Role of RBI in monitoring the market
CHAPTER - VI
ROLE OF RBI IN MONITORING THE MARKET

The growth in housing finance rate has been so fast that the Reserve Bank of India has had three meetings with banks where it has cautioned them about their lending practices and has asked banks to clarify the differences between fixed rate and variable rates of interest.

Analysts are worried about two aspects

1) Most players are entering into an entirely new territory as far as size and speed of portfolio growth are concerned.
2) Whether the pressure on growth numbers sees a dilution of credit practices.

"The housing loan market is not risk free as is commonly believed" says Suresh Menon, General Manager of HDFC, Mumbai Region. The finance company is able to keep non-performing loans to a minimum, because of their experience over a number of years.

The world over, lending against property is one of the biggest risks that a bank can take. The US suffered one of the biggest crises in the 1980’s, when hundreds of small banks collapsed after they advanced loans backed by land as collateral. As property prices sank, the collateral became worthless. In the early '90s, Japanese banking system faced the same problem. And in the late '90’s, it was the east Asian Tiger
economies where banks that lent to property speculators lost everything as those economies sank head long into recession.

The prevailing situations in India are quite different. Most of the loans have been made to homeowners and not to property speculators. In this case, default risk is kept to the minimum. Loans were made where property prices were low in the late '90s. It gives banks, at least some degree of cushion as far as the value of properties is concerned.

The risks creep in at the approval stage and the way banks approach customers. Many banks, especially private sector ones employ direct sales agents whose only aim is to sell as many loans as possible. There is little incentive for them to verify the bonafide of the customer or make sure whether his papers are in order. This leaves them wide open to fraud "Banks are supposed to go and inspect the property as well as make sure that the documentation is correct", says a Reserve Bank of India Source.

In their aggressiveness to grow their home loan portfolio, banks have substantially reduced the margins, which they demand from homeowners. On an average, banks now finance up to 85 – 90% of the property value or more (excluding stamp duty and registration) though some companies finance some of that too up from just 70% a couple of years ago. This is increasing the possibility of suffering a loss when the property prices fall below that of the loan amount.
Home loan interest rates are among the lowest that banks charge on any type of loan. This result in diversion of funds borrowed for purposes other than the one for which it is borrowed.

The growth has been so aggressive that the systems in banks set up to handle procedures relating to loans simply can not cope with the volumes at present. There are cases, where the refinancier failed to collect the property documents from the previous lender. Customer service on other fronts suffers tremendously too.

The real test will come a year or two down the line. “Most defaults begin to happen only a couple of years after a home loan has been taken”. If the new loan melas go the way the old ones, bankers and financiers will probably lose the roofs over their heads.

Over the last year, however banks have realized that while the demand for housing loan is tremendous, there is no substitute for prudent lending policies. RBI has sounded several warnings to banks directing them to exercise caution in lending for housing finance.

**Suggested measures**

1. Complete haul up of the legal system governing various aspects of real estate as the laws date back to the 19\textsuperscript{th} century. Since tenants continue to pay the same rent fixed in 1947, discouraged fresh investment in housing for rental purposes.

2.
3. Reduce stamp duties Otherwise; it will result in massive understatement of the proceeds of a sale.

4. More avenues like pension and provident funds be opened up to facilitate long term finance for the housing by housing finance companies.

5. Computerize land records.

Risk Management in Banks for improved corporate Governance

The Indian banking industry is going through a transformation process in its transitional journey from the era of protected confines of socialistic rhetoric to the tough world of market economy. Banks are expanding their operations, entering new markets and trading in new asset types. The changes in financial systems, products and structures have created new opportunities along with new risks.

Says Walter Wriston – Ex – CEO of Citibank.

The banking industry has been able to report record earnings in recent times, despite subdued economic growth riding on the back of low interest rate regime followed by the Reserve Bank of India and consequent impact on treasury income. But such favorable conditions are too good to last forever.

Fragility of banks and interconnection between them make the system, vulnerable to failure, which through contagious effects crodes public confidence and prompts the spectre of massive ‘Runs’. High
gearing ratio and asset liability mismatch act as catalysts to precipitate the crisis. The costs of such systemic shocks are manifold and the entire nation has to pay dearly for it, in the form of bail out packages.

Protection of depositors and safeguarding the integrity and soundness of the system through the prevention of bank failure is insisted upon by Basel II capital adequacy norm by the Bank for International settlements. The Basel II establishes a direct link between bank’s capital and its ability to manage risks through prescribing risk weighted capital requirements.

Corporate Governance is aiming at risk containment by proper risk assessment and early warning systems and prompt corrective action as earlier the detection, the lesser the costs.


Risk Management is the systematic process for identifying the risks the business faces; evaluating them according to the likelihood of their occurring and the damages that ensue, deciding whether to bear, avoid, control or insure against them (or any combination of these four); allocating responsibility for dealing with them; ensuring that the process actually works; and reporting material problems as quickly as possible to the right level.
Owing to diversity in the size of balance sheets and risk appetite among banks, there can be “no one-size-fit-all” risk management system. Each institution must design and develop its own system to suit its specific needs depending upon the size and complexity of business, risk philosophy, market perception and level of capital.
Figure – 1
Risk Management Structure

Board of Directors
Decides Overall risk Management

Risk Management Committee Board level committee
including CEO and head of credit market and
operational risk management committees decide
policies and strategies for integrated risk management.

Credit Risk
Management

Asset Liability
Management

Operational
Risk
Credit risk is the most fundamental of all the risks faced by a bank. The lender always faces the risk of counter party not repaying the loan or not making due payment in time. Banks are in the business of taking credit risk in exchange for a certain return above the risk free rate. Some of the traditional measures of credit risk are:

- Ratio of non-performing advances to total advances
- Ratio of loan losses to bad debt reserves
- Ratio of loss provisions to impaired credit
- Ratio of loan losses to capital and reserves
- Ratio of loan loss provisions to total income etc.

More advanced credit risk management requires quantification of

- Probability of default
- Exposure at default
- Loss given default
- Maturity or tenor of the exposure
- Level of diversification of the loan portfolio

**Correlation between credit risk and other risks**

Credit policy of a bank generally prescribes the criteria on which the bank extends credit and provides for the standards for credit risk management including:

a. Risk Selection: Establishment of a formal credit appraisal and approving system with clearly defined delegation of power.
b. Risk Limitation: Setting prudential exposure limits for maximum amount that can be lent to individual / borrower group / connected parties.

c. Risk Diversification: Spreading the credit portfolio over.
FIGURE – 2
Credit Risk Management Structure

Credit Risk Management Committee (Headed by CEO / CMD / ED comprising leads of credit, treasury, credit risk management and chief economist) Formulates clear policies and standards for credit risk management.

Head of credit Risk

Risk Planning
Cell.: Defining procedures.
Design of Credit process

Risk Assessment
and monitoring cell Sector review credit rating
Review of credit proposals (new)
Asset review (existing)

Risk Analysis
credit risk and pricing models
design and maintenance
portfolio analysis and reporting

Credit Risk system
Integration of Risk procedure
design and dev of support system

Core staff skills Credit operations

Core staff skills Sector expertise credit appraisal

Core staff skills Quantitative techniques
Basic exposure to credit

Core staff skills IT system skills Basic exposure credit
FIGURE – 3
Market Risk Management Structure

Asset Liability Management Committee (ALCO)
(Headed by CEO / CMD / ED including the chiefs of investment, credit resources) Ensures adherence to the limits, monitoring and control, articulating interest rate view / funding transfer pricing policy etc.

ALM Support Group
Consisting of operating staff responsible for analyzing, monitoring and reporting the

Middle Office
Consisting of experts in market risk management economists, statistics and general banker
In order to help various stakeholders to monitor the value of residential property prices, the National Housing Bank (NHB) had launched a project wherein it would index the residential property prices. The project called NHB RESIDEX envisaged computing the indices for selected major cities – Greater Mumbai, Kolkata, Delhi, Chennai, Bangalore, Hyderabd, Ahmedabad, Kanpur, Jaipur and Patna. “These indices would be useful for various stakeholders like individual builders, housing finance industry as well as Government and Policy makers”.

### Figure - 4

**Risk Matrix**

<table>
<thead>
<tr>
<th>Risk of Quality Management</th>
<th>Weak Quality of Management</th>
<th>Satisfactory</th>
<th>Strong</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Moderate</td>
<td>High</td>
<td>Highest</td>
</tr>
<tr>
<td></td>
<td>Low</td>
<td>Moderate</td>
<td>High</td>
</tr>
<tr>
<td>Lowest</td>
<td>Low</td>
<td>Moderate</td>
<td>High</td>
</tr>
</tbody>
</table>

Source: Comptroller of Currency Administrator of National Banks, USA.
Basel committee II has cautioned that over exposure to housing and other retail sectors could create bubbles in the market as a consequence of over spending by the salaried class followed by defaults and cautioned the banks against limitless lending. A large number of Indian households are over leveraged and while their salaries are not inflation linked, home and other loans which are on a floating basis are inflation linked. U.K and U.S experienced this in 1980s the negative effect was exacerbated by a sharp fall in the real estate prices. The demand for housing dropped as interest rates rose and defaults in the previous loans also shot up. According to a study conducted by Credit Rating Information Services of India Limited (CRISIL) of variable home loan market (ET 24.11.04) close to 90% of loans are under variable rate and 150-200bps rise in interest rate will adversely affect the repayment capacity of the borrowers who opted for tenure of 15 years and above. If interest rises by 200bps or more as about one fourth of the borrowers who are already using more than 50% of their salary to repay loans will fail to repay resulting in the increase of Non performing loans.

Credit Risk Management

Retail loans are basically consumption loans. They are largely unsecured (excepting housing loans). They run the risk of becoming bad as repayment depends upon the discretion of the customer with no
security in the hands of the bank to fall back and time consuming and prohibitive legal process.

The process of credit risk management necessitates the following to be addressed immediately.

- Deficiency in lending policy
- Incorrect product structuring
- In adequate loan screening and documentation.
- In effective post sanction monitoring / following.
- Weak collection / recovery mechanism.

In addition to the above, the bankers should strictly adhere to the five Cs of credit (i.e.) character, capacity, credit, covenants and collateral. The RBI has advised banks as a risk mitigating measure to keep the exposure of unsecured loans / guarantees within the limits (20% of Gross Bank credit GBC).

Increase provisioning of unsecured NPA under sub standard category from 10% to 20% increase risk weight on home loans from 50% to 75% and personal and consumer loan from 100% to 125%.

Further National Housing Bank is promoting a separate company as Mortgage Guarantee Corporation (MGC) to guarantee payment of principal and interest of housing loans to mitigate default risk. NHB is fixing the Housing Index which will help the promoters in various cities to know the real estate value correctly.
Concentration Risk

The retail loan as a percentage of Gross Bank Credit now constitutes 21% and is largely concentrated in corporation and metro centres. Banks are aggressively seen increasing their lending not only to the corporate but also to other sectors like agriculture. Banks are taking steps to diversify retail loans in rural and semi-urban are as to leverage their strength of semi-urban and rural branches where opportunities are more and competition is less.

Interest Rate Risk

In the past two-three years, banks have built up housing loan portfolio which carries 7.5% to 9.5% interest. Since 10% to 15% of these loans are on fixed rate basis, any increase in interest rates may cause loss to banks. In order to avoid this banks are introducing “force majeure” clause in the house loan agreement to reset interest rate in case of extreme volatility in interest rates. Since housing loans are for a long tenure of 15 to 25 years causing asset / liability mismatch, interest risk management is very important.

Operational Risk

Fraud / Forgery in retail loan are on the rise. The competition in retail loan segment is very fierce forcing the retail managers to show good performance. The retail is volume driven business. Genuine mistakes are accepted but misuse of authority by the retail managers need to be stopped. Only officers of proven intelligence and integrity
are selected and assigned this responsibility. The establishment of CIBIL, Credit Information Bureau of India Limited which has developed data base of credit housing / report of the borrowers, will provide the right information to the bankers in taking the right lending decision.

Monitoring / Follow up

99% of defaults happen in the first six months. Monitor the loan for first six months closely and you will know if the person is a fraud or not says M.D. Cholamandalam Investment and Finance Company.

The Manager should take timely steps for issuing demand notice, reminders and Inspectional insurance of assets. As soon as the first instance of default is noticed the manager should contact the borrower (employer, where salary tie up is held) to recover overdue installments.

Present PDCs on due date without fail. Initiate legal action immediately on dishonor of cheques as per NI Act (Negotiable instruments Act). Dishonored cheques should not be represented. Borrower should be asked to deposit the installment in cash, when it turns to NPA. Immediate action for seizure and sale of assets should be taken under the provision of the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act 2002.
## Fraud in Housing Loan (with ref to borrowers)

<table>
<thead>
<tr>
<th>Year</th>
<th>Number of Accounts</th>
<th>Amount in crores</th>
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</thead>
<tbody>
<tr>
<td>2002-03</td>
<td>236</td>
<td>28</td>
</tr>
<tr>
<td>2003-04</td>
<td>456</td>
<td>70</td>
</tr>
<tr>
<td>2004-05</td>
<td>380</td>
<td>50</td>
</tr>
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</table>
Preventive Vigilance

Of late, fraud and forgeries are on the rise. Even in the housing loan segment where bankers’ position is secured, there are instances of multiple financing against false title deeds and impersonalisation. The fabrication of income documents, balance sheet, misuse of loan in connivance with builders / dealers are common modus operandi to defraud banks.

Preventive vigilance helps banks to put in place the system of interval control and to create alertness, foresightedness and a sense of responsibility among employees for observing systems and procedures meticulously.

The retail loan market in India is in the nascent stage and it has contributed significantly in credit growth of the banks in the past few years. It has also fuelled economic growth. Assets impairment in retail loans in India so far, is much less than the other sectors and there is no systemic finance bubble as such.

As Indian banks are not having previous experience in retail lending, they were cautioned and asked to put in place the required risk management system. Any over reaction to stop retail credit will cost the banks as well as the economy dearly. There is a need to pull out weed and not dig up the garden.

Some of the deficiencies noted in the lending policies are.

(i) Incorrect product structure
(ii) Incorrect lending policies.
(iii) Inadequate loan documentation.
(iv) Deficiencies in credit appraisal.
(v) Absence of post sanctions surveillance and monitoring.
(vi) Inadequate risk pricing.
(vii) Inadequate defined lending limits.
(viii) Weak collection strategy.

**HR Side**

Banks should be prepared to be collaborative, supportive and nurturing towards their people. At the same time, they should be more exacting. Every talent management strategy will have to be the right mix of push factors such as motivation, recognition, career progression, capacity building and drawing out plans and pull factors higher pay, better benefits and heftier perks. Misalignment of mutual expectations, person job mismatch, perception of poor career advancement prospects and work life imbalances could be huge setbacks. The monetary and psychological needs of talent are in a melting pot today. Public sector banks could use this ambiguity as a source of opportunity. Effective recruitment in the midst of competing environment for talent search where information technology media, entertainment are the main competitors. Bank should adopt effective retention strategy also.
HOME LOANS

The Govt of Maharashtra has informed RBI that housing loans advanced by the top two home loan providers, HDFC and ICICI Bank are unsecured loans. This conclusion has been reached on the basis that adequate stamp duty has not been paid by these institutions on agreements between borrowers and banks for housing loans.

Stamp duty is a tax, on documents and not on the underlying transaction. It is legally permissible for a person to enter into a transaction without executing document.

If such a transaction takes place without a document, there is no liability to pay stamp duty. Under the provision of sec58 (f) of the Transfer of property Act, 1882 a mortgage by deposit of title deed can be created to secure the payment of money advanced or to be advanced by way of a loan in Calcutta, Madras and Bombay and other towns notified by the state Government, by a simple act of deposit of title deeds. Under the provision of the Transfer for property Act it is not necessary to execute any written document for creation of mortgage by deposit of title deeds.

In Maharashtra, if writing is recorded related to the deposit of title deeds such writing is subject to stamp duty @ 0.5% subject to a maximum of Rs. 10 Lakh. It, however, needs to be emphasized that this duty of 0.5% is payable provided there is a writing relating to the deposit
of title deeds. Imposition of such duty in no way makes it obligatory on
the lending institutions to record a writing or any document.

It is legally permissible to give a loan against a security by
mortgage, by deposit of title deeds without recording any writing as is
being done by HDFC & ICICI Bank. This arrangement can be enforced
in court in the event of default, as a mortgage by deposit of title deeds.
Such a mortgage is not illegal on the ground that the stamp duty is not
paid.

Lending institutions have a practice of obtaining a separate loan
agreement regarding the terms and conditions of the loan including the
equated monthly installments payable. It is not relating to deposit of title
deeds and can therefore be stamped as an agreement, legal, valid and
enforce able in law.

State Govts. which levy a heavy stamp duty on agreements as a
source of revenue, need to appreciate if the rates of stamp duty are
reduced to a nominal level, compliance will substantially improve.

TN has reduced the stamp duty on agreement relating to deposit of
title deeds to a maximum of Rs.5000/- which is Rs.10 Lakh in
Maharashtra. All banks and financial institutions pay stamp duty in
Tamil Nadu by recording a writing relating to deposit of title deeds and
getting it registered.

1. The long-term nature of residential mortgage lending.
2. How such long-term loans are funded and priced.
3. What is the proportion of fixed rate & floating rate loans in the total loan book.
4. What are the risk mitigation products available in the market (risks being maturity mis matching and the resultant interest rate risk)
5. What are the obstacles to the utilization / development of such risk management products could be.
6. What is the macro economic and monetary policy implication of different patterns of mortgage loans funding & pricing could be.

Findings:

(i) Proportion of Fixed rate & Floating rate not available.
(ii) Pricing mechanism ambiguous.
(iii) Floating rate loan currently in the market is generally not priced.

It is doubtful at the current stage of development of residential mortgages industry in India. There is enough information available on prepayments in general. inexorable (i.e.) relentless build up of housing loan assets continues.

Downtrend in Indian interest rates in the past 3 to 4 years is one among the factors, which offer a market benchmark but affect bank’s own lending rates. Benchmark rate is wholesale money market rates on the lines of the International London Interbank offered rate (LIBOR). It is still to develop fully in India.
There is very little floating rate funding on the liability side of the Indian banks. Fixed rate deposits dominate and these are shorter in tenor relative to the maturity of the mortgage assets they finance.

Interest rate risk management products such as Interest rate swaps are still to gain widespread acceptance in the market. No depth and liquidity beyond five years, mortgage run for fifteen years or longer encouraged the build up of the maturity mismatches in bank balance sheets. To be sure, it is quite possible that Indian Interest rates continue to be soft in future also.

But these challenges seem to be getting addressed if Budget 2005’ reference to Over The Counter interest rate derivatives and mortgages backed debt is any indication.

Housing activity has been witnessing a major boom in the recent past, mainly due to a continuous period of low interest rates. The trend of low interest rates has been reversed only recently, but this may not pull back the demand for housing activity. According to the Price Water house Coopers, the urban housing sector in India will require investments worth $125 billion over the next five year period.

Real estate investment in India is mainly for residential purposes. There are a few big developers in the real estate sector. No high investment not in return, is the only difference between investment in real estate and other investments. It gives return in the form of rent and capital gains.
Beyond the reach of retail investor for many reasons

1. Huge initial investment sale can be a real problem resulting in distress sale.
2. Concentration risks when that particular area experiences a down turn due to host of reasons like famine, floods, lack of economic activity etc.

REMFs can buy, develop, manage and sell real estate assets. They can also invest in shares and / or bonds of companies involved in real estate / mortgage backed securities.

Real estate investment is more complex because

1. It combines sociology, geography, demography, architecture and political forces along with the dynamics of fundamental economic trends complex financing problems, the perils of illiquidity and subtle valuation considerations.

Since real estate market is characterized by relative lack of illiquidity, large purchase size and high transaction cost, the low transparency of real estate market place leads to asymmetric information.

It will generate a return of 10 – 12% over a five year term.

REFERENCES
1 Professional Banker, July 2005 page 46.
2 Real Estate Mutual Funds