*Affordable Housing and Housing Finance**

V.K. Sharma

Mr. Abdul Qadeer Fitrat, Governor, Central Bank of Afghanistan; Mr. Arun Maira, Member, Planning Commission; Mr. R. Gopalan, Secretary, Department of Financial Services; Mrs. Kiran Dhingra, Secretary, Ministry of Housing and Urban Poverty Alleviation; Mr. Kamran Shehzad, Deputy Governor, State Bank of Pakistan; Mr. S. Sridhar, Chairman and Managing Director, National Housing Bank; Mr. Paolo Martelli, Director, South Asia, International Finance Corporation; Mr. R.V. Verma, Executive Director, National Housing Bank; distinguished guests and invitees, members of the electronic and print media, ladies and gentlemen.

2. First of all, I would wish to thank National Housing Bank for giving me this honour and privilege to address this distinguished and august audience. The National Housing Bank was set up as a wholly owned subsidiary of Reserve Bank of India under the National Housing Bank Act, 1987 to act as a principal apex national agency to promote housing finance by providing financial and other support to housing finance institutions.

3. I must acknowledge that the theme of the conference is contextually, and topically, most appropriate and relevant, considering that it represents a very key element/ component in India's indefatigable pursuit of the national agenda of sustainable and inclusive economic growth and prosperity. I must also acknowledge that the conference agenda is indeed quite comprehensive what with almost everything that there is to "Affordable Housing and Housing Finance" included, and to be expertly handled by a formidable line up of internationally renowned and distinguished professionals.

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I would, therefore, not venture to encroach upon their professional expertise and would instead confine my remarks to what to my mind represent key prudential and systemic concerns in affordable housing involving optimally harmonising and balancing the interests of lenders and borrowers in the housing finance market. Coming to brass tacks, I would wish to draw attention to a fairly standard and generally prevalent predilection on the part of banks and lenders to extend long-term floating-rate, including, more recently, teaser, housing loans. This is typically rationalised by arguing that lenders' liability maturity-profile is short-term and, therefore, it is only prudent that lenders make either short-term loans or long-term loans, which involve frequently resetting interest rates depending upon the evolving market interest rates. While *prima facie* this rationalisation may seem unexceptionable from the point of view of lenders, on a more incisive analysis, it turns out that, in the medium to long term, it is neither in the interests of borrowers nor lenders. This I say because a floating-rate loan typically transfers interest rate risk to borrowers who, unlike lenders, are far less endowed, in terms of expertise and capacity, to hedge and manage interest rate risk every which way one looks at it. In other words, such floating-rate long-term loans effectively substitute interest rate risk of lenders with potential credit risk in terms of creating potential non-performing housing loans. Of course, lenders might still argue that in some, or most cases, housing loan borrowers might prefer a floating-rate loan to a fixed-rate one. But then, it is precisely where the Reserve Bank of India's guidelines with regard to customer appropriateness and financial literacy and credit counseling, enjoined upon banks, come in. This is because typically an unsophisticated and uninitiated borrower may be driven largely by the prevailing lower short-term interest rates, almost completely oblivious to the potentially higher interest rates over such a long time horizon, as, say, 10 years, or more. At another level, a fixed-rate loan has more certainty both for borrower and lender and should, therefore, be more prudent one to make.

4. In support of my above proposition, I would like to cite the US example. In the USA, housing finance is pre-dominantly of the fixed-rate long-term mortgage variety with an embedded call option in favour of borrower to pre-pay, and refinance, mortgage should interest rates decline during the maturity of the mortgage. This structure makes housing more affordable to small borrowers as they enjoy either a fixed-rate or a lower rate. Of course, the option premium is built into the fixed-rate of mortgages in the way of a higher rate. However, during the low interest rate environment in the USA up to the end of 2003, when the Federal Funds rate was at its lowest at 1 per cent, a new trend of floating-rate mortgages, which in the USA are known as Adjustable Rate Mortgages (ARMs), emerged with, of course, its "teaser-rate variant" where, as we know, interest rates were set at rates lower than the ruling market rates during the initial period and variable rates, higher than the corresponding market rates, in the subsequent period. It is, of course, history now that when the Federal Reserve started raising interest rates from 2004 through 2006-07, there were widespread defaults precisely in the floating-

rate/teaser loan/ARM segment with, of course, collateral damage in the conforming, fixed-rate mortgage segment as well.

5. If, by now, I have been persuasive enough to disarm and convert lenders to the above proposition, I must still answer the legitimate question that lenders would logically have as to how then to make a long-term fixed-rate loan, whether for housing, or for infrastructure, without creating any serious asset-liability mismatch in their balance sheets. To this question, I have a very simple market-based solution which is that banks/lenders can easily have recourse to a very liquid and vibrant IRS (Interest Rate Swaps) market, where, as on January 22, 2010, outstanding notional principal amounts aggregated Rs. 38 trillion (almost 75 per cent of the total banking assets in India as also of the nation's GDP), and easily transform their short-term liability into a long-term fixed-rate one and thus create a synthetic long-term fixed-rate mortgage financing by doing the following :

(a) Receive fixed-rate for one year and pay floating overnight rate in the IRS market. (Assuming banks' average liability is about one year).

(b) Receive floating overnight rate and pay 10-year in IRS market. This effectively synthetically transforms a one year floating-rate liability of bank into a synthetic 10-year fixed- rate liability. By loading margin over this rate, banks can make a 10-year fixed-rate loan to a mortgage borrower. And, significantly, considering that IRS trades about 50 to 80 basis points below sovereign yield, it is win-win for both banks and long-term fixed rate mortgage borrower who, even after bankers' spreads/margins, will be able to borrow at a reasonable spread over 10 year G-Sec yield (currently 7.55 per cent). Significantly, this can be applied equally to creating long-term fixed-rate financing solutions for long gestation infrastructure projects as well. That is as simple as it can get in terms of creating two-in-one fixed-rate long-term market-based financing solutions for both affordable housing and infrastructure. And considering that the outstanding housing loans constitute a mere 10 per cent, and outstanding infrastructure loans of banks, a mere 8 per cent of the total outstanding notional principal amount of IRS of Rs. 38 trillion, the above solution is perfectly do-able. However, I would still leave the thought with this distinguished and discerning audience to explore and take it forward.

6. With these remarks, I close my address and wish the Conference all success that it so much deserves. Thank you all so very much.