Prudential Regulation of Housing Finance in India 1995 – 2011

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1. Summary

There are two distinctly identifiable sub-periods in the history of prudential regulation for housing finance in India between 1995 and 2011. From 1995 to 2001, the regime only comprised numerical restrictions (in the form of leverage restrictions, or explicit interest rate caps on deposits) on borrowing and lending for housing finance. Between 2001 and the present, in addition to these numerical restrictions, prudential regulation took the form outlined in Basel II, with risk weights being the primary instrument of regulatory policy. In this period, risk weights specifically for housing assets were introduced, and frequently modified. As these broader changes occurred, a system of priority sector lending norms remained in place through the entire period to target lending towards sectors designated by the government as socially important. Moreover, an interest subsidy (or subvention) scheme for small loans was in place towards the end of the period under consideration.

Two regulators operated during this period, namely the Reserve Bank of India (RBI) (who regulate bank lending to housing) and the National Housing Bank (NHB) (responsible for housing finance companies, or HFCs). The table below summarizes the regulations in place across the two sub-periods and regulators:

		1995 – 2001		2001 – till date	
		Bank	HFC	Bank	HFC
RBI	Quantity regulation	1. Priority Sector Lending targets 2. Overall leverage restrictions (not specifically for housing)		1. Priority Sector Lending targets 2. Overall leverage restrictions 3. Risk weights (specifically for housing)	
	Price regulation			1. Interest rate subventions for small loans. (2009 to present)	
NHB	Quantity regulation		1. Overall leverage restrictions (as multiple of net owned funds)		1. Overall leverage restrictions (as multiple of net owned funds). 2. Risk weights for specific sizes of loans
	Price Regulation		1. Interest rate ceiling on public deposits (as percent per annum).		1. Interest rate ceiling on public deposits (as percent per annum). 2. Interest rate subventions for small loans. (2009 to present)

2. Period 1: 1995 – 2001

This period saw the phased introduction of a risk asset ratio system for banks, in line with the Basel – I recommendations of 1988. Restrictions on specific loan sizes, loan tenure, and subsidies in the rates of interest were a major part of the governing framework for this period, across both banks and housing finance companies.

2.1. Bank regulation

The RBI introduced a risk asset ratio system for banks in India in April 1992 in line with the Basel–I accord recommendations of 1988. Under this system, balance sheet assets, non-funded items and other off-balance sheet exposures were assigned risk weights as prescribed by the Narasimham Committee (1991), but seem to have barely changed over this early period for any assets, see Table 1.[2] Under this regime, the risk weight for housing finance was a constant 100%, as housing finance was categorized as "Other advances" under the sub-heading 'real estate and other investments'.

Banks were expected to maintain unimpaired minimum capital funds as a percentage of aggregated risk-weighted assets on their balance sheets. Indian banks with branches abroad were expected to achieve the norm of 8 per cent before March 31, 1994. Foreign banks in India were asked to comply before March 31, 1993. Other banks with branches only in India were expected to achieve this target by March 31, 1996, with an intermediate target of 4 per cent by 1993.[3] Compliance with this requirement seems to have been the predominant concern throughout this decade.[4]

2.2. Housing finance company regulation

The National Housing Bank (NHB) regulates Housing Finance Companies (HFCs) in India. It is a wholly owned subsidiary of the RBI, and propagates norms that apply to all registered housing finance companies.[5] HFCs in India can be sub-classified into deposit–taking and non–deposit taking institutions. Deposit-taking HFCs must currently comply with the following rules: -

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[2] Note that many loans to housing (some types of which were defined as priority sector lending only after 1998) were guaranteed either by the Government of India, or State governments. The broader point here is that in a highly nationalized banking sector, loans are implicitly backed by the taxpayer. For example, the state of Andhra Pradesh established the State Housing Corporation Limited (APSHCL) in 1979 to "formulate, promoter and execute" housing schemes for weaker sections of society. Loans under the scheme were completely guaranteed by the Government of Andhra Pradesh. See *Housing for the Poor in India*, CGG Working Paper 4/2003. Accessed at: http://goo.gl/Plmxr on: Dec 21, 2011.

[3] *Report on Trend and Progress of Banking India: 1991-92,* Reserve Bank of India, p.54 read with RBI Circular No. DBOD.No.BP.BC.129/21.04043-92 titled *Income Recognition, Asset Classification, Provisioning and Other Related Matters*, issued on 27 April, 1992.

[4] The provisioning requirements on non-performing assets (NPAs) did not change between 1995 and 2000, in any of the categories, for large loans. However, small loans, less than Rs. 25,000 witnessed a rise in these requirements from 7.5% in 1994-95 to 10% in 1995-96 and another hike to 15% in 1996-97.

[5] The Housing Finance Companies (NHB) Directions (Herein after NHB Directions,), 2010, I (1) 2.

1. No HFC can accept / renew public deposits unless it has an investment grade rating for fixed deposits on a yearly basis.[6]
2. The ceiling on public deposits stands at some stated multiple (currently five times) of the HFCs' net owned funds (NOF).[7]
3. No HFC can accept / renew deposits repayable on demand unless the maturity of the deposit is more than 12 months[8] and less than 84 months.[9]
4. An HFC must comply with interest rate regulation on such deposits as prescribed by the NHB.[10]

Prudential norms (such as risk weights) that the RBI imposes on banks have also been imposed on HFCs, historically with a lag that has been shrinking over time.[11] The NHB Directions in 1989, a year after the establishment of the regulatory body, do not explicitly state a framework for prudential regulation.[12] However, until September 1997, the main instruments of prudential regulation seem to have been the interest rate ceiling on deposits with HFCs (see Table 3), as well as leverage restrictions on aggregate borrowings by HFCs (Table 4).

2.2.1. September 1997 asset management framework

From September 1997 onwards, HFCs were expected to maintain a certain percentage of assets in specified instruments. At least five per cent was expected to be placed on deposit with NHB, as a subscription to NHB bonds, or as a deposit with a scheduled commercial bank. Furthermore, no less than five additional percent of assets were required to be invested in "unencumbered approved securities".[13] The NHB published a set of these "unencumbered approved securities". Over and above such requirements, HFCs were required to hold a reserve fund of not less than twenty per cent of their net profits per year before dividend declarations.[14] Compliance with these requirements was to be reported to NHB daily. Failure to comply attracted a penalty of three per cent over and above the bank rate.

In 1999, the RBI issued directives to banks differentiating Non-Bank Financial Companies (NBFCs) registered with the RBI from those not so registered (such as HFCs). Banks were restricted in their lending to registered NBFCs, whereas no such restriction prevailed on lending to HFCs.

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[6] *Ibid*, 2010. II (3) 1 (i).
[7] *Ibid*, 2010. II (3) 1(ii). NHB Directions, 2010 also defines NOF in I (2u): " [']net owned fund['] means net owned fund as defined under section 29A of the National Housing Bank Act, 1987 including paid up preference shares which are compulsorily convertible into equity capital."
[8] The minimum maturity period was reduced from 24 to 12 by way of an amendment on 14 December, 1993. See: http://www.nhb.org.in/Regulation/Dir-5/Dir.5(Eng).pdf Accessed on: 23 Dec 2011.
[9] *Ibid* 2010, II, 4(a,b).
[10] *Ibid* 2010, II, 11(1(a)).
[11] *Ibid* 2010, *III* lays the foundation for prudential norms for HFCs. Read with RBI Circulars and Notifications (as done later in this analysis), they do not look different except for its timing.
[12] *Ibid,* 1989. Accessed at: http://www.nhb.org.in/Regulation/Dir-1/Dir.1,1989.pdf on Dec 23, 2011.
[13] *Ibid*, 1997 I (3)(11)
[14] *Ibid*, 1997 (3) 11(A,B).

3. Period 2: 2001 – till date

Explicit risk weights for housing loans of different sizes were introduced during this period for banks and housing finance companies, an important addition to the previously prevailing framework.

3.1. Bank regulation

The second Narasimham Committee in 1998[15] recommended several measures to strengthen the capital adequacy framework. During this period, RBI first considered prudential norms set by way of exposure limits to "sectors particularly sensitive to asset price fluctuations such as stock markets and real estate".[16] [17] While risk-weights on sectors came into existence much later, the powers to set them were vested with the RBI in February 1999 by way of a circular.[18]

Another important recommendation of this committee was: "The risk weight for a Government guaranteed advance should be the same as for other advances. To ensure that banks do not suddenly face difficulties in meeting the capital adequacy requirement, the new prescription on risk weight for Government guaranteed advances should be made prospective from the time the new prescription is put in place."[19] Consequently, a March 31, 2000 circular by the RBI brought into force such a change.[20]

A few other notable changes were introduced in the mid-term review of monetary and credit policy by the RBI in 1999.[21] The minimum capital to risk ratio was raised from 8 per cent to 9 per cent effective from March 2000. As mentioned above, advances guaranteed by the government were treated on par with other advances. Importantly, the time period for classifying debt as doubtful was shortened to the international standard of 90 days from 180 days.

3.2. Housing finance company regulation

In December 2001, the NHB Directions signaled a new chapter for prudential norms for HFCs.[22] [23] These directives were very similar in structure and implications to those issued by

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[15] *Committee on Banking Sector Reforms*, 1998. Hereinafter Narasimham Committee–II.
[16] *Committee on Banking Sector Reforms (Narasimham Committee – II) – Action Taken on the Recommendations,* October 2001. Accessed at: http://goo.gl/O2z6S. on Dec 22, 2011.
[17] Narasimham Committee – II. Chapter 3, Paragraph 3.40
[18] RBI Circular: DBOD.No.BP.BC.9/21.04.018/99 dated 10.02.99
[19] Narasimham Committee – II, Chapter 3, Paragraph 3.12
[20] RBI Circular: DBOD.NO.BP.BC.103/21.01.002/98 dated 31.10.98
[21] RBI Midterm review of Monetary and Credit Policy (MMCP), 1998-99. Accessed at: http://www.rbi.org.in/scripts/BS_ViewMonetaryCreditPolicy.aspx?Id=1 on Dec 23, 2011.
[22] RBI Circular DOS.FID.No.17 / 01.02.00/96-97 dated June 1997 set forth credit exposure norms for all banks in India. A consequent clarification was issued in August 2001 vide circular DBS.FID.No.C-3/01.02.00/ 2001-02 that these were applicable to refinancing institutions as well.
[23] NHB Directions, 2001, III(28)(1)(i,ii,iii) accessed at http://www.nhb.org.in/Regulation/Dir.1(Eng).pdf on Dec 23, 2011.

the RBI to banks between the years 1999 and 2001. The income recognition framework, classification of income from investments, accounting standards, asset classification (standard, sub-standard, doubtful and loss assets), provisioning requirements for NPAs and other such familiar sub-parts of the prudential regulatory framework were all very similar to those for banks.[24]

While up until 2001, there were explicit restrictions on the extent of borrowing HFCs could undertake, after this period, capital adequacy requirements were brought in. Every HFC was mandated to maintain a minimum capital ratio of 10 per cent on or before March 31 2001 and 12 per cent on or before March 31, 2002 of aggregate risk weighted assets.[25] Risk weights were further defined in the NHB Directives in 2001, and are shown in Table 5, which summarizes the changes in the regulations since 2001.

Furthermore, the NHB mandated a minimum holding of liquid assets. These were defined similarly to those in its earlier initial asset management framework. HFCs were expected to maintain no less than 6 per cent of public deposits (on a daily basis) in unencumbered approved securities. 12.5 per cent of public deposits were mandated either as deposits in a scheduled commercial bank, or as deposits at the NHB by way of bond subscriptions.[26]

Another change at this time was to make entry into housing finance more difficult. The RBI raised the minimum NOF to commence business for NBFCs from Rs. 2.5 million to Rs. 20 million. Consequently, NHB raised the bar to comply with the RBI regulations. The RBI issued the notification in April 1999 and the NHB issued equivalent directives only in January 2002.[27] [28] [29]

3.3. Subvention schemes

Various interest-rate subvention schemes were put in place in 2009 to support the cause of small loans. The first offers a 1% interest-rate subvention on the first 12 months of qualifying loans (smaller than a certain threshold size, in the first instance, up to Rs. 10 lakhs, currently

[24] HFCs cannot lend more than 15 per cent of its fund to any single borrower and 25 per cent of its fund to any group of borrowers. Furthermore, HFCs cannot invest in shares of any one company in excess of 15 per cent of its funds, and shares in a single group of companies exceeding 25 per cent of its owned funds. It cannot lend and invest (loans and investment) exceeding 25 per cent of its funds to a single party and 40 per cent to a single group of parties. See NHB Directions, 2001, III read with RBI Master Circular DBOD No. BP.BC/ 20 / 21.04.048 / 2001-2002 accessed at http://www.rbi.org.in/scripts/BS_ViewMasCirculardetails.aspx?Id=449&Mode=0 on Dec 23, 2011.

[25] *Ibid,* 2001, III(26)(1). Accessed at http://www.nhb.org.in/Regulation/Dir.1(Eng).pdf on December 23, 2011.

[26] NHB Circular No. NHB.HFC.LA-1 / CMD-2001 accessed at: http://www.nhb.org.in/Regulation/Folder%202/DIR.1,2001/L.A1.pdf on Dec 23, 2011.

[27] NHB Circular BHB.HFC.REG1.1/CMD/2002 accessed at http://www.nhb.org.in/Regulation/gazette%20-%208.1.2002.pdf and read with RBI Circular DNBS (PD) No. CC.10/02.59/98-99 accessed at http://www.rbi.org.in/scripts/NotificationUser.aspx?Id=33&Mode=0 on Dec 23, 2011.

[28] NHB Circular NHB.HFC.DIR.2/CMD/2010, 27(A) accessed at http://www.nhb.org.in/Regulation/DIR.2-CMD-2010.pdf on Dec 23, 2011.

[29] *Ibid*.

raised to Rs. 15 lakhs), for both Scheduled Commercial Banks and Housing Finance Companies. (Please see:
http://www.nhb.org.in/Urban_Housing/Interest_Subvention_Scheme.php).
It is important to note that, from the NHB documentation, "In case account turns NPA [non-performing asset, or default] after 12 months, subsidy would not be returned, as Scheme provides 1% interest subsidy for 12 months only." Moreover, at least two other subsidy schemes were in place through this period. First, on very small urban loans (< Rs. 1 lakh), there is a subsidy of 5% per annum on the principal of the loan, on the entire period of the outstanding loan. (Please see:
http://www.nhb.org.in/Urban_Housing/Interest_Subsidy_Scheme.php). Second, on rural housing loans to weaker sections of society, 100% of the principal amount qualifies for refinancing by the NHB at a set rate of interest (currently 8%) to be repaid between 3 and 7 years by the institution making the loan. (Please see:
http://www.nhb.org.in/Financial/Rural_Housing_Fund.PHP). It is our understanding that other mortgage credit guarantee and refinancing schemes were in place during the early period, and future versions of this document will be updated to describe these schemes as well.

Table 1: Capital Adequacy Risk Weights (1994 – 1999)

	Risk Weights (%)
(A) Funded Assets	
1. Cash, balances with RBI	0
2. Balance with other Banks, Call money	20
…	…
6. Other investments	100
7. Advances	
(i) Loans Guaranteed by Govt. of India and State governments	0
(ii) Loans granted to PSUs of Govt. of India and State governments	0
(iii) All other advances	100

Source: Report on Trend and Progress of Banking in India, various issues & *Capital Adequacy: Some Issues*, Brinda Jagirdar, Economic and Political Weekly, March 1996.

Table 2: Risk weights for housing assets – RBI (2000 – 2011)

	2001*	2002	2004	2005	2006	2007	2008	2010
Overall Capital Adequacy	Provision (%)							
Tier I and II Capital	9	9	9	9	9	9	9	9
Risk-weight categories	Risk weights (%)							
Market-risk	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
Below 7.5 million, LTV < 75%	100	50	75	75	75	75	75	75
Above 7.5 million, LTV < 75%	100	50	75	75	75	75	75	125
Below 7.5 million, LTV > 75%	100	100	100	100	100	100	100	100
Above 7.5 million, LTV > 75%	100	100	100	100	100	100	100	125

* By definition, till 1999, the weights were at 100 per cent as they were deemed as “other loans”.

Source: RBI Notifications, 2000 – 2011, various issues. The hyperlink for each year directs the reader to the underlying notification. Rs. Crores has been converted to Rs. Million in the table.

Table 3: Interest rate ceilings on HFC public deposits (1989 – 2011)

	Interest ceiling (% per annum)
12 Aug, 1989	14
01 Nov, 1995	15
14 Mar, 1997	No ceiling
29 Dec, 2001	14
24 Apr, 2002	12.5
27 Mar, 2003	11
06 Jul, 2007	12.5

Source: NHB Directions, 1989 – 2010, various issues.

The hyperlink for each number directs the reader to the underlying notification.

Table 4: Borrowing as multiple of NOF (1989 – 2011)

	Multiple of NOF for the HFC						
	1989	1993	1997	2000	2001	2001 – 2005	2006
Public Deposits							
Of maturity < 1 year	--	2	2	2	--	--	--
For all HFCs	--	--	--	5	5	5	5
< Rs. 2.5 mn	--	--	--	--	--	--	--
NOF (Firm Size) Buckets							
< Rs. 2.5 mn	--	--	3	3	Migration to Prudential Regulation 2001		
< Rs. 100	10	10	--	--			
> Rs. 2.5 < Rs. 100	--	--	10	10			
> Rs. 100 & < 200	12.5	12.5	12.5	11			
> Rs. 200	15	15	15	12			
All NOF	--	--	--	--	--	--	16

Source: NHB Directions, 1989 – 2010, various issues. The hyperlink for each year directs the reader to the underlying notification. Rs. Crore has been converted to Rs. Million in the table.

Table 5: Risk weights – NHB (2001 – 2011)

	2001	2002	2003	Oct 2005	Dec 2005	2006	2007	2008	2010
Overall Capital Adequacy	Provision (%)								
Tier I and II Capital	10	12	12	12	12	12	12	12	12
Non-Housing loan (standard assets)	--	--	--	--	--	--	0.4	0.4	0.4
Housing loan (Teaser loans)	--	--	--	--	--	--	0.4	2	2
Loan-to-value (LTV) Buckets	Risk weights (%)								
Below 7.5 million, LTV < 75%	75	75	50	75	75	75	75	75	75
Above 7.5 million, LTV < 75%	75	75	50	75	75	75	75	75	125
Below 7.5 million, LTV > 75%	100	100	100	100	100	100	100	100	100
Above 7.5 million, LTV > 75%	100	100	100	100	100	100	100	100	125

Source: NHB Directions, 2001 – 2010, various issues. The hyperlink for each year directs the reader to the underlying notification.