Research Paper

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An Analysis of the Housing Loan Segment of Commercial Banks in India

ECONOMICS

KEYWORDS : COMPOUND RATE OF INTEREST, EMI, HOUSING LOAN

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ABSTRACT

Commercial banks command a major share in the total banking operations in India. Housing loan is one among the variety of loan schemes offered by the commercial banks. Generally people are very reluctant to take a loan from the bank . This paper will focus on how a customer can benefit by taking a housing loan rather than utilizing the surplus fund with him to construct his dream house. The main objective of the study is to analyze the extend of customer advantage of housing loans by comparing fixed deposits and the equivalent amount of housing loan.

The result of the study revealed that total amount paid for a housing loan of thirty year duration is lesser than that of the total amount received from the equivalent amount of fixed deposit of same duration.

Commercial banks command a major share in the total banking operations in India. The essential functions of a commercial bank are to lend money and to accept deposit from the public. Housing loan is one among the variety of loan schemes offered by the banks. Housing is one of the three basic needs of life, always remains in the top priority of any persons, economy, government and society at large. The home loan sector in India is on a boom. The factors that contributed to the aggressive growth in the portfolio of housing loans of banks are: tax incentives on repayment of principal and interest , rising income level of middle class, falling interest rate, easy availability of housing loans, fluctuations in real estate prices. Although there is strong growth in housing loans by financial institutions in India, we are still behind the developed countries in terms of housing loans to GDP ratio. In India, it is around 2.5% compared to 57% in the UK and 54%in the US. It shows that there is a vast scope for housing loans in India. This paper is an attempt to identify the customer benefit by taking a housing loan rather than utilizing his own fund for constructing a house

OBJECTIVES OF THE STUDY:

- To make an analysis of housing loan segment of reputed commercial banks in India.
- To understand the customer benefit of taking a housing loan by comparing fixed deposits and the equivalent amount of housing loan.

SCOPE AND METHODOLOGY

The present study is mainly based on the four leading commercial banks which provide housing loans for 30 years duration namely State Bank of Travancore (SBT), Federal Bank, State Bank of India(SBI) and Indian Overseas Bank(IOB). The study is mainly based on Secondary data received from the websites of various banks like SBI,SBT,IOB,FEDERAL BANK etc. for the month of May 2015. Various tools like EMI Calculator, FD calculator etc. were used for the analysis of data.

MEANING AND DEFINITION OF HOUSING LOAN

A Home Loan is a secured loan with the property pledged as collateral with the bank/ housing finance company. In a home mortgage, the owner of the property (the borrower) transfers the title to the lender on the condition that the title will be transferred back to the owner once the payment has been made and other terms of the mortgage have been met. Home mortgages allow a much broader group of citizens the chance to own real estate, as the entire sum of the house doesn't have to be provided up front. But because the lender actually holds the title for as long as the mortgage is in effect, they have the right to foreclose the home (sell it on the open market) if the borrower can't make the payments.

A home mortgage is one of the most common forms of debt, and it is also one of the most advised. Mortgage loans come with lower interest rates than almost any other kind of debt an individual consumer can find. A home mortgage will have either a fixed or floating interest rate, which is paid monthly along with a contribution to the principal loan amount. As the homeowner pays down the principal over time, the interest is calculated on a smaller base so that future mortgage payments apply more towards principal reduction as opposed to just paying the interest charges.

TYPES OF HOME LOAN

The two basic types of housing loans are the fixed rate mortgage (FRM) and adjustable-rate mortgage (ARM) also known as a floating rate or variable rate mortgage. In some countries, fixed rate mortgages are the norm, but floating rate mortgages are relatively common.

Fixed rate mortgage **(FRM)**

FRM means repayment of home loans in fixed equal installments over the entire period of the loan. In this case, the interest rate doesn't change with market fluctuations.

Benefits of Fixed rate Mortgage (FRM)

- Interest rate remains fixed irrespective of market conditions
- A fixed-rate home loan is excellent for those who are good at budgeting and want a fixed monthly repayment schedule, which is easy to budget and doesn't fluctuate
- It brings a sense of certainty and security

Drawbacks of FRM

The major drawback with fixed interest rates is that they are usually 1 to 2.5 percentage higher than the floating rate home loan. Secondly, if for any reason the interest rate decreases, the fixed rate home loan doesn't get the benefit of reduced rates and the borrower has to repay the same amount every time. Another area of concern is whether the fixed rate home loan is fixed for the entire tenure or only for a few years. This has to be cross-checked with the bank while taking the home loan. A fixed home loan, which can be changed every few years, will definitely wipe out the very spirit of such a loan. Experts agree on the fact fixed rates are a better option if the economic scenario promises a rise in interest rates in the near future.

Floating rate mortgage or adjustable-rate mortgage **(ARM.)**

Floating rate mortgage by name implies that the rate of interest varies with market conditions. Home loans on floating interest rates are tied to a base rate plus a floating element thereof. So, if the base rate varies the floating interest rate also varies.

Benefits of ARM

- The biggest benefit with floating rate home loans is that they are cheaper than fixed interest rates. So, if you are getting a floating interest rate of 11.5 per cent while the fixed loan is being offered at 14 per cent, you still save money if the

floating interest rate rises by up to 2.5 percentage points.
- Even if the floating rate goes over the fixed rate, it will be for some period of the loan and not the entire tenure. The interest rates will surely fall over a long period and, thus, the floating interest rate brings a lot of savings.

Drawbacks of ARM

The drawback with floating interest rates is the uneven nature of monthly installments. This makes it difficult to budget with floating interest rate home loans. As seen in recent times, due to the hike in floating home loan interest rates, the borrowers had to shell out thousands per month extra as their EMIs, throwing their entire budget out of order.

ELIGIBILITY CRITERIA

Eligibility criteria for Home Loan will differ for salaried and self employed individual. Your age, annual income, cost of land, total estimated budget of construction, work experience in the current organization and your total work experience, educational qualification and your profession are all considered by banks and financial institutions to decide on a housing loan amount for you. For some banks and financial institutions the city you live in and the company you work for are important deciding factors. Housing Loans range vary according to the lending bank and the borrower's ability to pay back. The repayment options are usually flexible, and it can be between 15-30 years, depending on the lender and the credit history of the borrower. The time taken to disburse housing loans varies from lender to lender. Your loans may be approved in as little as 24 hours or may take up to 30 business days, based on your credentials.

LIST OF DOCUMENTS REQUIRED FOR HOME LOAN (APPLICABLE TO ALL APPLICANTS)

- Completed loan application
- 3 Passport size photographs
- Proof of identify (photo copies of Voters ID card/ Passport/ Driving
licence/ IT PAN card)
- Proof of residence (photo copies of recent Telephone Bills/ Electricity Bill/
Property tax receipt/ Passport/ Voters ID card)
- Proof of business address for non-salaried individuals
- Statement of Bank Account/ Pass Book for last six months
- Signature identification from present bankers
- Personal Assets and Liabilities statement.

- Original Salary Certificate from employer (Salaried persons)
- TDS certificate on Form 16 or copy of IT Returns for last two financial years, duly acknowledged by IT Department.

INTER BANK COMPARISON OF HOUSING LOAN RATES IN INDIA

Different banks charge different interest rates for Housing Loans. The rate of interest also vary based on (a) the quantum of the loan; (b) period for which loan is intended to be availed etc. It is not possible to give the name of one bank which charges the lowest rate of interest for all tenures and all levels of loan amount.Moreover, these rates are frequently changed by banks . Following table- 1 will represent the inter-bank comparison of Housing loan rates in India.

TABLE – 1
INTER BANK COMPARISON OF PERSONAL LOAN RATES IN INDIA

Name of the bank	Rate of interest (up to Rs.75 lakhs)	Duration of loan
SBI	9.85% for women 9.9% for Men	30 YEARS
SBT	10.15%	30 YEARS
IOB	10.25%	30 YEARS
FEDERAL BANK	10.35%	30 YEARS
SOUTH INDIAN BANK	10.5%	15 YEARS

Source: compiled from the websites of different banks on May 2015

Note:- The above rates are floating rates, and are linked to base rate.

EMI AND THE HOUSING LOAN

Commercial bank's Housing Loan repayment is based upon **Equated Monthly Installment** (EMI).An EMI is defined by Investopedia as "A fixed payment amount made by a borrower to a lender at a specified date each calendar month. Equated monthly installments are used to pay off both interest and principal each month, so that over a specified number of years, the loan is paid off in full." Here's the formula to calculate EMI:

$$E = P \cdot r \cdot \frac{(1+r)^n}{((1+r)^n - 1)}$$

where

E is EMI

P is Principal Loan Amount

r is rate of interest calculated on monthly basis.

n is loan term(in number of months)

The interest component of the EMI would be larger during the initial months and gradually reduce with each payment. Even though your monthly EMI won't change, the proportion of principal and interest components will change with time. With each successive payment, you'll pay more towards the principal and less in interest.

INTER BANK COMPARISON FIXED DEPOSIT(FD)

Fixed Deposit schemes are offered by all banks in India. Banks usually offer relatively higher rate of returns on fixed deposits than on savings or current accounts. Fixed deposit is a deposit of a fixed sum of money for a fixed period of time which can vary anything from a few days to a few years- at a fixed interest rate known at the beginning of investment. Interest is compounded at periodic intervals like monthly, quarterly etc. The following Table – 2 represent the interbank comparison of the rate of interest for the fixed deposit of more than five year duration.

TABLE – 2
INTER BANK COMPARISON OF THE INTEREST RATE OF FIXED DEPOSIT (5 YEARS &MORE)

Name of the bank	Rate of interest for ordinary FD
SBT	8.0%
SBI	8.25%
IOB	8.00%
FEDERAL BANK	8.25%

Source: compiled from the websites of different banks on May 2015

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FIXED DEPOSIT AND THE COMPOUND RATE OF INTEREST

Fixed Deposit is based upon compound rate of interest .Compound interest arises when interest is added to the principal so from that moment on, the interest that has been added *also itself* earns interest. This addition of interest to the principal is called *compounding.*

The following formula gives you the total amount one will get if compounding is done:-

$$A = P\left(1 + \frac{r}{n}\right)^{nt}$$

Where,

- A = Final Amount that will be received
- P = Principal Amount
- r = Annual nominal interest rate (as a decimal i.e. if interest is paid at 5.5% pa, then it will be 0.055)
- n = number of times the interest is compounded per year
- t = number of years

The original deposit amount together with fixed deposit interest earned is returned to the depositor at the end of the fixed deposit maturity date. In India banks use quarterly compound interest calculator in rupees.

Effective yield is the actual return on your Fixed Deposit. It depends on the rate of interest and the frequency of compounding. Effective yield increases with every increase in the compounding.

CUSTOMER BENEFIT DUE TO THE DIFFERENCES IN THE PRINCIPLES OF EMI AND COMPOUND RATE OF INTEREST

The housing loan EMI is based on the principle of *Discounting rate of interest.* In other words, the interest component of the EMI would be larger during the initial months and gradually reduce with each payment. With each successive payment, you'll pay more towards the principal and less in interest. As a result, the actual rate of interest we paid for a housing loan of 30 year duration is lesser than that of the nominal interest rate specified in the loan.

On the other hand, Fixed deposit is based on compound rate of interest **.**Compound interest arises when interest is added to the principal so that from that moment on, the interest that has been added also itself earns interest. This addition of interest to the principal is called compounding.

Actual gained rate of interest or effective yield from a fixed deposit of long duration will be more than that of the nominal rate of interest offered by the banks. Therefore a customer who have enough money to construct his dream home, can make a gain by taking a Housing loan of long duration rather than utilizing his money for home construction. The extend of gain a customer can earn from the housing loan can be explained with the help of equivalent amount of fixed deposit with same duration.

The following Table – 3 shows the extend of customer gain arrived from the differences in the principles of EMI and Fixed deposit Compound interest rate.

TABLE – 3

INTER BANK COMPARISON OF HOUSING LOAN REPAYMENT AMOUNT AND EQUIVALENT AMOUNT OF FIXED DEPOSIT

(A) Bank	(C)* EMI for Housing loan of Rs.30 Lakhs (30 year duration)	(D)* Total amount paid for Housing Loan	(E)** Total amount received from 30 year FD of Rs.30 lakhs (at 8.25% rate of interest)	(F) Difference between Housing loan amount paid and FD maturity Amount received (F) = (E)-(D)
SBI	25995.22 (Women) 26105.73 (Men)	9358279 9398062	34758858 34758858	25400579 25360795
SBT	26660.29	9597704	34758858	25161154
IOB	26883.04	9677894	34758858	25080964
Federal Bank	27106.31	9758272	34758858	25000586

Source: compiled from the websites of different banks on May 2015

Note:* computed by using EMI Formula

** computed by using FD calculator

It is evident from the Table – 3 that total amount paid for aRs.30 lakhs housing loan (30 year duration)is very smaller than the amount received from the equivalent amount of fixed deposit of a thirty year duration. This large difference is due to the basic differences in the principles of Personal Loan EMI and Fixed Deposit Compound Interest . Therefore a customer can make an advantage of taking a Housing loan rather than utilizing the money which he possess in his custody to construct his dream house.

FINDINGS OF THE STUDY

- AS long as Housing Loan's EMI is based on Discounting rate of interest the actual rate of interest we paid for the loan, is lesser than that of the nominal rate specified in the loan.
- If the duration of loan repayment allowed by the bank increases, the effective rate of interest we paid for the loan decreases.
- As long as the fixed deposit in banks is based on compound rate of interest, the actual gain of interest on FD or effective interest rate will be higher than the nominal rate of interest of FD
- If the duration of fixed deposit increases, the effective yield from the deposit also increases. If the bank offers 8.25% nominal rate of interest for a thirty year FD, then the effective yield from that FD will be nearly 35.29% per annum.
- If the Housing loan rate is increasing and FD rate remains the same, the yield from the differences of FD and housing loan is decreasing.

CONCLUSION:

Home loans may also be referred to as mortgage loans. Different banks charge different rate of interest for housing loans. Paying your home loan EMI on time is an excellent way to build a repayment track record. As long as housing loan repayment EMI is based on Discounting rate of interest and the fixed deposit depends on compound rate of interest, a customer can make an advantage by taking a housing loan from a bank which offers reasonably very low interest rate. To conclude if you have the eligibility to get a housing loan from the bank at the reasonable rate of interest, it is better to take Housing loan rather than utilizing the money with you to construct or modify the house. Because housing loan is a better choice to get money and save money.

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