CHAPTER IV

Cost of Operations

4.1 Resource mobilisation

As the cost of funds is crucial to a finance company, its ability to generate them is essential for its operations. It is noted that the ability of the HFCs to raise resources at the lowest cost is constrained compared to banks due to the absence of access to low-cost retail deposits. Also, the HFCs do not have an extensive branch network and ability to provide cheque issuing facilities.

Audit analysis of the HFC's resource profile incorporates the cost of resources and appropriateness of the funding strategy under following sub-heads:

4.2 Asset Liability Management

4.2.1 The HFCs are exposed to credit, interest rate, liquidity, equity/commodity price and operational risks and therefore have to put in place systems and internal controls to manage these risks especially those relating to interest rates and liquidity. The Asset Liability Management (ALM) provides a comprehensive and dynamic framework for measuring, monitoring and managing liquidity and interest rate risks of a HFC.

4.2.2 The ALM is the practice of managing risks that arise due to mismatches between assets and liabilities and assumes special importance in the housing sector as practically all the housing loans (assets) are long term while the corresponding financing resources (liabilities) of the HFCs are short to medium term borrowings. The ALM is the ongoing process for formulating, implementing, monitoring and revising strategies in relation to these assets and liabilities towards achieving financial objectives for a given set of risk tolerance and constraints.

4.2.3 The interest rate volatility in an increasingly de-regulated environment brings in higher risks. The mismatch could adversely affect the business as the interest rates on current borrowings are variable, and the future borrowings' terms and conditions are uncertain.

4.2.4 The NHB as a regulator, had issued (June 2002) detailed guidelines for monitoring the ALM in all HFCs. As per the guidelines, mismatches (negative gap) representing the difference between cash inflows (liabilities) and cash outflows (assets) were not to exceed 15 *per cent* of the cash outflows. The HFCs could, however, operate on higher levels of mismatch if approved by their Board of Directors, up to 30 September 2002.

4.2.5 Securitisation of assets is a funding alternative by which financial assets are pooled together and repackaged into marketable instruments. Securitisation is possible if there is a predictable income stream which converts the incomes/cash flows into capital for reinvestment and allows businesses, which do not have traditional assets upon which banks are prepared to lend, to raise capital from the market. The funding through securitisation of assets can be cheaper than bank loans as the investment is against an identifiable set of assets the credit risk of which is perceived to be lower. During 2005-

06, Housing Development Finance Corporation Limited (a private sector HFC), mobilised funds of Rs.1016 crore through three issues of mortgage backed securities. This route of raising finance has however, not been resorted to by any of the public sector HFCs reviewed in audit during the period of five years ending 31 March 2006. In the case of PNBHFL, its Board of Directors had only recently approved securitisation of assets worth Rs.500 crore (October 2007).

4.3 Cost of borrowings

Traditional sources of financing for the HFCs are through debentures, bank loans, priority sector funds, loans from multilateral agencies, NHB refinance, retail funding, fixed deposits, *etc*. A recent trend of securitisation of assets is also gaining popularity as a funding alternative.

A financing business requires careful planning and systematic assessment of requirement of funds to keep the cost of borrowings at the very minimum. Weaknesses in this could lead to unnecessary borrowing or idling of funds resulting in avoidable interest expenditure; or non-availability of funds for its disbursement programme leading to loss of business. These aspects were evaluated for the five HFCs and the results are as under:

4.4 Higher cost of borrowing

4.4.1 All HFCs prepare resource mobilisation plans on the basis of their annual targets for disbursement of loans. For mobilisation of funds, avenues are explored depending on the market conditions and while deciding the resource mix, economy in operations is considered as the most critical factor. The housing finance business is market-driven and the rates of interest for loans disbursed are fixed by the HFCs based on the market trends. Therefore, the HFCs have to take adequate measures to keep its cost of borrowing at minimum to have a higher interest margin for maximising their profit.

4.4.2 The cost of borrowing of each of the five HFCs compared to a private sector HFC for the period 2001-02 to 2005-06 is shown in Table 5 below:

Table 5: Average cost of borrowing of HFCs

(Figures in percentage)

HFCs reviewed	**2001-02**	**2002-03**	**2003-04**	**2004-05**	**2005-06**
HUDCO	11.21	9.87	9.11	7.71	7.69
BOBHFL	10.71	10.39	8.42	7.90	7.08
CBHFL	11.72	10.43	9.68	8.91	8.83
IHFL	-	-	7.70	5.71	5.94
PNBHFL	12.07	10.30	9.09	7.42	6.95
HFC in Private Sector					
HDFC	10.93	9.38	7.21	6.00	5.98

4.4.3 From the Table 5 it can be seen that while the average cost of borrowing of IHFL was comparable to one of the leading HFCs in the private sector, HUDCO, PNBHFL, CBHFL and BOBHFL were borrowing at higher cost in comparison. HUDCO stated (October 2007) that its average cost of borrowings was not comparable either with HDFC which enjoyed higher credit rating, or with PNBHFL and IHFL whose size of operations was smaller than HUDCO. In view of the reply, HUDCO needed to make efforts to maintain appropriate mix of resources to keep the cost of borrowing to minimum. IHFL accepted that the cost of borrowing was higher for the HFCs compared to the SCBs, as the latter had access to current and savings accounts and dealt with a host of products. The higher cost of borrowings of the HFCs could be offset by lower non-interest costs to maintain their profitability.

4.4.4 The sources of funds of the HFCs as on 31 March 2006 is shown in Table 6:

Table 6: Mix of borrowings of public sector HFCs as on 31 March 2006

(Amount: Rupees in crore)

Sl. No.	Instrument	HUDCO	BOBHFL	CBHFL	IHFL	PNBHFL	Total of Instruments
1	Bonds, Debentures and Retail funding	10149.56 (47.29)	20.00 (9.13)	-	60.00 (3.84)	125.00 (11.96)	**10354.56** **(42.18)**
2	Bank Loans, Commercial Paper	7380.10 (34.39)	185.45 (84.69)	83.06 (31.91)	1340.37 (85.88)	459.93 (43.99)	**9448.91** **(38.49)**
3	Public Deposits	1905.33 (8.88)	-	46.75 (17.95)	-	134.28 (12.84)	**2086.36** **(8.50)**
4	Loans from GOI and FIs	1204.73 (5.61)	-	-	-	88.26 (8.44)	**1292.99** **(5.27)**
5	Loans from multilateral agencies	821.68 (3.83)	-	-	-	-	**821.68** **(3.35)**
6	NHB refinance	-	13.52 (6.18)	130.52 (50.14)	160.45 (10.28)	238.08 (22.77)	**542.57** **(2.21)**
	Total	**21461.40**	**218.97**	**260.33**	**1560.82**	**1045.55**	**24547.07**

Note: Figures in bracket indicate the percentage to the total borrowings of the HFC.

4.4.5 As can be seen from Table 6, these HFCs mainly raised funds through bonds, bank loans and commercial papers. The Public Deposits and NHB refinance routes were not resorted to in a big way by these HFCs.

4.5 Net Interest Margin

4.5.1 Earnings are a key input to augment capital required for supporting growth and absorbing losses, as well as to attract equity and debt. Earnings for the HFCs are driven mainly by their Net Interest Margin (NIM), being the difference between the average yield of the loan assets and average cost of funds deployed. The audit evaluated the stability and sustainability of the profitability as reflected in the funding structure, operational efficiencies and portfolio quality.

4.5.2 A thin NIM indicates low profitability which limits the Company's capability to generate resources and to meet the challenge of business risks arising out of the NPAs and fluctuations in interest rates. Table 7 indicates the comparative data of the NIMs of the HFCs benchmarked against those of HDFC during the period of review:

Table 7: Net Interest Margin of HFCs

(Figures in percentage)

HFCs reviewed	**2001-02**	**2002-03**	**2003-04**	**2004-05**	**2005-06**
HUDCO	0.41	1.91	2.16	1.89	1.66
BOBHFL	2.24	1.62	1.49	1.52	2.25
CBHFL	1.49	1.74	0.48	(-) 0.45	0.02
IHFL	-	-	1.92	2.09	2.29
PNBHFL	2.36	2.07	2.11	1.94	2.45
HFC in Private Sector					
HDFC	2.11	2.17	2.46	2.38	2.57

Source: Annual accounts of the HFCs

4.5.3 It is evident from the above table that the NIMs achieved by PNBHFL and IHFL matched the trend prevailing in HDFC. In all other HFCs, the NIMs were on the lower side thus indicating that these HFCs were not competitive enough. Some of the major factors attributable to lower NIM in these HFCs were:

(i) unlike the SCBs, these HFCs had no access to low interest retail finance such as current accounts and savings accounts.

(ii) the refinance support of the NHB did not work effectively as public sector HFCs like HUDCO were not able to meet requirements of low level of the NPA.

(iii) poor credit ratings of these HFCs reflected in higher cost of borrowing.

(iv) higher proportion of operational costs in relation to business volume.

4.6 Declining trend in mobilisation of funds through Public Deposit Scheme

Mobilising funds through Public Deposits (PDs) has certain inherent advantages over other sources of financing *viz.*, non-requirement of securities, medium to long span of holding without much change in interest costs, and regular flow of funds from regular depositors. As per the NHB (Directives) 2001, an HFC could raise PDs up to five times of its Net Owned Funds♦. Funds mobilised through PDs by the HFCs are given in ***Annexure XIII***. It was observed that despite the stated advantages, the HFCs did not resort to this route to mobilise funds.

BOBHFL and IHFL did not mobilise funds through PDs. Based on the year end balances in the case of PNBHFL and CBHFL, it was seen that their funding through PDs reduced from 28.97 *per cent* (2001-02) to 12.84 *per cent* (2005-06) and 39.18 *per cent* (2001-02) to 17.96 *per cent* (2005-06), respectively. For HUDCO, there was a declining trend in mobilisation of funds through PDs; mobilisation through this source reduced from Rs.247 crore during 2004-05 to Rs.82.37 crore during 2005-06 though this source was cheaper in 2005-06. HUDCO stated (May 2007) that it had increased the mobilisation of PDs to Rs.350 crore during 2006-07 and was targeting to raise Rs.2000 crore during 2007-08 through PDs. However, the Company did not elaborate the strategy by which it planned to raise these huge resources.

4.7 Mid-way reduction in cost of borrowings

In order to get the cheapest funds from the markets, the HFCs depending upon the market conditions were expected to carry out dynamic treasury operations. In one case, the audit noticed that CBHFL in 2004 decided to retire its high cost debts of the NHB and to reduce interest burden on outstanding dues as there was a decline in interest rates in the market. The NHB accepted CBHFL's request to allow prepayment of loans amounting to Rs.98.61 crore. Accordingly, CBHFL approached its parent bank for sanctioning a term loan of Rs.98.00 crore. CBHFL could neither get the term loan from its parent bank nor did it resort to any other alternative source of borrowing.

CBHFL stated (May/October 2007) that the Company could not pre-pay the high cost funds of the NHB as the parent bank could not provide the required funds at cheaper rates because of the arm's length policy of the Reserve Bank of India and the borrowings from other sources were available at a rate of 8.50 *per cent*. However, in view of the fact that the weighted average cost of the NHB funds was in the range of 9.25 *per cent*, CBHFL could have approached other sources to save the interest cost.

4.8 Refinance from NHB

With the objective of providing long term funds to the HFCs, the NHB offers refinance on certain terms and conditions in respect of the loans extended by them. The refinance scheme was not availed by the HFCs in a big way because to qualify for the same, the NHB required prepayment charges and had stipulated that NPAs of the HFCs should not be more than five *per cent*. The internal credit rating system of the NHB also did not allow these HFCs, having comparatively poor credit rating, to resort to refinance from the former.

♦ Net Owned Funds represent the aggregate of paid up capital and free reserves reduced by accumulated losses, deferred revenue expenditure and other intangible assets.

Three HFCs (HUDCO, PNBHFL and IHFL) availed refinance facility up to 32.33 *per cent* of the total borrowings during the last five years ending 31 March 2006. In PNBHFL, refinance facility had come down from 32.33 *per cent* (2001-02) to 22.77 *per cent* (2005-06). The refinance from the NHB was not availed by HUDCO during 2004-05 and 2005-06 as the interest rates of the NHB were comparatively higher than the rates prevailing in the market. HUDCO stated (March 2007) that its housing loans disbursed to Housing Boards, State Government and its Agencies were not eligible for refinance from the NHB. HUDCO stated that it did not prefer the NHB refinance due to stringent conditions coupled with higher rate of interest.

The innate objective of the NHB to provide refinance facility to the HFCs, thus, remained largely unfulfilled.

4.9 Employee cost

4.9.1 A factor that affects maximising profitability of the HFCs is employee cost. As such a lower percentage of employee cost to the amount disbursed during the year is indicative of higher efficiency. An analysis of the percentage of employee cost to disbursements revealed that when compared to the private sector HFC, *viz*., HDFC, the cost was higher in the HFCs under review, as shown in the Table 8 below:

Table 8: Percentage of employee cost to disbursements

(Figures in percentage)

HFCs reviewed	**2001-02**	**2002-03**	**2003-04**	**2004-05**	**2005-06**
BOBHFL	0.53	0.34	1.10	*	*
CBHFL	0.75	0.66	0.80	1.72	9.68
IHFL	-	-	1.33	0.53	0.48
PNBHFL	0.68	0.89	0.98	1.02	0.93
HFC in Private Sector					
HDFC	0.42	0.39	0.36	0.32	0.32

**** Due to merger decision, BOBHFL had stopped fresh disbursements during these years.***

In case of HUDCO the ratio could not be worked out as data regarding number of staff for housing and urban infrastructure projects were not separately available.

4.9.2 The above data indicates that the ratio of employee cost to disbursements in HDFC ranged between 0.32 to 0.42 *per cent* and showed a declining trend over the period of review. While except for IHFL in the public sector the other HFCs had very high ratios indicating low efficiency of operations. In case of CBHFL, the marked jump in the ratio in 2005-06 was attributed to the fall in the disbursement of loans by 78.92 *per cent* in 2005-06 as compared to the previous year, as discussed in para 5.2.4 *infra*.

4.10 From the foregoing study of the HFCs' resources profile, it emerged that:

- The ability of the HFCs to raise resources at the lowest cost is constrained compared to the SCBs due to the absence of access to low-cost retail deposits. Further, the innate objective of the NHB to provide refinance facility to the HFCs remained largely unfulfilled, as the HFCs like HUDCO were not able to meet requirement of low level of NPA.
- The five HFCs mainly raised funds through bonds, bank loans and commercial papers. The Public Deposits and the NHB refinance routes were not resorted to in a big way and the option of raising finance through securitisation of assets had not been resorted to by any of the HFCs reviewed during the five years ending 31 March 2006. Except for IHFL, the other four HFCs comparatively borrowed at higher cost.
- Net Interest Margin achieved by PNBHFL and IHFL matched the trend prevailing in one of the leading HFCs in the private sector. In the other three HFCs, it was on the lower side, indicating that these HFCs were not competitive enough and therefore, vulnerable to elimination from the housing finance market.

Recommendation No.3

(i) ***The HFCs should strive for a proper mix of resources in order to minimise the cost of borrowings.***

(ii) ***In order to promote the easy availability of low-cost resources for housing finance, the Government of India and the NHB may consider suitable measures to increase the depth of the market for mortgage backed securities and to encourage the HFCs to resort to securitisation of assets as a funding alternative.***

(iii) ***The NHB re-financing mechanism needs to be revisited to facilitate the public sector HFCs in availing ready credit at competitive rates.***