always, oblivious of its advantages.

The success of securitization depends on whether a secondary market can be developed for these instruments. certificate of deposits, commercial papers, participation certificates, etc., have not become very popular due to non-development of an active secondary market for these instruments. Thus, for securitization to provide liquidity, it requires an active secondary market. The following factors are recognized as the main factors that have hindered the development of securitization in India:

i. One of the main impediments in the development of securitization market in India is the levy of stamp duties. As mentioned before, any transfer of asset attracts stamp duty as per the Transfer of Property Act, 1882. Any asset securitization deal will have to pay hefty stamp duties thereby increasing the overall cost of the deal process.

ii. Mortgage securitization is facing a bottleneck in the foreclosure norms that restrict the transfer of property without the intervention of a court of law. This makes the securitization of mortgages difficult.

iii. The guarantor of a loan cannot mortgage his own property in case if receivables are not properly accrued. This inhibits the quality of assets thereby decreasing the quantum of homogenous quality assets for a mortgage-backed securitization.

However, this is possible only if some supportive measures are undertaken like:

i. Legal and legislative changes to make transfer of assets an easy exercise.

ii. Stipulation of stricter capital adequacy norms to take care of risks involved in the process.

iii. Unlimited amount of funds should be allowed to be raised through securitization.

iv. Issue of separate set of guidelines for capital requirements, etc.

To make this concept a success, massive publicity to market it as an alternative instrument to investors and educating investors is also necessary.

19.9.1 Banks Sale of Stressed Assets

Banks have been advised to take suitable measures to address the problem of NPAs that includes internal restructuring of stressed assets, and legislative means of resolving NPAs under various laws like the Insolvency and Bankruptcy Code, 2016.

Asset Quality of SCBs continued to improve steadily through 2021-22, with gross non-performing assets (GNPA) ratio declining from 7.4 per cent in March 2021 to a six-year low of 5.9 per cent in March 2022. RBI evolved a simple and harmonised Prudential Framework for Resolution of Stressed Assets (Prudential Framework) which was issued on June 7, 2019, which enshrined the following fundamental principles:

- Early recognition and reporting of default in respect of large borrowers by banks, FIs and NBFCs.
- Complete discretion to lenders with regard to design and implementation of resolution plans, subject to the specified timeline and independent credit evaluation.
- A system of disincentives in the form of additional provisioning for delay in implementation of resolution plan or initiation of insolvency proceedings.
- Withdrawal of asset classification dispensations on restructuring. Future upgrades to be contingent on a meaningful demonstration of satisfactory performance for a reasonable period.
- For the purpose of restructuring, the definition of ‘financial difficulty’ was aligned with the guidelines issued by the Basel Committee on Banking Supervision; and,
- Signing of inter-creditor agreement (ICA) by all lenders was made mandatory, which will provide for a majority decision making criteria.

The approach of RBI towards resolution of stressed assets outside IBC has been to incentivise timely initiation of resolution efforts; proper recognition of increased credit risk to the lenders on account of the concessions granted in the form of debt recast; and the borrowers are required to demonstrate that the concessions have improved their viability by performing satisfactorily on their debt obligations during a reasonable period subsequent to the debt recast.

In addition, in Budget 2021, NARCL (National Asset Reconstruction Company Limited) was created which will acquire stressed assets worth about ₹ 2 lakh crore from various commercial banks in different phases. Another entity, India Debt Resolution Company Ltd (IDRCL), will then try to sell the stressed assets in the market. PSBs and Public Financial Institutes (FIs) will hold a maximum of 49% stake in IDRCL. The remaining 51% stake will be with private-sector lenders. The NARCL-IDRCL structure is the new bad bank structure.

Banks should lay down an approved policy of sale of stressed financial assets. They should have a clear policy with regard to the valuation of assets proposed to be sold. To ensure that banks' interest is protected, the cost of valuation exercise shall be borne by the bank. The efficacy of their policy should be periodically reviewed and necessary amendment to be made from time to time if needed. Two independent external valuations to be obtained for accounts with exposure greater than ₹ 500 million.

At the beginning of every financial year, the bank shall identify the financial assets beyond a specified value, which are classified as doubtful in their books for sale to SCs/RCs and others with the approval of their Board and invite bids on "e-auction'' platform which will ensure price discovery. Bank should provide adequate time for completion of due diligence by prospective buyers.

Once bids are received, (above the minimum defined threshold), the order of preference to sell the asset shall be as follows: i) The SC/RC that has already acquired the highest significant stake; ii) The original bidder and iii) The highest bidder during the counter bidding process. The sale of assets would not be restricted to Securitization Companies (SCs) and ARCs only and would be made available to other classes of investors such as banks, NBFCs, FIs, etc. If the bank decides not to sell the asset to the winning bidder, bank will be required to make immediate provision on the account.

To create a more transparent framework for the sale of stressed assets, RBI has appointed a six-member panel, headed by Canara Bank Chairman T. N. Manoharan to make the processes align with global best practices. The objective for such an exercise is to assess the possibility of setting up a loan transaction platform for the sale of stressed assets and to standardize the information.

Example: DHFL Bankruptcy - Securitization

Certain types of hindrances in securitisation have come into notice with the resolution of Dewan Housing Finance Company (DHFL) in bankrupt NMFCs during year 2020. The major issue is what happens to the receivables or loans which were securitized and subject to a charge. How the investor who had purchased the loans through securitisation claim to have rights over the receivables in spite of having a pre-existing charge? Another question to be answered is can the investor initiate recovery efforts against loan defaulters in case the original lender was under insolvency proceedings? As the new law, Insolvency and Bankruptcy Code is an evolving law, protection of the rights of the investors of assets under securitisation is to be taken care of.

Source: DHFL bankruptcy raises questions over securitisation - The Hindu BusinessLine dated 17th August, 2020; Accessed on 26.07.2022

19.10 Securitization: India's New Regulatory Landscape[40]

The capital market regulator in India, the Securities Exchange Board of India (SEBI) has come out with the requisite rules and regulations for listing and

[40] Jyotsna T, "Securitization: India's New Regulatory Landscape", Portfolio Organizer, The Icfai University Press, Hyderabad, October 2008.

trading securitized debt instruments in India. These regulations are called the SEBI (Public Offer and Listing of Securitized Debt Instruments Regulations), 2008 (SDI Regulations). Most securitized deals were private and were not allowed to be listed on the stock exchanges as the securitized products did not conform to the definition of ‘security’ according to the Securities Contracts Regulation Act, 1956 (SCRA). However, in the year 2007, SCRA was amended and the definition of `security' was rewritten to include the instruments arising from a debt or receivables issued to investors or any Special Purpose Distinct Entities (SPDEs). This cleared the way for the SEBI to give a clear framework for the listing and trading of securitized products in the Indian stock exchanges.

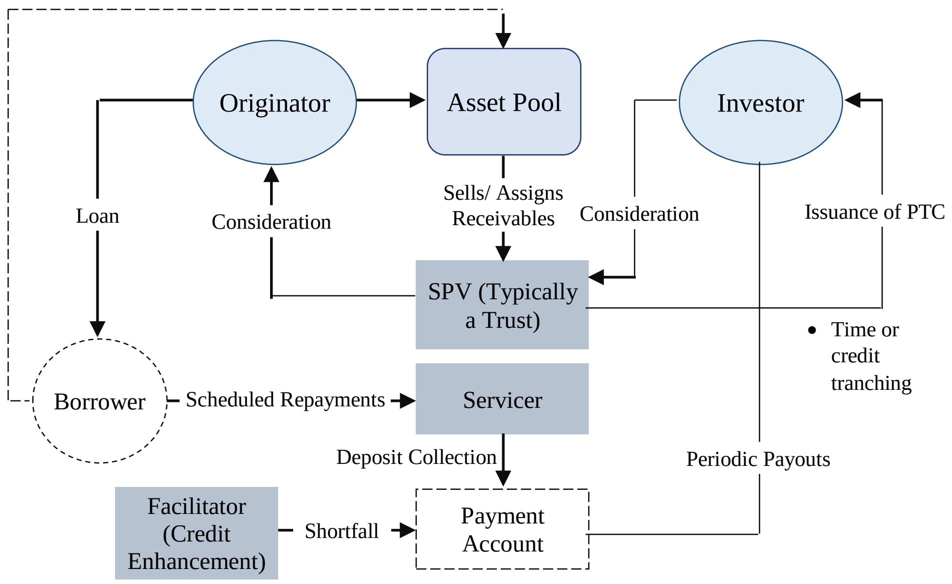
There has been a lot of criticism on the part of SEBI for not creating a vibrant market for securitized debt products in India for quite some time. The US subprime crisis and the global credit crunch have given a tough time to the biggest investment banks of the world giving due credit to the much-acclaimed securitized products. Though India had been resilient to the global financial turbulence, it is high time that the regulators shield the economy from the future possible shocks taking a cue from the global experiences. Perhaps these rules have perfect timing as to their introduction.

Just to touch upon the basics, the RBI in one of its reports defines `securitization' as the process of pooling and repackaging homogenous illiquid financial assets into marketable securities that can be sold to investors.

A securitization transaction usually involves some or all of the following parties:

- The initial owner of the asset, called the originator, who has a loan agreement with the borrowers called the obligors.
- A special purpose vehicle, who issues securities to the investors.
- The investment bankers who structure the whole transaction.
- The rating agencies, who assess credit quality of the instruments and assign a credit rating.
- The credit enhancer, usually a bank, a surety company, or an insurance company, who provides credit support to the investors through a letter of credit, guarantee or other assurance.
- The service provider, usually the originator, who collects payments due on the underlying assets for a fee and pays them over to the security holders.
- The trustee, who acts as an intermediary and deals with the issuer, credit enhancer and the service provider on behalf of the security holders.
- The legal counsel, who aids in the structuring of the transaction.
- The swap counterparty who provides interest rate/currency swap, if needed Figure 19.3 presents a typical securitization structure.

Figure 19.3: A Typical Securitization Deal



Source: https://www.rbi.org.in

The securitized debt enables risk holders to spread their risk over a wide array of investors. For instance, when a bank or a financial institution bundles a pool of assets such as mortgage loans or auto loans and sells them to investors, returns to the investors are in the form of payouts from repayments by the borrowers. Thus, securitization allows banks to take loans off their books by transferring them to the investors. The banks are thus spreading their risk across a wide group of investors. Normally banks need to cover their loans with sufficient capital in order to shield themselves from possible defaults. By transferring their risk to investors, they need not maintain additional capital and in turn can increase their further lending capacity. Barring the 2008 subprime crisis, the world over, banks and investment banks have lauded the concept of securitization.

19.10.1 Crux of the SEBI Guidelines

According to the SEBI, the new rules conform to the market needs, transaction costs, competition policy, the professional expertise of credit rating agencies, disclosures and obligations of the parties involved in the transaction and the interest of investors in such instruments. The SEBI has been very prudent in emphasizing the roles of originator/obligor/sponsor, SPDE or SPV, trustee, service provider, liquidity provider and last but not least, the investors.

When a securitized debt instrument is offered to 50 or more persons, it is a public offer and the SEBI regulations would be entailed. When these instruments are offered privately, the regulations are still valid. The SEBI guidelines define receivables for securitization purpose as those that could result in a cash flow. Accordingly, the eligible assets for the purpose are mortgage loans, non-performing assets, credit card receivables, auto loans, student loans, corporate debt, export receivables, offshore remittances or even inventory receivables.

The instruments should be in dematerialized form and the draft offer document should be filed with the SEBI at least 15 days before opening of the issue.

19.10.2 Clear Distinction between the Originator and the SPDE

The SEBI has clearly spelled out the roles of the originator and the SPDE so as to avoid any conflict of interest and to ensure smooth flow of transactions.

The owner of the asset, i.e., a bank or a financial institution is the originator. As a part of the securitization deal, the originator transfers the cash flows from the assets to the SPDE, which has to be a registered trust. The members of the trust and the trustees are registered with the SEBI as intermediaries and they are responsible for protecting the interests of the investors. The actual securitization deal is entered into between the originator and the trustees. The trustees also sign contracts for the deal on behalf of the investors as well. Thus, they ensure that the cash flows are properly received and distributed. The trust also includes a liquidity provider to correct liquidity shortfalls in the cash flow streams and a credit enhancer to improve the credit of the asset pool.

The SEBI has granted extensive powers to the SPDE by clearly spelling out the manner in which they can acquire receivables and the type of instruments they can issue. The regulations pertaining to the debt securitization are made such that apart from focusing on disclosures they even address various issues relating to transactions. The recent experience of the top-notch investment banks globally with respect to the securitized products could have prompted SEBI to be more cautious in framing the securitization rules for India.

The SEBI has also clearly mandated that in no case the originator shall control the trust/SPDE but must ensure at all times that the assets should maintain the promised quality and the transactions are at arm's length basis. Further, the SEBI had spelled out that the SPDE and the originator should be structured in such a way that even in the case of one’s default the other is unaffected. Also, it is the onus of the originator to ensure that a deal is complete in all respects and the sale is a `True Sale'. The originator is responsible for managing the asset pool collections and distributions to the investors.

19.10.3 Cash Flows Divided into Tranches

The SDPE can slice or pool the cash flows into several tranches of securities. Each tranche of securities can attract different individual ratings varying from investment grade to junk grade. According to the SEBI, the top 20% of the asset pool would receive investment grade, the next 60% would receive a sub-investment grade and the remaining 20% would be rated as junk securities. Investors buying the top 20% of the asset pool are called the senior investors and those buying the 60% of the asset pool are called the subordinate investors.

Investors usually have less appetite for the junk grade cash flows; they would be sold back to the originator so as to avoid defaulting by investors.

This kind of segregation of the cash flows by SEBI allows the trustees of the SDPE to segregate cash flows of different schemes from one another so that the quality of one asset pool does not pollute the cash flows of other pools. The SEBI has also clearly stipulated adequate disclosures and the credit ratings requisite for different pool of assets while offering these instruments to the public. A rating from at least two credit rating agencies is made mandatory by SEBI, which have to be furnished in the public offer documents.

19.10.4 Securitization of Markets Abroad

[41]The global structured finance issuance increased by 43% from $1.1 trillion in 2020 to $ 1.5 trillion in 2021.

Agency Mortgage Backed Securities are a major constituent of the market in 2022 after they witnessed a major increase in 2019-20. Growth in non-agency MBS market was negative in 2021. Securitization was started to create asset-backing or mortgage-backing to risky securities. Such securities are collateralized by money flows from the borrowers. Despite its size, this is an invisible market, as most of the securitized instruments do not trade in the exchanges.

The following are some of the advantages of securitization as seen by financial experts in the US:

i. Salability of illiquid assets

ii. Securitization of any kind of payment flows

iii. Designation of securities to provide for any risk level

iv. Achievement of AAA rating, even for risky and obscure assets

However, the following are the disadvantages as per the same experts:

- During sharp economic contractions, liquidity of securitization may be illusionary
- Securitization can lead to the creation of excessive credit
- Expectations of consumer behavior may not be correct and the cash flows expected may be different

Europe - The total securitization market in Europe stood at EUR 1.24 trillion at the end of Q4 2018, registering an increase of 1.9% YoY and 3.3% QoQ of which Asset-Backed Commercial Paper (ABCP) comprises approximately 100 billion. Multiseller conduits are the largest category of issuers in the ABCP market, particularly from France and Ireland. During the last quarter of 2018, EUR 88.4 billion of securitized products registered a whopping increase of 62.1% from Q3

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[41] https://vinodkothari.com/2022/03/global-securitisation-markets-in-2021-a-robust-year-for-structured-finance/

2018 and an increase of 19.3% from Q4 2017. Of this 40%, amounting to EUR 35.2 billion represents issuance. Overall European structured finance credit performance experienced a modest decline in 2019 in terms of volumes. In 2022, the market witnessed a slowing down of the upward trend with decreasing number of transactions in Q3 of 2022 (278) compared to Q1 of 2022 (300).

Australia - Over the last 25 years, securitization has played an important role in Australia and is a valuable and important product for the Australian economy in facilitating competition in mortgage lending. Of the US$10 trillion of the securitized global debt market, around 85% is in the USA and the rest in Europe and Asia. In Australia, it is $AU120 billion, which is a miniscule. Debt securitization in Australia is used mostly by non-bank lenders. However large banks, regional banks, small banks, credit unions also are in this market. Having said that, Housing credit growth in Australia has slowed and further due to the tightening of regulation standards, there is restricted access to credit for some borrowers, which is affecting the property price in major capital cities and the securitization market as well.

China - The Chinese securitization market makes it the largest market in Asia and the second largest in the world first being the United States and accounts for 4.6 percent of the total debt capital for the Chinese economy. The market registered a growth of over 3.5% YoY. The major products in this market are consumer debt such as residential mortgages and auto loans. Chinese residential mortgage-backed securities issuance registered a record high in 2018, making it the single largest securitization asset class followed by Auto loan asset-backed securities. However, the growth rate may continue to be normal there will be a concern for reduced liquidity, uncertainty from the trade tensions with the U.S, which may pose threat to the performance of some industries. However, it is expected that securitization will continue to remain largely shielded by conservative asset selection and transactions' repayment structures.

The market displayed modest growth with a growth rate of 5% year on year. 2021 marked the China's property crisis and the China Evergrade Group was officially declared default by S&P Global.

Japan - The securitization market in Japan is expected to perform well as per Moody's report. The total securitization amount was ¥4,786.7 billion, which showed an increase of 6.5% YoY while at the same time the number of issues was by 4.6% YoY. In terms of securitization assets, they were leases, consumer loans and shopping credits, sales receivables/commercial bills while the securitization products were trust beneficiary rights and bonds. Although one can expect stable rating performance in 2019, the volatile Japanese economy may hurt the performance of the underlying loan portfolios.

As per an S&P Global Report, ABS and RMBS dominated the structured finance issuance in Japan. It made up for more than 95% of total issuance. Within the

ABS Sector, major asset class was consumer loans. Japan's housing finance agency accounted for one fourth of overall Japanese structured finance issuance in 2021-22.

Basel Committee on Banking Supervision Framework on Capital Charges

In December 2014, the Basel Committee on Banking Supervision published "Revisions to the Securitization Framework".

The new framework aims to make capital requirements more prudent and risk-sensitive, reduce mechanistic reliance of the industry on external credit ratings.

The committee proposed to replace the existing risk-weighting methodologies for securitizations with a simple hierarchy of risk-weighted approaches to determine the capital requirements.

a. Banks having the capacity and supervisory approval may use the Securitization-Internal Risk-Based Approach (IRBA).
b. If banks cannot employ the IRBA, the Securitization-External Ratings-Based Approach (ERBA) has to be applied.
c. If either cannot be used, the Securitization Standardized Approach (SA) needs to be employed.

The risk-weight floor of 15 percent for any securitization tranche is necessary. The IRBA and SA are based on the Simplified Standardized Formula Approach (SSFA). The SSFA does not depend on external ratings, but is based on four main inputs:

(i) Capital charge of the underlying pool
(ii) Tranche thickness
(iii) Credit enhancement
(iv) Supervisory adjustment factor

The level of capital is determined by the supervisory adjustment parameter for a securitization compared to the capital charges that the underlying exposures would attract.

Example: Functioning of NARCL and IDRCL

Setting up of National Asset Reconstruction Company (NARCL) Ltd. is one of the major announcements during the budget of 2021. Along with NARCL India Debt Resolution Company also had been set up. Union Cabinet approved ₹ 30,600 crore of securities receipts.

NARCL is a bad bank in the mould of asset reconstruction company. IDRCL is a service company to manage the assets. It will loop in market professionals and turnaround experts.

Source: NARCL: What are NARCL and IDRCL? How do they work and what is the plan?, BFSI News, ET BFSI (indiatimes.com), dated 17th September, 2021; Accessed on 27.07.2022

Check Your Progress - 2

6. Which one of the following is not a security backed for ABS?
   a. Computer lease receivables
   b. Credit card receivables
   c. Trade receivables
   d. Rent receivables
   e. Automobile trucks and cars
7. Which one of the following is not correct as regards the benefit of securitization?
   a. The loan originators can raise money as soon as they create loans
   b. Securitized debt can be costlier than other forms of funding
   c. Security is of a good quality debt (usually rated AAA)
   d. Securitization enables to take advantage of more profitable investment opportunities
   e. Securitization helps by transforming an illiquid asset on the balance sheet into cash
8. What is the risk to investor due to cross-border securitization transactions?
   a. Credit risk
   b. Collateral deterioration risk
   c. Legal risk
   d. Sovereign risk
   e. Swap counterparty risk
9. Which one of the following features is not correct in the case of a whole loan?
   a. A whole loan sale is without recourse to the seller
   b. The seller may retain the right to service the loans
   c. The seller may also not retain the right of servicing the loan under a whole loan sale
   d. The buyer may take on the loan only on the seller making specific representations and warranties with respect to the loan
   e. A whole loan may be with or without recourse to the seller
10. A mortgage-backed bond is collateralized by mortgages that have a market value of ___________
    a. 90 to 100 percent of the principal amount of the bond
    b. 100 percent of the principal amount of the bond
    c. 50 to 100 percent of the principal amount of the bond
    d. Above 200 percent of the principal amount of the bond
    e. 110 to 200 percent of the principal amount of the bond

Activity 19.2

As an official of New Indian bank, explain diagrammatically how you will do a securitization for a client who is renting 10 flats that he owns in Mulund suburbs of Mumbai.

19.11 Summary

- Securitization is a process by which assets are sold to a special purpose vehicle (SPV) in return for an immediate cash payment. It converts illiquid assets into liquid assets.
- The process of securitization involves 1) Transfer of assets by the originator to a special purpose vehicle (SPV). 2) SPV divides this pool of assets into marketable securities called pay or pass-through certificates and resells it to various investors who can be being a bank, mutual fund or state or central government.
- To obtain an investment credit rating and make the transaction attractive to the investors, some type of credit enhancement procedure is usually necessary.
- Credit rating forms an integral part of the securitization deal. Each rating agency has defined a series of criteria that must be adhered to in order to obtain its designated ratings.
- Asset-backed securities includes a wide range of pooled assets, such as credit card receivables, aircraft leases, home equity loans, etc., whereas it is the only mortgage in the case of MBS.
- There are various risks in securitization such as credit risk, market risk, sovereign risk, collateral deterioration risk, prepayment risk, service performance risk, swap counterparty risk and financial guarantor risk.
- Securitization of mortgages is done to convert underlying longer maturity loans into short-term marketable securities and is called mortgage-backed securities.
- A mortgage-backed bond is a collateralized term-debt offering and is secured by mortgages that have a market value of 110 to 200 percent of the principal amount of the bond.
- Pay-through certificates are those securitized instruments when the seller transfers the assets to an SPV who issues notes that are collateralized by the assets or receivables.

- RBI - to promote long-term resolutions for a large amount of stressed assets in India came out with a new set of guidelines for sale of the stressed assets on September 01, 2016. The broad guidelines on the sale of stressed assets cover the type of assets (Financial) to be sold, the norms and procedure for sale of such assets, valuation procedure to be followed and the delegation of powers of various functionaries.

19.12 Glossary

Asset-Backed Securitization: The traded securities are backed by collaterals which are a pool of assets consisting of heterogeneous assets such as credit card receivables, aircraft leases, home equity loans, automobile loans and leases, equipment leases and exotic assets such as entertainment/intellectual property, mutual fund fees.

Credit Enhancement: Credit enhancement is the process to lower the risk of securities for investors. It is essential to get the required rating from the credit rating agencies for particular investments. There are various types of credit enhancements such as asset-backed securities, mortgage-backed securities, Excess spread, surety bonds, wrapped securities, cash collaterals, over-collateralization, etc.

Doubtful Assets: An asset would be classified as doubtful if it has remained in the substandard category for a period of 12 months.

Loss Assets: As per RBI, "Loss asset is considered uncollectible and of such little value that its continuance as a bankable asset is not warranted, although there may be some salvage or recovery value."

Mortgage-Backed Securities: Mortgage-backed securities are asset-backed securities secured by a mortgage or collection of mortgages that are securitized, or packaged together into a security that investors can buy.

Non-Performing Assets (NPA): A Non-Performing Asset (NPA) is an advance or loan given by a bank or financial institution where the borrower has defaulted or not paid the principal or interest payment and it remained overdue for a period of 90 days. The lender in such cases has to classify NPAs further into substandard, doubtful and loss assets depending on the period of overdue/ default.

Obligor: An Obligor is a legal entity or person who is obliged to provide the benefit to the investor. He is a bond issuer who has to make interest and principal repayment on a debt. The person who received the benefits is the obligee.

Originator: The *originator* is the one who is the owner of the assets that is going to be securitized. A large portfolio of assets is pooled and transferred to a special purpose vehicle.

Securitization: Securitization is defined by RBI as a process by which assets are sold to a bankruptcy remote special purpose vehicle (SPV) in return for an immediate cash payment. The cash flow from the underlying pool of assets is used to service the securities issued by the SPV.

Special Purpose Vehicle (SPV): An SPV is a subsidiary company and is a legal entity with an asset/liability structure. They are formed through limited partnerships, trusts, corporations, limited liability corporations. They are designed to be independent in terms of ownership, management and getting funds. They are formed as protection of a project from operational or insolvency issues.

Substandard Assets: Assets that have remained NPA for a period less than or equal to 12 months.

19.13 Self-Assessment Test

1. Define securitization and discuss the steps in the securitization process.
2. Discuss the various aspects of internal credit enhancements.
3. What is future flow securitization and what are its advantages?
4. What are ABS and MBS? List out the differences between them.
5. Discuss the various benefits of securitization.
6. What are the various risks involved in securitization?

19.14 Suggested Reading/Reference Materials

1. Anthony Saunders, Marcia Millon Cornett, Anshul Jain (2021), Financial Markets and Institutions, 7th edition, Tata McGraw-Hill Education
2. Prasanna Chandra (2020), Fundamentals of Financial M, 7th edition, Tata McGraw-Hill Education.
3. Devie Mohan (2020), The Financial Services Guide to Fintech, 1st edition, Kogan Page Limited.
4. Siddhartha Sankar Saha (2021). Indian Financial System. 2nd edition, Tata McGraw-Hill Education
5. Dr. R. Shanmugham (2020). Financial Services. 2nd edition. Wiley India

19.15 Answers to Check Your Progress Questions

1. **(b) Separate entity was formed exclusively for charting the deal and providing funds to the originator**

   Special purpose vehicle is a separate entity formed exclusively for charting the deal and providing funds to the originator.

2. (e) Future sales in a supermarket

Future sales of a supermarket cannot be securitized.

3. (c) Regulator

Regulator is not a party to a securitization transaction.

4. (b) Credit facility from third party lender

Credit enhancement procedure is necessary to cover the possibility that the loan portfolio will generate an insufficient payment to fund payments of notes interest when due, which needs some form of liquidity support through a credit facility from a third-party lender.

5. (a) It is backed by the assets that are traceable

In the case of ABS, the assets are backed by movable securities that may not be easily traceable.

6. (e) Automobile trucks and cars

Asset-backed securities include receivables and not assets parse. It is the financial claims on the asset.

7. (b) Securitized debt can be costlier than other forms of funding

Normally, securitized debt can be cheaper than other forms of funding as the securities enjoy a wider investor base and certain liquidity.

8. (d) Sovereign risk

Sovereign risk is the risk that arises due to the case of cross-border securitization transactions where the assets and investors belong to different countries.

9. (a) A whole loan sale is without recourse to the seller

A whole loan sale may be with recourse or without recourse to the seller.

10. (e) 110 to 200 percent of the principal amount of the bond

A mortgage-backed bond is a collateralized term-debt offering and is secured by mortgages that have a market value of 110 to 200 percent of the principal amount of the bond.

Financial Services

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