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STATE OF THE LOW-INCOME HOUSING FINANCE MARKET 2018

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About FSG Mumbai

FSG is a mission-driven nonprofit supporting leaders in creating large-scale, lasting social change. Through strategy, evaluation, research, and field work, we help many types of actors—individually and collectively—make progress against the world's toughest problems. As part of our nonprofit mission, FSG directly supports learning communities and initiatives.

The Inclusive Markets team based in Mumbai works on market-based solutions that address development challenges central to the lives of low-income families. The team runs programs, provides thought leadership, and supports action across sectors including affordable housing, education, healthcare, energy, and sanitation.

To learn more, please visit: **http://www.fsg.org.**

Our Work in Urban Low-Income Housing

In 2006, as part of the Monitor Group, Ashish Karamchandani and the Inclusive Markets team began to build a new low-income housing industry that would enable thousands of low-income households to own homes in urban India. They were supported by the National Housing Bank (NHB), the World Bank Group, the Michael & Susan Dell Foundation, the Rockefeller Foundation, and the United Kingdom's Department for International Development (DFID). The genesis of this effort lay in the fact that low-income households, who often lived in rented accommodation, could afford to buy small houses at market prices, but no one was building these houses or financing such customers.

The team started with creating supply. Developers intrinsically knew this demand existed, and the inclusive markets team showed them the profitability of serving this market. A few banks and housing finance companies agreed to fund customers in pilot projects, but it was still difficult to convince developers to create supply. After reaching out to more than 600 developers in three cities, the team finally convinced a smaller developer in Ahmedabad. They helped him select a site, refine layouts and pricing, and even sign up customers in local factories. The 450-unit project was sold out on the day of launch, with a waiting list of 9,000 customers! This led to other developers in Ahmedabad starting low-income projects. The Monitor Inclusive Markets (MIM) team leveraged this success to get similar projects started in other markets and to get a broader range of players involved - from new participants like Jerry Rao, who founded VBHC, to established corporations like the Mahindra Group.

Many urban low-income customers work in the informal sector and have no documentation of income. Hence banks and traditional housing finance companies, which rely on such documentation to assess creditworthiness, were reluctant to serve them. In 2009, the team began promoting a new housing finance model that assessed

applicants' creditworthiness through field-based credit assessment. They incubated Micro Housing Finance Company (MHFC), led by former senior banking executives, to pioneer this model. They also helped an established player, the Muthoot Pappachan Group, start a housing finance company using this model. Soon there were a number of new "Affordable Housing Finance" companies (AHFCs) using this model to serve informal sector low-income customers. The NHB actively supported the model by providing refinancing to these AHFCs and giving licenses to new AHFCs.

The government also recognized the value of leveraging the private sector in its goal of providing "housing for all." The team worked with the Ministry of Housing and Urban Poverty Alleviation to provide feedback on the recommendations of the "Affordable Housing Task Force" (much of the feedback was subsequently included in government programs like Pradhan Mantri Awas Yojana (PMAY) and the Credit Linked Subsidy). Recognizing the key role of the state, the team also worked with the Department of Housing and Urban Development, Odisha, to develop a conducive state affordable housing policy (which could also serve as an example for other states).

In 2013, the team carried out a "State of the Low Income Housing Market" study and found that more than 80,000 units had been sold and eight new AHFCs had a loan portfolio of close to 1,000 crores ($200 million). The team also found that in the preceding 19 months, 30,500 homes costing less than ₹10 lakhs ($20,000) had been launched in 132 projects across 22 cities. In other words, a vibrant market was on its way to scale.

The Inclusive Markets team joined FSG in 2015 to set up its Mumbai office, and this study is our endeavor to circle back to the housing finance model we helped create for low-income informal customers. Our objective is to document the opportunities and challenges facing the low-income housing finance market and recommend steps to enable more urban working poor to purchase homes.

We would like to acknowledge and thank the following for their leadership in the urban low-income housing program as part of the Inclusive Markets team: Bala Venkatachalam, Madhavi Soman, Naina Batra, Smarinita Shetty and Vikram Jain.

We would like to acknowledge and thank the following team members for their contributions to the urban low-income housing program: Abhishek Agarwal, Aditya Agarwal, Alexandria Wise, Anamitra Deb, Anand Raj, Ashutosh Parande, Darsh Maheshwari, Faheem Bhimani, Girish Karira, Indrani Handa, Kushagra Merchant, Mayank Jain, Nabomita Dutta, Namrata Kapoor, Nidhi Hegde, Nishant Lalwani, Nitin Jain, Parendim Bamji, Pradeep Prabhala, Pranay Mehrotra, Ramesh Krishnamurthy, Raina Singh, Raoul Uberoi, Riti Karnad, Rukesh Reddy, Rohini Ramanathan, S. K. Lakshmisha , Sandeep Nair, Sangeetha Ramachander, Srivatsa Anchan, Subhash Chennuri, Suchitra Shenoy, Swati Chaudhary, Tanushree Kumar, Vivek Hurry, and Zenobia Driver.



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EXECUTIVE SUMMARY

The Need for Low-Income Housing and Housing Finance

Rapid urbanization and the lack of planned affordable housing in India have led to a shortage of 10–12 million urban homes and 26–37 million urban households residing in informal housing, often in poor living conditions. The bulk of these households are low-income—Economically Weaker Section (EWS) households, with annual incomes below ₹3 lakhs ($4,600), and Low Income Group (LIG) households with annual incomes of ₹3 lakhs to ₹6 lakhs ($4,600–$9,200).

The government recognizes the need for new low-income housing and has set up the Pradhan Mantri Awas Yojana (PMAY), a scheme that aims to facilitate the provision of 20 million houses in urban India with financial assistance from the central government.[1]

While a section of low-income households (e.g., the lower end of EWS) cannot afford to buy a privately constructed home or improve their homes without significant help from the government, a large number of the upper end of EWS and LIG households can afford a home/home improvement without subsidies or with small subsidies (as provided by PMAY). However, most of these households need a housing loan to do so.

The Growth of Affordable Housing Finance

The bulk of low-income households work in the informal sector and do not possess reliable documentation of income. These households therefore cannot obtain housing loans from banks and traditional housing finance companies, which focus on middle- and high-income formal sector customers and provide loans on the basis of reliable income documentation.

A new group of "Affordable Housing Finance Companies" (AHFCs) is now addressing this gap and serving low-income, urban informal customers using an innovation pioneered in India—field-based credit assessment. These companies have grown from a combined loan book of close to ₹1,000

1 *PMAY (Housing for all) Scheme Guidelines*, Ministry of Housing & Urban Poverty Alleviation, 2016.

crores ($200 million) in March 2013 to over ₹27,000 crores[2] ($4.1+ billion) in December 2017, at an average loan ticket size of ₹9.3 lakhs ($14,350), and have facilitated the ownership of more than 230,000 affordable homes.[3]

This rapid growth is likely to continue because there is significant equity and reasonably priced debt available, and AHFCs are moving into new states as well as deepening their coverage in states where they already work by reaching smaller urban locations.

Supply of Affordable Housing

Sixty-two percent of the new housing being financed is "self-constructed," standalone houses. Self-constructed homes are typically located on the outskirts of large cities and tier 2 and 3 towns. This type of standalone housing has always been popular in India as customers prefer a house where they have the option of expanding the structure. But instead of saving for years to buy land and then again saving for years to construct the house, households now save to buy the land and then use a loan to construct the house. However, since it requires significant equity to purchase land (which AHFCs typically do not finance) this type of housing is more accessible to the higher end of low-income households.

Thirty-eight percent of financing from AHFCs is helping low-income customers purchase apartments, often in areas with higher land costs, where self-construction is less affordable. Such apartments are typically supplied by small "informal" developers that construct small projects in localities with high demand, typically in *Gram Panchayat* areas, just outside cities. They are able to supply this housing at lower prices because they follow *Gram Panchayat* norms that allow greater use of space.

Large and mid-sized formal developers have largely been unsuccessful in supplying affordable housing to low-income customers as they tend to be more expensive and construct large projects that are further away from the city in less desirable locations. These distant locations also may lack infrastructure and require large investments, which further shrink the already low margins of such projects.

The uptick in new housing activity is also addressing two key issues in the country: availability of rental housing and employment. Most households buying homes are moving out of rented accommodation and thereby freeing up rental stock. The type of housing being financed—self-construction and small apartment buildings—requires significant unskilled/low-skilled labor, and hence provides much needed employment.

2 Based on data from 26 AHFCs, excluding HFCs that do not fit the AHFC definition in the glossary (REPCO Home Finance, Gruh Finance, DHFL, PNB Housing Finance) and part of loan book acquired through the merger of Vysya into Aadhar Housing Finance in Dec 2017.

3 Estimate based on current portfolio of AHFCs, excluding non-housing loans (e.g., LAP, project finance), home-improvement/extension loans, and loans taken over by banks and other PLIs through balance transfer.

The Health of Affordable Housing Finance

Gross Non-Performing Assets (NPAs) are likely to be higher for informal customers (e.g., 2 percent against the Indian norm of 1 percent for the formal sector) due to the higher variability in income. While most AHFCs have relatively low gross NPAs, a couple of players have NPAs of 4 percent and 5 percent. However, actual losses are minor because loan-to-value ratios (LTVs) are low and the AHFCs are able to repossess and sell the houses of chronic defaulters.

One of the challenges for AHFCs is the loss of good customers. Once customers have a track record of regular payments, banks and larger HFCs are taking them over by providing loans at better rates and with "top-ups." For some AHFCs, the annual outflow of such customers is as much as 18–24 percent. Regulations do not allow pre-payment charges in India, so these "balance transfers" affect both the profitability of the AHFCs and the quality of the loan books (because they are losing some of their best customers), which in turn hurts their ability to improve their credit ratings and get lower-cost debt. This may lead to some AHFCs deprioritizing smaller customers since the cost of acquiring these customers is the same as the cost of acquiring larger customers, and in a short loan tenure regime, a larger customer is economically much more attractive.

Increasing Affordability and Expanding the Market to Unserved and Underserved Households

The credit-linked subsidy (CLS) under the PMAY scheme can be very helpful in increasing affordability as it provides an upfront reduction of up to ₹2.67 lakhs for a loan of ₹6 lakhs. It has reached tens of thousands of borrowers, but it has had little impact on affordability because customers only know whether they are getting the CLS after receiving a loan, and hence cannot factor it into their home purchase decision. Also, the bulk of new housing being financed by AHFCs is constructed on the peripheries of the approximately 4,500 urban areas notified for CLS, and therefore is often not eligible for the subsidy. In addition, there are disincentives for AHFCs to offer CLS, especially for smaller ticket sizes. AHFCs get a flat ₹3,000 and out-of-pocket expenses instead of their normal processing fees (typically 1.5 percent of the loan amount) for CLS loans less than ₹6 lakhs. Their outstanding portfolio also gets reduced as the CLS reduces the size of the loan.

The Beneficiary Led Construction (BLC) vertical of PMAY provides financial support for families who own land but do not have *pucca* houses[4] or have small houses (below 21 sq. meters). While the subsidy is significant (e.g., in Odisha, ₹1.5 lakhs from the central government and ₹0.5 lakh from the state government), most households still require a loan to construct a house. Urban local bodies (ULBs) that manage this scheme look to public sector banks to finance these customers, but

4 Dwellings that are designed to be solid and permanent.

these banks are usually not interested in lending to EWS households for whom they cannot readily assess repayment capacity. Some AHFCs and many other lenders, e.g., Small Finance Banks (SFBs) and NBFC-MFIs, are interested in servicing such loans, but find it difficult to identify BLC beneficiaries who want a loan. Current beneficiary lists contain applicants, not customers who have been approved. Also, customers who have been approved may not be interested in constructing at this stage and hence may not need a loan.

Fourteen million urban households (17 percent of urban India) live in slums with poor living conditions. Many of them have the financial resources and would like to improve/extend their homes. They would like a 3–5 year loan of ₹1–₹3 lakhs to do so. While no lender is currently providing such loans, some AHFCs and a number of other lenders (SFBs and NBFC-MFIs) are interested in doing so. However, the legality of such lending is not clear (some states have Acts that make improving such houses a crime, while on the other hand, the government itself provides households financial support for installing toilets). Also it may not be easy to repossess and sell these houses in case of default, so the loan may not be a typical secured housing loan. Many SFBs and NBFC-MFIs are comfortable with this lack of security because they are used to financing rural housing and price in the risk.

Recommendations for Shaping a More Inclusive and Robust Market

In summary, while AHFCs are doing a phenomenal job of enabling home ownership for low-income informal customers, there is an opportunity to improve affordability, expand opportunities to unserved/underserved markets, and foster a healthy, affordable housing finance market.

Increasing affordability: CLS could help a significant number of low-income households purchase a home or afford a larger one, if the households know for certain they would receive it—a pre-approval process would enable this. Including more semi-urban areas (where urban households are buying or constructing housing) would enable more customers to get the subsidy. Affordability could also be increased by eliminating the need to have sanction plans for self-construction on small plots (as is prevalent in certain states) and reducing costs such as GST, stamp duty, and mortgage registration fees for small homes.

Expanding the market: Housing finance for home improvement/extension in slums would benefit low-income customers most affected by poor living conditions. This could be facilitated by explicitly allowing lending to households in slums, starting with households that own land and households that live in notified slums. Urban authorities working with BLC beneficiaries could provide them details of lenders who are interested in financing them and have local presence. To encourage financing these segments, NHB could provide additional refinance lines specifically for them.

Fostering a Healthy Affordable Housing Finance Market

To address the impact of balance transfers on AHFCs, lenders who acquire small ticket loans within two years of origination could be required to pay the originating AHFC a fee for "sourcing" the customer. To encourage AHFCs to provide CLS, they could be reimbursed a larger amount that encourages them to source such customers.

To increase supply of housing from small developers, their need for working capital could be addressed by providing AHFCs an additional refinance line for construction finance. To stimulate supply from larger formal developers, land could be made available to them by housing boards or by demarcating zones for affordable housing projects where infrastructure is provided on a priority basis. An expedited process for approvals would also help these developers. Finally, relaxing some of the restrictions on the 80-IBA tax exemptions and providing pre-approvals would allow developers to use the exemptions and reduce prices for end-customers.



THE LOW-INCOME HOUSING CUSTOMER

Senthil Murugan[5] works as a sales representative with a consumer goods distributor in Coimbatore, Tamil Nadu. He lives with his mother, Padma, who is a daily wage worker employed at a garment factory on the outskirts of the city. They earlier lived in a poorly maintained, dingy rented house with inadequate water and sanitation, but life has changed for this small family since they moved into their own house a year ago.

"We paid ₹5,500 as rent every month for a very small house. My mother had to stand in queue every morning to get water. They wouldn't even let me park my motorbike on the premises." After saving up for years, Senthil and his mother pooled together ₹8 lakhs to purchase a 1,000 sq. ft. plot of land on the outskirts of the city, about 3km from the factory where she works. Soon after, they approached a bank for a loan to build their new house. But Senthil and his mother had little luck with this endeavor: they were rejected by two banks because Senthil worked for a little-known organization and his mother received her salary in cash. The family was in a quandary. The contractor working on their house's plan and construction suggested a solution. He recommended they apply for a loan from a housing finance company that specialized in lending to semi-formal and informal low-income customers like them.

The credit officer from the housing finance company evaluated their repayment ability, the ownership documents for their plot of land, the technical aspects of construction, and disbursed a loan of ₹10 lakhs at 14 percent for 15 years. Senthil and his mother funded the balance with what remained of their savings. The construction of their new house cost them ₹14 lakhs in total.

The family pays an EMI of ₹13,317, from a monthly household income of ₹35,000. "Yes, it is more than the rent we used to pay," says Senthil, "But we have our own home now. We can invest in it, keep it clean and pretty. We have water, clean toilets, and my mother is able to get to work much quicker than before."

5 Fictional profile, for illustrative purposes only.

THE NEED FOR AFFORDABLE HOUSING

Millions of urban, low-income families in India, like Senthil and his mother, live in poorly constructed, inadequate housing, lacking basic amenities. The government of India estimates a shortage of 10–12 million[6] houses in urban India. Furthermore, an additional 26–37 million households in urban India live in informal housing, often with poor living conditions.[7]

The Indian government recognizes this shortage in urban housing, and in 2015 launched the Pradhan Mantri Awas Yojana (PMAY), a scheme which intends to provide new affordable housing to the urban poor. In 2015, 305 cities and towns across nine states were identified[8] for the construction of 20 million such houses for Low-Income Group (LIG) and Economically Weaker Section (EWS)[9] households by the year 2022 through financial assistance from the central government.[10]

Low-income[11] customers are keen to own/improve their homes and can afford to do so if there is supply at market-feasible prices,[12] even if these homes are small. Such families require housing in reasonably well-connected locations from where they can easily commute to their jobs,[13] and which have English-language schools for their children. These customers are comfortable taking mortgages up to 40 times their monthly income, but find few banks and traditional housing finance companies willing to lend to them.[14]

There has historically been a lack of access to housing finance for such low-income customers, as many of them are employed in the informal sector. Banks and traditional housing finance

6 While the estimate of the Urban Housing Shortage for the 12th Five Year Plan (2012–17) published by the Ministry of Housing & Urban Poverty Alleviation is around 19 million, later assessments led to a revision of the estimate to around 10 million according to MHUA, and close to 12 million as mentioned by government officials as part of an NHB workshop.

7 *Informal Housing, Inadequate Property Rights*, FSG, December 2016.

8 Expanded to 4,318 cities (472 Class I cities) of 35 states/UTs, as of January 2018.

9 LIG: Households with annual incomes between ₹3 lakhs and ₹6 lakhs ($4,600–$9,200); EWS: Households with annual incomes below ₹3 lakhs ($4,600), under PMAY guidelines.

10 *PMAY (Housing for all) Scheme Guidelines*, Ministry of Housing & Urban Poverty Alleviation, 2016.

11 Low-income customers are defined as households with monthly incomes of up to ₹6 lakhs, i.e., it includes both EWS and LIG customers as currently defined by PMAY.

12 Market-feasible prices are prices based on current prices of land and construction with fair margins for providers.

13 Typically 20–40 minutes on a motorbike.

14 *Micromortgages: A Macro Opportunity in Low-Income Housing Finance*, Monitor Inclusive Markets, October 2010.

companies geared toward servicing middle- and high-income formal sector customers require formal documentation of income in order to provide housing loans, something potential home-owners employed in the informal sector lack. But recent years have seen the emergence of a new group of "Affordable Housing Finance" companies (AHFCs) which are beginning to address this market gap for informal sector customers. These AHFCs realized that while informal sector low-income customers did not have reliable documentation of income, they did have reasonable and steady incomes. In order to reliably assess the income, assets, and repayment capability for such customers, they developed field-based, detailed credit assessment and verification processes. These companies focus on urban and semi-urban areas so that they can use the SARFAESI Act[15] to repossess houses and sell them to recover loans in cases of default.

By 2013, companies like Aadhar Housing Finance, Aptus Value Housing Finance India, India Shelter Finance Corporation, Home First Finance Company India, MAS Rural Housing and Mortgage Finance, Micro Housing Finance Corporation, Muthoot Housing Finance Company, and Shubham Housing Development Finance Company were beginning to use this model extensively. Monitor Deloitte's *State of the Low-Income Housing Market 2013* report estimated that these AHFCs together constituted close to a ₹1,000 crore loan portfolio and were growing rapidly.[16] Supported by the NHB, the sector showed promise in assisting low-income households that had aspirations to own their own home.

15 The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002, which allows banks and other authorized financial institutions (including many housing finance companies) to auction residential or commercial properties to recover loans.

16 Gruh Finance and DHFL were not included as new AHFCs at the time, given they had been catering to the low-income housing finance market since the 1990s.



STUDY APPROACH

The study followed a three-phase approach: beginning with mapping and understanding activity in affordable housing finance, investigating challenges and opportunities for AHFCs and developers, and finally, developing a set of recommendations with inputs from various experts and stakeholders. The information provided here has been synthesized from 30+ interviews conducted with 26 AHFCs, interviews with 22 affordable housing developers, 25+ customers across six cities, more than 20 experts in affordable housing and housing finance, and eight primary lending institutions apart from AHFCs (housing finance companies, small finance banks, traditional banks, and NBFC-MFIs) lending to low-income customers. The FSG team conducted multiple in-person conversations with many of these organizations to understand their lending model, business approach, viability, future aspirations, challenges, and opportunities.

In this report, we examine how the affordable housing finance market has evolved in the last half decade to serve an increasing number of low-income customers with primarily informal sources of income.

- We begin by developing an understanding of the state of the current market (from sizing the market and mapping geographic spread, to other characteristics such as loan sizes, interest rates, and the type of housing being financed).
- We analyze the health of the market in terms of various indicators such as NPAs and balance transfers.
- We identify the segments of the market that are currently unserved/underserved and how they could be reached.
- The findings of the study are finally synthesized to develop a set of practical and prioritized recommendations that are intended to inform policy and decision making by various stakeholders in the ecosystem for affordable housing finance and affordable housing supply.



THE GROWTH OF AFFORDABLE HOUSING FINANCE

The early promise showed by AHFCs has materialized into a healthy and thriving market. The NHB, in its capacity as the regulator for housing finance in India, has been instrumental in nurturing the affordable housing finance market, for example by facilitating 16 new/acquired licenses for AHFCs since 2012[17] and providing refinance. Bolstered by this support, the sector has not only served hundreds of thousands of low-income households that otherwise would have found it difficult to get financing from banks and traditional HFCs, but has also financed housing in locations where banks and traditional HFCs were not keen on financing (e.g., construction in areas under the purview of *Gram Panchayats*, construction of houses with plans sanctioned by *Gram Panchayats*, and certain types of informal titles such as *laal dora* in Delhi). We estimate that these AHFCs had a loan portfolio of more than ₹27,000+ crores[18] ($4.1+ billion) in December 2017 at an average loan ticket size of ₹9.3 lakhs[19] ($14,350), a mighty jump from ₹1,000 crores ($200 million) in 2013. At such volumes and loan ticket sizes, affordable housing finance has likely led to the ownership of more than 230,000[20] affordable homes so far.

The success of AHFCs seems unlikely to stop at this milestone. They are likely to continue their steep growth trajectory, as significant equity has already entered this market, and more is likely to come. Debt is also easily available: Some of the newer AHFCs can access debt at just under 9 percent. More importantly, there remains a vast, unaddressed market of informal, low-income aspiring homeowners in urban India. AHFCs are recognizing that this opportunity exists across the country and are expanding to leverage it, both by expanding geographical coverage as well as deepening their coverage in states where they already operate (Figure 1).

17 Between 2012 and 2017.

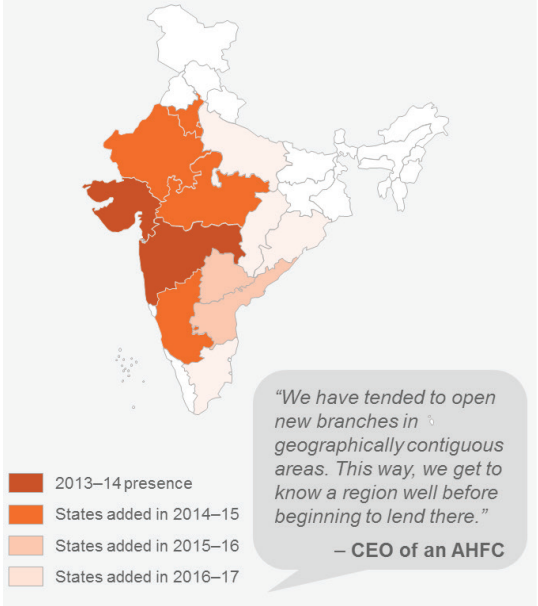
18 Based on data from 26 AHFCs, excluding HFCs that do not fit the AHFC definition in the glossary (REPCO Home Finance, Gruh Finance, DHFL, PNB Housing Finance) and part of loan book acquired through the merger of Vysya into Aadhar Housing Finance in Dec 2017.

19 Primarily variable rate loans.

20 Estimate based on current portfolio of AHFCs, excluding non-housing loans (e.g., LAP, project finance), home-improvement/extension loans, and loans taken over by banks and other PLIs through balance transfer.

FIGURE 1: EXPANSION OF AHFCS

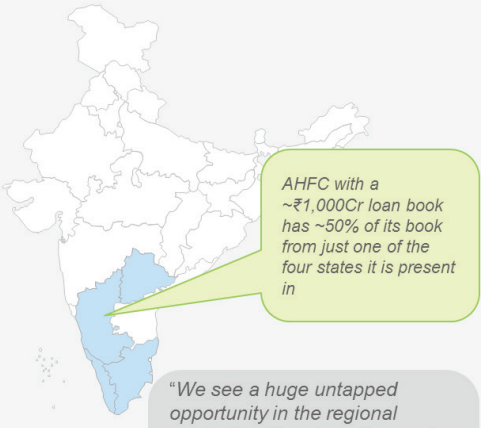
Some AHFCs are expanding geographical coverage*



"We have tended to open new branches in geographically contiguous areas. This way, we get to know a region well before beginning to lend there."

– CEO of an AHFC

Other AHFCs are building deeper coverage in states*



"We see a huge untapped opportunity in the regional market itself, so have focused on first serving this market well enough before thinking of venturing into new geographies."

– CEO of an AHFC

Note: Fictional profiles, for illustrative purposes only

Source: Based on representative data provided by AHFCs

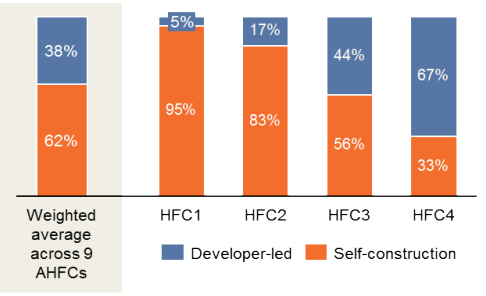


Households are Constructing their Own Homes

A significant volume of the new housing being financed by AHFCs is "self-construction" of stand-alone new housing, where the household uses a loan to construct their new home with the help of a contractor (Figure 2).

FIGURE 2: TYPE OF NEW HOUSING FINANCED AND LOAN CHARACTERISTICS

Type of new housing being financed*
(% of loan book for new housing [1])



Self-construction loan characteristics observed during field visits[2]

For informal low-income borrowers

- Loan sizes vary from **₹4L to 18L**, average is **₹10L**
- Interest rate is 11–18% p.a., typically **13.5-14.5%**
- Loan tenure is **7-20** years, typically **15 years**
- EMI is **30–40%** of **monthly household income**
- LTV is between **35–75% of construction costs**, typically **60%**

AHFCs offer different types of products to foster individual home ownership

Offered by most AHFCs

Construction loans *– to finance the construction of a new house or for a home improvement / extension, when borrowers already own land*

Offered by some AHFCs

Plot loans *– to finance the purchase of land*

Plot + Construction loans *– to finance the purchase of a plot as well as home construction, reducing the need for homeowner equity*

Note: *Excludes loans against property (wtd. avg. 11% of total loan book), loans for resale housing (wtd. avg. 4% of total loan book), home extension and improvement loans (wtd. avg. 3% of total loan book), top-up loans, project financing, etc.

Source: 1. Based on data provided by AHFCs; 2. FSG primary research

Some self-construction customers are fortunate to have ancestral land at their disposal, e.g., some of these customers build a reinforced cement concrete (RCC) house in place of an existing load-bearing brick house with a tile roof. A vast majority, however, seems to be households that saved up for years to buy land, and instead of waiting many more years to save up for construction, they now use housing finance to construct their home. Some AHFCs have also made "plot and construction" loans available to customers who want to purchase land and then construct a home, but such loans form a very small proportion of their books as AHFCs have experienced several cases where the construction amount of the loan was not used within the given time period.

Self-construction of new affordable housing is typically located on the outskirts of large cities, such as Bengaluru, Pune, and Coimbatore, as well as tier 2 and 3 towns. Households tend to choose the location for their new home within a reasonable commuting distance to their place of work, typically staying within 10 kilometers in larger cities and 3–4 kilometers in smaller towns.

Many self-construction homeowners could not find apartments in locations of their choice, but more importantly, show a marked preference for owning land. This permits them to build an extension or an additional floor in the future to accommodate a larger household or to generate a supplementary source of income by renting out the additional space.

AHFCs serve customers across different income segments: some targeting upper-EWS households while others target upper-LIG and lower-MIG I[21] customers. For upper-EWS households, the total home prices for self-construction (including purchase of land) may lie in the range of ₹12–₹18 lakhs (Figure 3), and EMIs are often close to 40% of monthly income; that is, these loans are close to the maximum amount such households can service. Upper-LIG households can afford larger, or better located and therefore more expensive, homes, which may be in the range of ₹18–₹30 lakhs (Figure 3), and EMIs may be a lower proportion of monthly household incomes, with the cost of the house limiting the loan amount and not the customer's repayment capacity.

FIGURE 3: CUSTOMER PROFILES FROM FIELD VISITS

Portrait of an EWS customer*



- Nuclear family of 4; husband is a painting contractor, wife is a homemaker
- Monthly household income: **~₹24K**
- Constructing a **1,000 sq. ft. G+1 house** on a **600 sq. ft. plot**
  - Plot is located on NA land in GP area, and cost **₹5.4 lakh**
  - Construction cost: **₹10.5 lakh**

Product used**

- **₹7.4 lakh** construction loan **(70% LTV)**
- Tenure: 15 years
- Interest rate: 13.95%
- EMI: **₹9.8K**

Portrait of an upper-LIG customer*



- Nuclear family of 3; husband is a vegetable vendor, wife runs a tailoring shop, with a 3 year old daughter
- Monthly household income: **~₹49K**
- Constructed a **1,800 sq. ft. G+1 house on a 1,000 sq. ft. plot**
  - Plot is located on the outskirts of city, within Corporation limits, and cost **₹10 lakh**
  - Construction cost: **₹18 lakh**

Product used**

- **₹12.6 lakh** construction loan **(70% LTV)**
- Tenure: 15 years
- Interest rate: 13.5%
- EMI: **₹16.4K**

Notes: *Fictional, for illustrative purposes only; **Without CLS

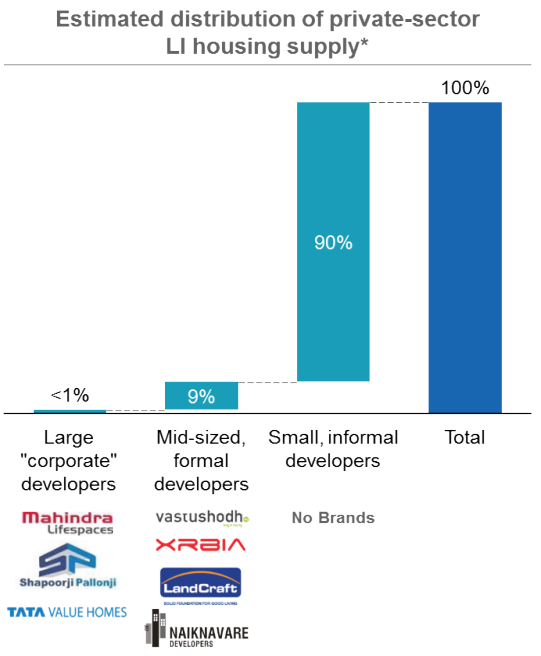
Source: FSG primary research

21 MIG I – Middle Income Group I, with household income between ₹600,000 and ₹1,200,000.

Developers Supply a Section of the Market

As we see in Figure 2, a number of homes financed by AHFCs are supplied by developers. Housing credit has helped low-income customers buy apartments, especially in areas with higher land costs where self-constructed homes would be unaffordable. However, a majority of this developer-led housing supply is not coming from large and mid-sized formal developers active in the affordable housing space. Instead, it is being supplied by small, informal developers, who typically construct small projects in newly urbanizing areas on the outskirts of cities, in the jurisdiction of *Gram Panchayats* (Figure 4).

FIGURE 4: DEVELOPER-LED SUPPLY OF AFFORDABLE HOUSING BY TYPE OF DEVELOPER



Small, Informal Developers

- Have a hyper-local business model
- Active in *Gram Panchayat* areas outside large cities, typically where self-construction is not possible for LI customers due to high land costs
- Construct small projects, 20-100 units, with faster turnaround
- Keep costs and prices low by providing only the most basic amenities, do not always have all permissions in place

Mid-Sized, Formal Developers

- Have a regional presence
- Active in the peripheries of large cities, usually within the jurisdiction of a "development authority"
- Construct large projects, 200-2,000 units
- Reputation conscious, hence provide amenities and have all permissions in place

Large Corporate Developers

- Have a national presence or presence across states
- Selective projects in the peripheries of large cities, usually within the jurisdiction of a "development authority"
- Construct volume projects: 1,000-5,000 units
- Highly reputation conscious, hence provide amenities and have all permissions in place

Note: *Triangulated estimates from multiple experts, including AHFCs

Source: FSG primary research

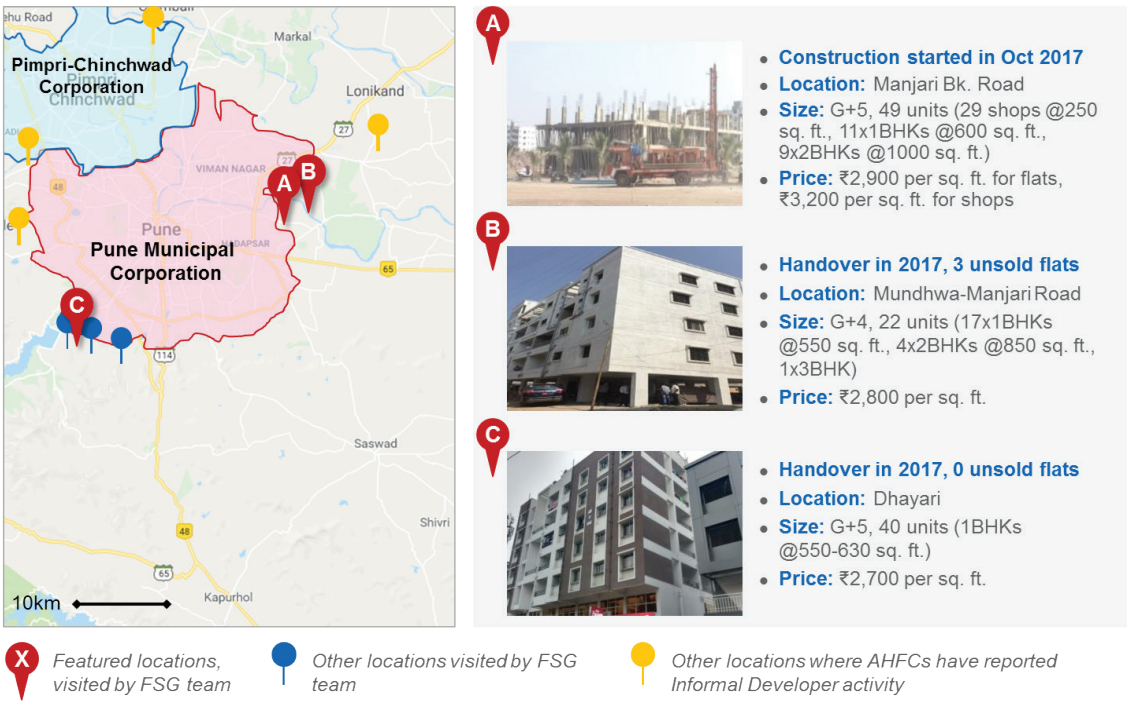
These small, informal developers have a hyper-local approach to their business: local knowledge enables them to select smaller pockets of land where demand has been identified, and they keep inventories low by restricting projects to 20–100 units. "There were a lot of rental units being constructed for migrant industrial workers by local residents in this area. So we decided to build a project with forty 300 sq. ft. apartments priced at ₹7–₹8 lakhs for the migrant workers to own," said one of these small, informal developers in Kadodara, just outside of Surat.



Small, informal developers use multiple workarounds to keep costs low. Constructing in *Gram Panchayat* areas often gives them land at relatively cheaper rates and with smaller bribes, helps them obtain greater FSI[22] than with urban development or municipal authorities in certain states, allows them to stay outside the applicability of RERA[23] registration and regulations, and helps get approvals faster than in ULB areas. Some of these developers look to maximize land use by constructing more FSI and height than is allowed and by reducing setbacks.

To finance construction, small developers resort to using equity or informal sources of financing (e.g., money lenders, obtaining building materials on credit). They minimize their working capital by restricting projects to 20–100 units and entering into partnership agreements/revenue-sharing models with landowners.

FIGURE 5: EXAMPLES OF AFFORDABLE HOUSING SUPPLIED BY INFORMAL DEVELOPERS, IN AND AROUND PUNE



Source: FSG primary research

There has been a growth in supply from such small, informal developers due to high demand for apartments at their low price points (e.g., ₹2,700–₹2,900 per sq. ft. for some sites around Pune)

22 Floor space index.

23 The Real Estate (Regulation and Development) Act, 2016 (RERA), intends to protect the interests of home buyers and enhance transparency in the real estate sector.

and good locations, but changing market trends may constrain their activity in the near future. Low-income customer demand is beginning to shift to "ready-to-move-in" apartments, resulting in a capital crunch for developers during construction. While small, informal developers do try to get "pre-booking" customers who make milestone-based payments before/during construction, such customers are few and their cash flows are not enough to finance construction. Project financing from banks is also not an option for such developers as they tend not to have track records or the necessary project approvals from a ULB.

Large and midsized formal developers have largely been unable to create a sustainable or substantial supply of affordable housing for low-income customers. Some developers that experimented with affordable housing projects a few years ago have since exited the market because of the lack of viability of such projects. Some others are going slow or have put a hold on the creation of new supply.

Their greatest challenges have been land-related: available large land parcels (necessary for large volume, appropriately priced projects) are typically far from the centers of cities, with poor connectivity and infrastructure. Developers are often forced to invest in basic trunk infrastructure such as roads and water provision when the local government fails to provide it during construction or by the time the project is ready for occupation, eating into already thin margins. These locations also tend to be more isolated, for which end-customer demand is low, leading to unsold inventory for months after project completion, or "ghost townships" where a significant number of apartments have been purchased by investors and not occupants.

These formal developers also often face significant delays in obtaining all the requisite approvals for their projects from various local, state, and central bodies. These delays are unpredictable and difficult to estimate, affecting project planning and escalating costs. Even though delays in obtaining approvals affect formal developers across segments, the impact is more severe for affordable housing projects, as margins are thinner and IRRs lower.

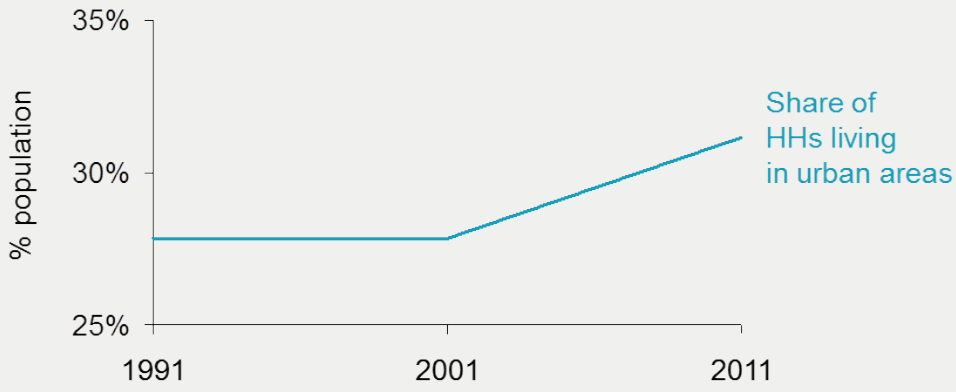
Formal developers have also largely been unable to use the 80-IBA tax exemption. Developers are unable to commit to the policy's timeframe requirements to complete projects within three years from the date a project is first approved. This is especially unsuitable for a phased construction model, which such developers often use. The first date of approval also applies to conversion of land from agricultural to non-agricultural. This makes most parcels of land available in urban and semi-urban India ineligible for these tax exemptions because they typically pass through a few transactions over the years before being acquired by a developer. Also, since there seem to be no cases of peers successfully using these tax exemptions, developers are uncertain that they can use them. They therefore do not want to risk factoring it into lower prices for customers.

NEW LIG HOUSING PROVIDES RENTAL STOCK AND EMPLOYMENT

Rapid urbanization in India over the last couple of decades (Figure 6) has led to an acute shortage of housing overall. This shortage is felt most acutely in the paucity of rental housing. But growth in low-income housing supply could help alleviate this issue: as more low-income households transition to home ownership, they vacate existing rental stock that could then be used to address the need for rental housing.[1]

Some homeowners also construct an additional floor or a few extra rooms to rent. A rent of ₹5,000–₹6,000 could potentially add 12%–15% to an LIG household's monthly income.

FIGURE 6: URBANIZATION IN INDIA



Source: Census data

The supply of low-income housing also provides employment for informal and unskilled workers. Based on our estimates, the organized residential real estate market in India (which excludes self-construction and projects by small, informal developers) is expected to employ ~48 million unskilled and clerical workers by 2022.[2] As self-constructed houses and projects by informal developers (which constitute the majority of low-income housing supply) involve significantly more human labor than large formal projects using advanced construction techniques, the total workforce employed by the affordable housing market is likely to be significant.

1 Interviews with new low-income homeowners financed by AHFCs indicated that a majority of them previously lived in rented accommodation.

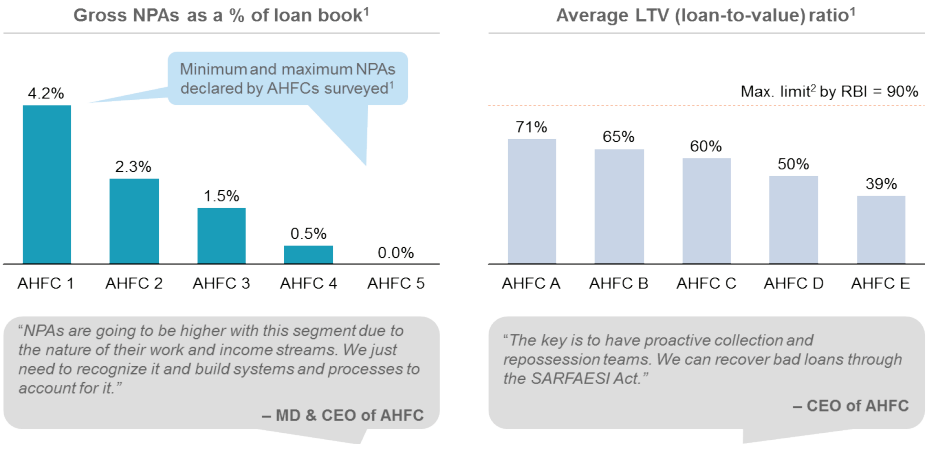
2 As per the National Skill Development Corporation, the real estate market, which is estimated to employ ~57 million unskilled and clerical workers by 2022, is divided into 3 sub-sectors: industrial and other, commercial, and residential. Organized residential projects make up 85% of value of the real estate market (Source: Residential Real Estate in India, Bain & Company). This estimate of ~48 million (i.e., 85% of 57 million) is based on the assumption that each sub-sector employs the same number of people per rupee of investment.

For mid-sized developers especially, the evolution of end-customer demand to ready-possession units has meant that cash flows from pre-booking customers can no longer be used to finance construction. This change in the nature of demand has forced them to raise debt in order to finance project construction, again resulting in thinner margins.

Monitoring the Health of Affordable Housing Finance

Gross NPAs vary across AHFCs and are likely to be higher (Figure 7) than for home loans by traditional HFCs serving formal sector middle- and high-income households (which are typically about 1 percent of the loan book). This is due to the more variable nature of income and greater impact of "shocks"[24] on informal sector low-income households. However, AHFCs are confident that they can recover these loans, as LTVs are relatively low, and through the provisions of the SARFAESI Act, AHFCs can repossess the property and sell it to recover the loan. Practically, AHFCs rarely have to take this step: initiating the recovery process under the SARFAESI Act seems to act as a push to the homeowner to repay outstanding amounts. There have also been instances of homeowners working with AHFCs to sell the house and pay back their outstanding loan.

FIGURE 7: GROSS NPAS AND LTVS FOR SELECT HFCS



Note: RBI allows an LTV of up to 90% for home loans of ₹30 lakh or less (vide notification #RBI/2016-17/317)

Source: [1] FSG primary research

While AHFCs have been able to manage the credit risks of lending to low-income customers, balance transfers[25] to banks and traditional HFCs present a threat to their sustainability.

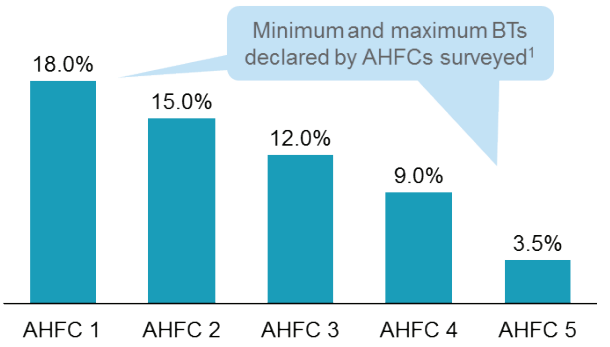
24 For example, a health-related absence from work for a small entrepreneur may have a greater impact on their business than just a temporary halt in revenues. They may lose regular customers who find an alternative vendor.

25 Balance transfer of a loan is the process where a customer transfers his outstanding principal amount to another bank or financial institute primarily for a better rate of interest and better features.

AHFCs often lend to informal sector customers, incurring higher customer acquisition costs compared to other Primary Lending Institutions (PLIs) because they use a field-based method of assessing credit-worthiness. To cover these higher customer acquisition costs, risks, and higher cost of borrowing, the AHFCs charge higher interest rates. Other PLIs such as PSU[26] banks, private banks, and larger HFCs have an advantage when it comes to giving their borrowers more attractive interest rates, and they leverage this by transferring low-income AHFC customers with good repayment records to their books. They acquire such customers through various channels, e.g., direct sales agents (DSAs), who source these customers for commissions, or developers supplying housing to such customers. Traditional PLIs also offer top-ups (e.g., ₹1–₹3 lakhs) as an added incentive to customers who transfer.

Balance transfers affect the sustainability of AHFCs in many ways. Part of an AHFC's profitability comes from interest income on the spread, which is curtailed in case of a balance transfer as the duration of the loan is cut short. Balance transfers also adversely impact the quality of the loan book as borrowers with good repayment behavior are the ones being poached. As a result, the AHFC's credit ratings may not improve, and their cost of capital may remain high.

FIGURE 8: ANNUAL BALANCE TRANSFER LOSSES FOR SELECT AHFCS (AS % OF LOAN BOOK)



"If BTs continue, I may have to stop serving EWS customers as it takes more time for such loans to be profitable. Acquisition costs are the same as with LIG customers, while interest income is lower for smaller ticket sizes."

– CEO of an AHFC

Source: Based on data provided by AHFCs; FSG primary research

26 Public Sector Undertakings.

OPPORTUNITIES TO INCREASE AFFORDABILITY AND DEEPEN THE MARKET

While the low-income housing market demonstrates strong growth, certain sections of the market continue to be excluded from accessing subsidies or from accessing housing credit itself.

Credit-Linked Subsidies

By the end of 2017, credit-linked subsidies (CLS) under the PMAY had benefited tens of thousands of end-users, but it does not seem to have improved the affordability of homes. Homeowners and potential homeowners we met during our field visits were typically aware of the scheme, but were unsure of the criteria and whether they would be able to get the subsidy. They therefore did not factor the subsidy amount into their home purchase or construction decision. This lack of understanding of the criteria also leads some customers to hold the AHFC or the developer responsible if their application is rejected. This discourages AHFCs to market CLS, as they continue to interact with the customer for the duration of the loan. Moreover, a section of AHFC field staff lacked clarity on CLS criteria and did not submit applications for some customers who may have actually been eligible. We came across instances where field staff believed that the household would not be eligible for CLS if a female borrower's name was not on the title deed for the land the home was being constructed on, whereas as per the scheme guidelines, female ownership is mandatory for obtaining the CLS only if the loan is for acquisition of a house, but not mandatory for construction on land owned or improvement of an existing house.

Some AHFCs have also been shy of marketing the CLS because it adversely impacts their loan books and margins. CLS reduces the principal component of the loan, shrinking the loan book. Further, AHFCs are not allowed to charge processing fees for CLS-eligible loans up to ₹6 lakhs, and while the NHB allows charging out-of-pocket expenses[27] and reimburses ₹3,000 (in lieu of other processing fees) per loan, it is significantly less than the 1.5 percent of loan value they typically charge as processing fees. This reduces margins on small ticket loans and may decrease AHFCs' interest in serving EWS customers. However, over the longer term as the market gets more competitive and word about the CLS spreads among customers, AHFCs may be bound by market forces to facilitate uptake of the subsidy.

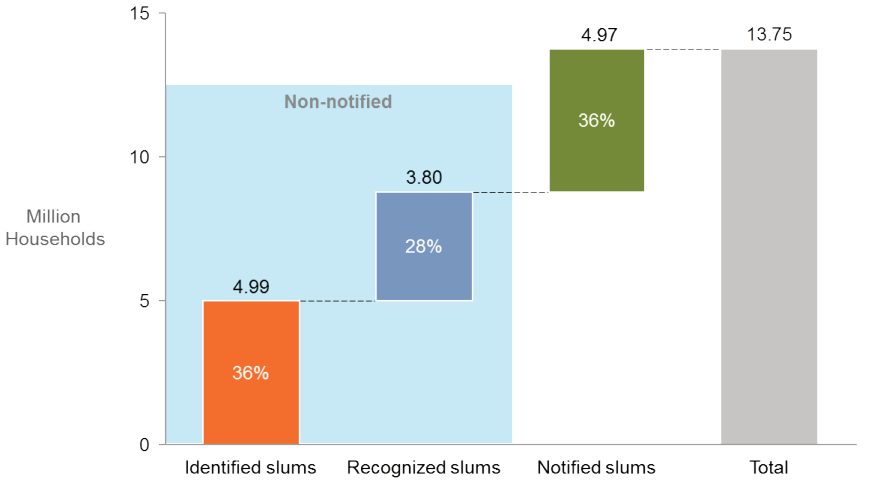
27 AHFCs are allowed to charge out-of-pocket expenses such as technical charges, legal charges, and CERSAI charges to their borrowers.

A significant number of low-income households have been excluded from accessing CLS benefits because of the location of their new homes. As we noted previously, the bulk of low-income housing is being constructed on the peripheries of the approximately 4,500 urban areas notified for CLS, which typically come under the purview of *Gram Panchayats*. Houses in these localities are not eligible for CLS until state governments "notify" these areas as per PMAY (U) guidelines.[28] In other cases, the homes are being constructed in states where building sanction plans are not required by local guidelines for houses under a certain size. However, CLS requires an approved sanction plan, and it is challenging for homeowners to get these "extra" approvals.

Home Improvement in Slums

Fourteen million urban households in India live in slums with poor infrastructure and living conditions (Figure 9). Many such households invest in improving these conditions in their houses: 68 percent of owner-occupants who believe they can construct on premises have done home improvement in the past.[29] Many owner occupants would like to continue to improve their houses and would like a housing loan, but no PLI is currently providing them with an appropriate product. This, despite the fact that the home loan opportunity in notified slums itself is ₹23,000 crores (Figure 10).

FIGURE 9: NUMBER OF HOUSEHOLDS LIVING IN SLUMS, ACROSS SLUM TYPES



Notes: Households in Notified slums have greater tenure security than in Non-notified slums (Recognized and Identified) as they have the right to live in their houses and cannot be evicted without due process. Households in Non-notified slums do not have any formal right to live in their houses, but most have been doing so for a while and are confident they will be allowed to continue doing so.

Source: Census 2011

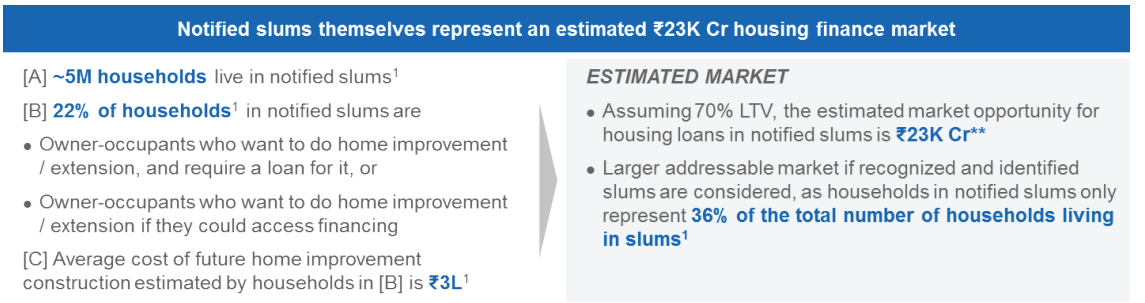
28 In January 2018, a circular stated that land under urban and industrial development authorities is eligible for CLS, which would ease this constraint near some larger cities, but there are still many areas in the country that are not eligible.

29 *Informal Housing, Inadequate Property Rights*, FSG, December 2016.

Microfinance institutions (MFIs) and small finance banks (SFBs) are currently reaching households living in slums with products that have small ticket sizes (below ₹1 lakh) with short tenures (1–2 years) at high interest rates (22–26 percent), which is not an appropriate product for home improvement. The ticket size that households actually require for a home improvement loan is typically between ₹1 lakh and ₹3 lakhs. The current product—even with an increase in magnitude—would not work as the short tenure and high interest rate would lead to an unaffordable EMI.

There is an opportunity to provide a ₹1–₹3 lakhs loan for 3 to 5 years at an interest rate of 18 percent for which customers would be able to afford the corresponding EMIs.[30] Some MFIs and SFBs are interested in providing such loans, and while most AHFCs are not interested in this market because of both the small ticket size and the perceived high operating costs, a few AHFCs are also interested in providing such loans.

FIGURE 10: OPPORTUNITY IN NOTIFIED SLUMS



Note: *Market Opportunity = [A] x [B] x [C] x 70% LTV;

Source: [1] *Informal Housing, Inadequate Property Rights*, FSG, Dec 2016

However, many PLIs that are interested in lending for home improvement in slums are not sure about the legality of doing so. Legislation in a few states seems to indicate it is a criminal offense. For example, in Maharashtra, financing construction in notified slums is a criminal offence under the state law, and AHFCs are concerned that they may be prosecuted for doing so.[31] On the other hand, the government does seem to want to support home improvement in slums: under the urban component of the Swachh Bharat Mission, the government provides a subsidy for the construction of individual toilets irrespective of land ownership/tenure security.[32]

30 *Informal Housing, Inadequate Property Rights*, FSG, December 2016.

31 Maharashtra Slum Areas (Improvement, Clearance and Redevelopment) Act, 1971 (amended), specifies that any construction in slums beyond the ground situation as of 1995 is prohibited. Improvement or rehabilitation projects can only be undertaken by the municipal body or slum rehabilitation authority (SRA); some AHFCs work around this by obtaining an NOC from local authorities to finance construction in these slums.

32 Ministry of Housing and Urban Affairs, Guidelines for Swachh Bharat Mission – Urban.

Tenure security also varies in slums: some households in slums have clear ownership of the underlying land, while others have ownership without all documents in place. Other households, such as those in certain areas of Jaipur, hold *pattas* with the right to transfer/mortgage property, while households living in notified slums cannot be evicted without due process. In other words, some of the properties in slums may be mortgage-able. But even if the customer has a mortgage-able property, it may not be possible to use the home as collateral, since loan recovery may not be feasible due to low marketability of properties in slums.

Some SFBs and NBFC-MFIs are open to providing loans in spite of the non-recoverability/marketability of properties in slums. Their willingness to finance this segment stems from analogous experience with rural titles, which are also not recoverable and marketable in practice. They view these loans as unsecured lending for all practical purposes and will price in the additional risk of lending into their interest rates. However, NBFC-MFIs would need debt at a lower cost to service such loans.

The few AHFCs that are interested in lending for home improvement in slums are unused to unsecured lending and therefore concerned about not being able to repossess the house under SARFAESI or sell it after repossession. They would like a reasonably priced credit guarantee product to mitigate the risk of defaults.

Beneficiary-Led Construction by EWS Households

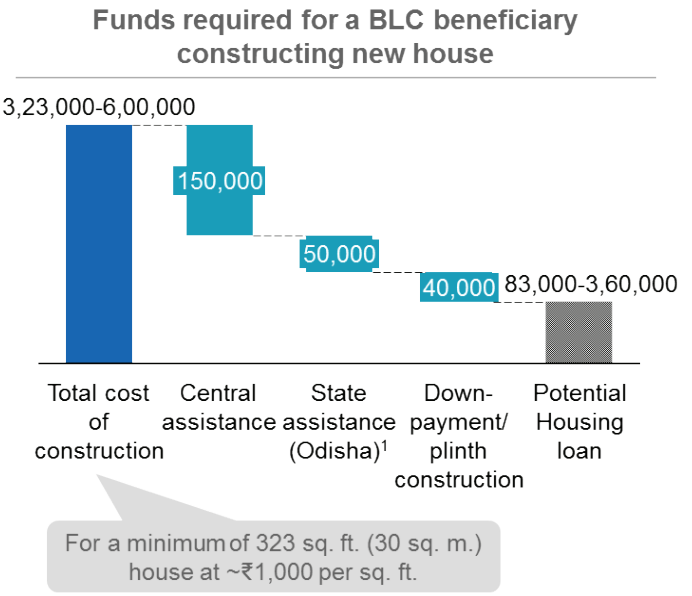
According to the Technical Group on Urban Housing Shortage, 88 percent of India's urban housing shortage is from the EWS segment and only 11 percent from LIG households.[33] Another vertical under the PMAY, beneficiary-led construction (BLC), provides some of these EWS households (those that own land, but do not have a *pucca* house) a central government subsidy of ₹1.5 lakhs for the construction/extension of their homes. This is typically supplemented with a subsidy from the state government (e.g., ₹50,000 in Odisha). In addition to the subsidy, a typical BLC beneficiary still requires ₹1.2–₹4 lakhs (Figure 11) to construct their new house, and the program requires them to build the plinth before the subsidy starts (a cost that could be about ₹40,000). It is therefore likely that such beneficiaries may need a loan of ₹83,000–₹360,000 (Figure 11).

33 Report of the Technical Group on Urban Housing Shortage (tg-12), Ministry of Housing and Urban Poverty Alleviation, 2012–17.

FIGURE 11: LENDING OPPORTUNITY FOR BLC BENEFICIARIES

Profile of a BLC beneficiary:

Individual in EWS category with "ownership of land," does not own a *pucca* house (for new construction only), and may or may not be living in a slum



Sources: 1German Cooperation, GIZ, Odisha Urban Housing Mission 'AWAAS', Housing & Urban Development Department Government of Odisha – Beneficiary-led Individual Housing Construction Enhancement (BLC): An Approach; FSG primary research

However, some issues should be addressed to facilitate PLIs in funding BLC beneficiaries. Current BLC lists prepared by ULBs contain the names of applicants instead of beneficiaries approved for the subsidy. These lists are less useful for PLIs in sourcing customers because it is not clear if and when the applicant may be approved. Even approved EWS beneficiaries may not necessarily be able to take a loan, as they may not have the ₹40,000–₹50,000 required to build the plinth, a pre-requisite to get the subsidy. PLIs also cannot apply the Central Credit Guarantee scheme for such customers. Finally, the small ticket sizes and difficulty in accessing credit worthiness of such customers (typically without documented income) make them unattractive to banks, traditional HFCs, and many AHFCs. Only a few AHFCs are interested in financing small amounts in the range of ₹83,000–₹360,000 despite these being secured loans. Other PLIs such as SFBs and NBFC-MFIs seem more willing to explore this opportunity, but NBFC-MFIs would require longer tenure debt to finance such loans. State governments should therefore look to the PLIs that are interested in this market to extend housing credit to approved BLC beneficiaries, rather than their current focus on PSU banks.

CREDIT GUARANTEES COULD MITIGATE RISKS OF EXPLORING UNTAPPED MARKETS

The Central Credit Risk Guarantee Fund Scheme (CCRGFS) for LIH has had limited uptake from AHFCs. Current loans issued by AHFCs are typically secured, making them ineligible for the credit guarantee. Even if current loans were eligible for the CCRGFS, AHFCs would be unlikely to use the CCRGFS since they are confident of recovering defaulting loans using the SARFAESI Act (and low write-offs substantiate this perception). Additionally, the scheme cannot be combined with any vertical of the PMAY.

Therefore, while AHFCs do not need a credit guarantee for their current lines of lending, there are segments where some AHFCs would like to lend, but are concerned about the credit risk, such as BLC beneficiaries and those living in slums. However, the scheme does not cover such segments, e.g., it does not cover BLC customers (as the scheme cannot be combined with any other vertical of PMAY) or home improvement in slums (as it requires land ownership). Allowing the credit guarantee to work for these customers would help AHFCs serve credit-worthy customers among these segments, and a reduced cover of 70% (instead of 85%–90%) may ensure appropriate incentives for responsible lending.

Home Extension and Improvement Loans

There have been relatively few home extension/improvement loans in spite of the likely demand and availability of finance. Seventy percent of low-income households living in unauthorized housing[34] (12–20 million households live in unauthorized housing) that believe they are allowed to construct on premises plan for home improvements such as constructing another floor, a room, a toilet, or a kitchen.[35] Customers often prefer independent houses to apartments because it gives them the leeway to construct an additional floor. So there should be significant demand for home extension/improvement loans. On the other hand, AHFCs already offer home extension/improvement loans and would like to add more of these loans because they are a low-risk product due to the low LTVs. But despite this likely demand and their willingness to finance, AHFCs have not seen significant activity in this product category—home extension/improvement loans constitute less than 5 percent of the loan book among the AHFCs surveyed in this study. Low customer awareness of Affordable Housing Finance Companies' willingness to finance such loans, and preference among AHFC field staff to source customers who require higher ticket size loans (e.g., for new construction), could be potential reasons why home improvement products have not seen much uptake.

34 "Unauthorized housing" refers to unplanned settlements and areas where housing does not comply with current planning and building regulations, but where the residents have uncontested ownership of the land, as defined in *Informal Housing, Inadequate Property Rights*, FSG, December 2016

35 *Informal housing, Inadequate Property Rights*, FSG, Dec 2016

RECOMMENDATIONS FOR SHAPING A MORE INCLUSIVE AND ROBUST MARKET

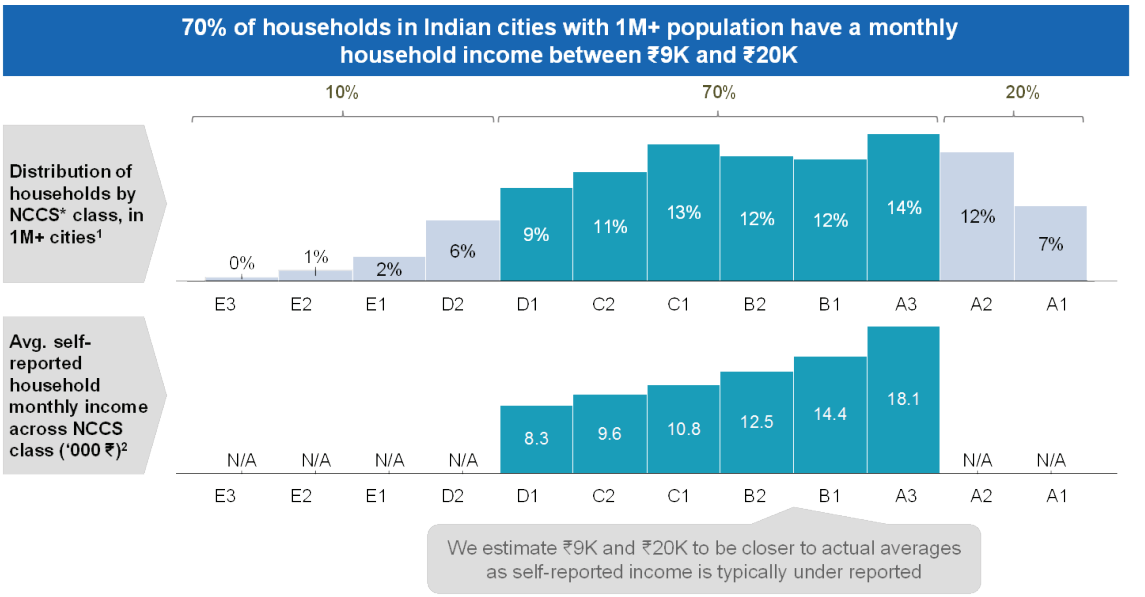
In summary, Affordable Housing Finance Companies are increasingly providing access to housing credit in urban India as demonstrated by the growth in their outstanding portfolio. For the first time, informal LIG and EWS customers can access housing finance, enabled by an innovation pioneered in India—field-based credit assessment—which is being documented for application in other countries. AHFCs have enabled households to conduct self-construction more easily and rapidly, which now represents about 62 percent of loans for new housing provided by such companies. Developers, especially small and informal ones, play a key role in enabling home ownership in areas with relatively higher land costs, and for relatively poorer customers.[36] Access to home ownership for low-income households has freed up existing rental stock in urban areas and created employment opportunities for informal and unskilled workers.

However, the growth in housing finance has still not reached a large share of the urban poor. In Indian cities with a population of more than 1 million, 70 percent of households have monthly incomes between ₹9,000 and ₹20,000, and the largest loan that a household with monthly income of ₹20,000 can afford is ₹600,000. With a weighted average loan ticket size of ₹9.3 lakhs, the bulk of the housing finance supply is likely not reaching households poorer than the upper-end of EWS,[37] thus failing to enable home ownership for a large share of the urban population.

36 Because apartments require less homeowner equity than self-construction.

37 EWS households are defined in PMAY as households having an annual income up to ₹300,000 (i.e., monthly income of ₹25,000).

FIGURE 12: DISTRIBUTION OF HOUSEHOLDS BY NCCS CLASS AND AVERAGE SELF-REPORTED MONTHLY HOUSEHOLD INCOME



Note: *NCCS is used to classify households in socio-economic classes, based on two variables: the education level of the chief wage earner and the number of consumer goods owned by the household (from a pre-defined list of 11 durables)

Source: 1. IRS data 2014; 2. FSG primary research (2015), based on data from 4.3K respondents across NCCS classes A3 to D1 in 8 cities (5 cities of over 5 million people and 3 cities with between 1-5 million people)

Going forward, the market needs to be nurtured and existing players require support to ensure sustained access to Affordable Housing Finance (and therefore affordable housing) for LIG/EWS households. It is also important that stakeholders focus on expanding supply further down the market in order to reach segments of the urban population without home ownership. To do so, we recommend actions to increase affordability for customers, to expand the market to reach new segments, and measures to foster healthy affordable housing finance and affordable housing markets.

Increasing Affordability for Customers

More households would be able to purchase a home, or afford a larger or better-located home, if they could factor the credit-linked subsidy into their home purchase decision. However, customers cannot easily comprehend the scheme guidelines and whether they are eligible for the subsidy. Providing a mechanism for customers to obtain a "pre-approval" for CLS, contingent on the house being purchased or constructed in a CLS-covered area, would help them do so (e.g., pre-approval could be done by empaneled PLIs for a fee). Moreover, "pre-approvals" would also help increase the sustainability of AHFCs as customers would tend to take larger loans that factor-in the CLS amount.

Many potential homeowners also do not meet the eligibility criteria for the CLS because their homes are located in areas that have not been notified as urban. Expanding the scope of CLS to cover housing being constructed in newly urbanized areas[38] would cover such customers (e.g., expanding the scheme's coverage to 7,935 urban areas covered by Census 2011,[39] including Statutory Towns, Census Towns, Urban Agglomerations and Out Growths). If the government cannot afford subsidies at this scale, it could consider restricting the CLS to EWS customers.

Customers also incur significant costs in obtaining sanction plans in states that do not require these below a certain house size. Removing this requirement for sanction plan submission with CLS application for houses below a certain size in these states would ease the flow of subsidy to these customers.

Affordability could also be increased by reducing miscellaneous costs such as GST, stamp duty, and mortgage registration fees for Affordable Housing units (both individual houses and apartments), e.g., for units below 60 sq. m. and/or below ₹1,000,000 selling price. Removing the requirement for customers to obtain an approved sanction plan for standalone houses[40] in all states (which is already the norm in certain states like Rajasthan) would also help reduce miscellaneous costs (e.g., for houses on less than 1,000 sq. ft. of land, as long as they follow basic FSI and height restrictions).

Expanding the Market to Reach New Customer Segments

There is a need to unlock housing finance for those most affected by poor housing conditions, such as households living in slums. Explicitly allowing lending to slums with high tenure security (including notified slums) and extending permissibility of lending to slum housing with a lesser degree of tenure security would help these households gain access to housing finance. Access to finance for BLC beneficiaries could be facilitated by sharing the details with beneficiaries of PLIs with local organizations (including SFBs and NBFC-MFIs) that are interested in providing housing finance to them.

However, some PLIs require support mechanisms to serve these higher-risk segments. Restructuring the Central Credit Guarantee Scheme to cover unfinanced segments with the highest need could serve as one form of support. This could be done by explicitly expanding the coverage of the scheme to segments with high need, and where AHFCs perceive economic risks (e.g., to BLC

38 State governments could still notify additional areas, as is currently done.

39 Census defines urban areas as all places with a municipality, corporation, cantonment board, or notified town area committee, etc., or all other places that satisfy the following criteria:
i. A minimum population of 5,000; ii. At least 75% of the male main working population engaged in non-agricultural pursuits; and iii. A density of population of at least 400 persons per sq. km.

40 Customers may even incur expenses of ₹40,000–₹50,000 to obtain sanction plans.

beneficiaries and slum dwellers). Allowing the combination of the Central Credit Risk Guarantee Fund Scheme with PMAY verticals would further reduce risk for PLIs and encourage them to lend to these customers. At the same time, the scheme could be redesigned to ensure responsible lending to these riskier segments, e.g., by reducing the cover of the scheme to 70 percent of loan principal (instead of 85–90 percent) while keeping pricing the same. PLIs would also be further incentivized to reach these unserved segments if they could use additional refinance lines specifically for notified slums and BLC beneficiaries, in addition to the refinance they are eligible for through other NHB schemes (these refinance lines should be for all PLIs including SFBs and NBFC-MFIs).



Fostering a Healthy Affordable Housing Finance Market

AHFCs currently face adverse incentives in serving EWS customers, and removing some of these disincentives could ensure they continue serving this market and potentially even go deeper. Requiring PLIs that acquire small ticket housing loans (e.g., below ₹8 lakhs[41]) within two years of origination through balance transfers to pay "sourcing charges" (e.g., 2 percent of outstanding loan principal) to the originating AHFC would reduce these disincentives. For loans that are eligible under the CLS scheme, increasing reimbursement in lieu of processing fees for loans below ₹6 lakhs from ₹3,000 to ₹9,000, while continuing to allow charging processing fees for loans above ₹6 lakhs, would incentivize AHFCs to seek out and source more of these customers.

Addressing barriers constraining developer-led housing supply could put apartments within the reach of many more households living in areas with higher land costs. Developers' working capital constraints could be reduced by encouraging AHFCs to extend project finance for Affordable Housing Projects[42] through an additional NHB refinance line. The loan size for project finance could be capped (e.g., at ₹2 crore) to ensure financing to small projects, e.g., those in *Gram Panchayat* areas that are focused on serving such customers.

Affordable Housing Projects could be created in appropriate locations by having housing boards sell large tracts of land (e.g., 3–5 acres). Some eligibility requirements could be established to ensure that the intervention only supports Affordable Housing Projects, e.g., capping the size of units and/or ticket size. Demarcation of zones for Affordable Housing Projects where infrastructure is provided on a priority basis could minimize developers' investment in trunk infrastructure, in the same way as is currently done in Gujarat and Maharashtra by the Gujarat Industrial Development Corporation and the Maharashtra Industrial Development Corporation for industrial zones.

41 Maximum loan amount that can be reimbursed by an EWS customer, assuming ~₹10K EMIs, 15-year tenure at 14%.

42 Affordable Housing Projects would be projects that predominantly serve low-income customers, e.g., 75% of the project area is for units that are less than 600 sq. ft. super-built-up area or for which unit prices are less than ₹12 lakhs.

Implementing an expedited approval process for Affordable Housing Projects (e.g., by capping the time to process applications or pre-approving template plans) would also help developers reduce costs and manage project delivery more efficiently. Ideally, a process that is standardized across states would be beneficial to large and midsized developers working across different parts of the country.

Developers (and eventually end-customers) could benefit from tax exemptions under section 80-IBA if its requirements were modified. The relaxation of criteria to use these tax exemptions, such as the first date of approval clause, and the clause that requires a project to be completed within three years, would enable developers to take advantage of the exemptions. Enabling pre-approvals for tax exemptions would give developers more confidence in obtaining these benefits, which they could then pass on to end-customers.

GLOSSARY

- **Affordable Housing Finance Company (AHFC):** A Housing Finance Company that
  - Focuses on urban/semi-urban areas,
  - Serves informal customers enabled by field-based credit assessments, and
  - Primarily serves low-income customers (i.e., LIG and EWS customers).
- **Formal Customer:** A customer seeking a housing loan who has formal documentation of their income.
- **Formal Housing:** Housing for which the owner has defensible and documented rights (e.g., property registration documents).
- **Informal Customer:** Customers seeking a housing loan who do not have formal documentation of their income. AHFCs typically use an intensive field-based credit assessment mechanism to assess the creditworthiness of the customer in such cases.
- **Self-Construction:** Housing constructed by customers for their own use on land owned by them, where construction work could be executed by a contractor.
- **Unauthorized Housing:** Construction on land owned by the customer, but without all permissions in place (e.g., approved building plan in states where required, or lack of appropriate setbacks);

  OR

  Construction on land owned by the developer or in joint-venture with the landowner, where all permissions (including plan approvals) may not have been obtained, or where permissions may have been obtained from an authority that has unclear jurisdiction (such as Gram Panchayat) over the area.

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