Market wisdom INVESTOR EMPOWERMENT SERIES

LESSON NO. 29 FROM THE HOUSE OF ASIT C. MEHTA INVESTMENTS

Interest on Housing loans

An average Indian person dream of moving into his OWN home after satisfying other basic needs. In the past few years, buying a house has been facilitated by enabling environment, with low interest rates and competing organizations wooing the individual households with many attractive schemes for housing loans and soliciting calls from banks and housing finance companies.

Many individuals have borrowed large amount, say Rs.10 lacs for example, for a long period, say 15 years in the form of housing loan, and the interest rate was around 7.5% per annum for such loans. The repayment amount every month for such a loan known as EMI (Equated Monthly Installment) has been around Rs.9270. This installment amount may vary if the interest amount is calculated on a daily rest basis or annual rest basis. Similarly, interest rates are computed on Fixed basis or Floating basis or even hybrid basis.

A **daily rest** basis gives credit for the repayment on the date of payment and reduces interest accordingly. An **annual rest** basis does not give credit for the repayment during the year and charges interest on the opening balance through out the year. Hence the monthly installment will be higher for interest charged on annual rest basis. There are other variations like **monthly rest** basis resulting in different monthly installment for similar loans. Individuals need to understand the terms of loan for comparing the interest rates of different offerings by the banks and finance companies.

The interest rates on housing loans may be on **fixed rate basis or floating rate** basis. The fixed rate as the name suggests is fixed for the tenor of the loan. It is necessary for the individuals to read the fine print. The fixed rate loan agreement may state that the bank will have the right to reset after 5 years! This will change the monthly installment after the reset period. This is similar to a combination of fixed and floating rates and can be called hybrid. At the time of initial fixing of interest rates, a floating rate is normally less than the fixed rate, Subsequently these may vary with the benchmark rate from time to time, say Prime Lending Rate (PLR) of the bank. The monthly installment may fluctuate more with the change in interest rates. Remember that the PLR is the lending rate that the bank gives it to its best borrowers. It is not necessarily the best rate in the market as a whole. Also it is changed by many a banks, upwards quickly and downwards very slowly, and are not correctly synchronized with the interest rates in the market place. In other words, they will rise rapidly and fall slowly for the borrower and vice versa for the depositors.

The benign environment in interest rate is changing. Due to inflationary pressure in the economy, RBI is compelled to give signals that have changed interest rates. For example, the interest rate for 15 year housing loan is currently around 11 per cent per annum. This is a very steep increase indeed and is expected to increase further.

Let us understand the implication of the interest rate increase to 11 percent: if one pays the **same monthly installment of Rs.9270 as agreed above the individual has to pay for 41 years** to completely repay the principal and interest instead of the 15 years or alternatively the individual has to pay **increased monthly payment of Rs.11366 to complete the repayment in 15 years**. **The following table indicates the impact on repayment tenors for various changes in interest rates:**

Rate of interest	7.50%	8.50%	9.50%	10.50%	11%
EMI	9,270	9,847	10,442	11,054	11,366
Tenor in months	180	205	244	331	493
in years	15	17.08	20.33	27.58	41.08

Many of the housing loan agreements do have **pre-payment penalty clauses** that mean if you want to completely repay the loan as the interest rates have risen, you may have to pay a penalty for earlier repayment!

Even some of the nationalized banks loan agreement has such a clause or they obtain the concurrence of the borrower while confirming the balance of loan.

At a macro level, the steep increase in interest rates will have significant impact. At the household level the increase will result in higher payment of monthly installment or payment for a longer period of time of the same installment. In some cases the repayment may well extend beyond the employable or working lifetime of borrower causing sever stress on the retirement life. The The low interest period has also resulted in appreciation in the housing prices making the dwelling units costlier. The increased interest rates may dampen the rise in the prices of dwelling units. Thus there is the risk of the household having a large loan amount due and a risk of owning a dwelling unit whose price is stagnant or falling. This double-edged sword cuts very deeply in rising interest rate scenario due to additional liability and reduced liquidation value. Converse is not true so to say that when interest rates fall, the asset prices go up forcing you to borrow more for financing and pay large installments and the rise in asset price is not useful as you cannot encash it easily in our country due to high transaction costs in real estate market in our country.

The increase in interest rates will affect the banks and finance companies too. The delinquent loans will increase as some of the household may find it difficult to meet the increased monthly installments and some may not be able to pay for the longer period to meet their commitment.

The developed markets have addressed the above issues by providing mortgage insurance and mortgage guaranty to the households, securitization of loans and selling them in the market place to diversify risk among different players.

Until such schemes are in vogue in the Indian context, an individual must exercise caution in assessing the requirement for housing loan, understand the various provisions governing the terms of the loan and read the fine print in the agreement to make appropriate choices that may suit his or her requirements.

To summarise, the best policy that a household should adopt for "home equity" is to save a very large part of potential consideration for the house and wait for high interest rate times to invest in the house. At that time, borrow part of the cost in floating rate basis so that when the rates go down, the investor gets a double benefit of reduced rates and price rise. Once the rates go down, convert the terms of the loan into a fixed rater loan by paying a small premium/penalty to the lender then. Of course not many marketing agencies will be there when interest rates are high and asset prices are down!

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• NSE C.M. : INB 230607239
• DP Registration (C.M & Derivatives) : IN - DP - CDSL - 28 – 29

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