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CONTENTS

A) REVERSE MORTGAGE – A VALUABLE OPTION FOR SENIOR CITIZENS- page 1

by Suresh S., Director, DMS Financial Services Co.P.Ltd.

B) OVERCOMING PROJECT COST OVER-RUNS - page 4

by Anagha S., Project Leader, TCS

REVERSE MORTGAGE – A VALUABLE OPTION FOR SENIOR CITIZENS

by Suresh S.

Director, DMS Financial Services Co. (P) Ltd.

Senior citizens have a disadvantage from the age point of view as also earning capacity point of view. Having built a house they cannot mortgage it the way a business man does for raising funds. They might have spent a major part of their savings building this house and may not have much wealth invested otherwise. What do they do if they want more cash flows to make two ends meet? They live in that house but what use is that asset after their lifetime? More so, if they value their independence, or do not have children or wish not to depend on their children! The ideal solution would be for that asset to generate cash flows for them without (i) their having to move out/sell/sacrifice their residence and (ii) without having to ‘repay’ the loan in their lifetime. Reverse mortgage offers such a solution.

Reverse mortgage is a loan facility which enables senior citizens generate income out of the house they already own, without having to sell the house and move to a smaller house. The bank/Housing Finance Company (HFC) approves a loan against the security of the house and makes available the money to the couple either as part lump sum and part periodic payment, or as pure periodic payment.

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Typically such lump sum options could come in handy for hospitalization needs etc. The loan is settled generally by sale of the house on the demise of the surviving spouse. Alternatively the heirs could have the option of retaining the property by settling from their other sources, the principal and interest outstanding. Also, anytime the couple themselves decides they would like to close the loan, they could do so and free the property from the Bank/HFC.

The recent launch by Central Bank of India of an improved version of its Reverse mortgage scheme looks attractive. The product offers annuity for life on the back-up of the owned house of the elderly couple. The offer has been made possible due to the tie up of Central bank with Star Union Dai-chi Life Insurance.

The annuity could be monthly, quarterly, semi-annual or annual payments. If the couple wishes to have a combination of part Lump sum and part Annuity, the Bank would give 25% of the loan amount as Lump sum subject to a maximum of Rs.15 lakhs.

Monthly inflow/Annuity calculated below is based on CBI & SBI's Reverse Mortgage offering:

Item	Central Bank of India	SBI	Remarks
Property value today	Rs. 30 lakhs	Rs. 30 lakhs	Fresh valuation every 5 years
Maximum loan eligible	Rs.24 lakhs @ 80%	Rs.27 lakhs @ 90%	Some Banks include Interest in calculation
Loan availed by couple	Rs. 20 lakhs only	Rs.20 lakhs only	Assumed
Tenure	10 years	10 years	Residual value of property to be at least 20 years
Cash inflow monthly per lakh loan	Rs.490	Rs.468	CBI: 'Annuity' without return of capital
Cash inflow monthly for Rs.20 lakh loan	490 X 20 = Rs.9800	468 X 20 = Rs.9360	To this extent couple's monthly "income" goes up*
Total cash inflow	20 lakhs X 10 yrs X 490 pm X 12 months = 1176000	20 lakhs X 10 yrs X 468 pm X 12 months = 1123200	SBI: exempt from income tax under Section 10(43) of the Income-tax Act, 1961.CBI:Taxable
Interest as stated by Bank/HFC	9.50% pa	10.75% pa	
Interest on monthly compounding (IRR)	10.24% pa	11.11% pa	

*'income' here means cash inflow

The features of the Central Bank of India scheme which make it attractive are:

- Annuity for life. Comparable schemes offer maximum 20 years tenure of the loan.
- The house would be available for residence as long as the last surviving spouse is alive
- The amount of the Annuity is higher compared to earlier schemes.
- If the investment made by Dai-chi earns a return exceeding 6% during a financial year, 80% of the excess over 6% will be distributed to the senior citizens as cash bonus.

NHB guidelines prohibit levy of prepayment charges.

A very important feature of Reverse mortgage in India is the 'no negative equity guarantee' by the Bank/HFC. The liability of the borrower cannot exceed the estimated value of the property and if it does the borrower is not liable. Hence the Bank/HFCs include the interest in the total when computing the ratio of Loan to Cost. One of the guidelines is that the equity of the borrower in the residential property called as Equity to Value Ratio never falls below 10% at any time during the tenor of the loan.

Bank of Baroda stipulates that the house should be completely self-occupied. Hence no portion should be sub-let or given on rent. The couple also needs to stay in that house. They cannot take a Reverse mortgage on their house to enable them to stay in an 'old age home'. Commercial property is also not eligible. SBI offers Reverse mortgage even to senior citizens who have an on-going outstanding normal housing loan with them by foreclosing the loan with the proceeds of the Reverse mortgage loan.

The annuity option for life is a welcome feature. If instead of Annuity the Bank/HFC defined the term as say 15 years and the couple survives the term, the loan would perforce need to be extended. Let's say it is extended for 5 years. What happens if the estimated Valuation of the property is less than the computed outstanding after 5 years? If such valuation is short, it would lead to a very delicate position – the couple cannot be asked to vacate for sale of the property nor can a fresh tenure of loan be given!

There are two types of annuity options:

- Amount fixed per period payable as long as the second of the couple survives
- Amount fixed per period as above plus a one time lump sum representing purchase price (equivalent of initial investment which generates annuity).

The second option would have a lower amount per period as compared to the first option. The second option would be preferred if the heirs express interest to retain the property. The return of the initial investment would make it easier for them to retain the property by arranging marginal amount to settle the bank outstanding.

Four factors make for complication in an otherwise simple offering:

- Senior citizens would need to incur costs such as costs of legal opinion, processing fee, registration costs of mortgage and valuation costs.

- Where the property is sold on the demise of the elderly persons, the difference between the cost of acquisition and sale proceeds would be liable for Capital gains tax. Interest paid cannot be deducted or adjusted against the Capital gains.
- If the value of the property is not enough to pay the capital gains tax after payment of Principal and interest, the heirs would need to cough up this amount from their sources.
- If the senior citizens start receiving the annuity from Cent Swabhiman Plus (the Central Bank scheme now announced), they cannot surrender or modify it.

OVERCOMING PROJECT COST OVER-RUNS HOW PROJECT PLANNING CAN HELP

by Anagha S.

Most technology projects suffer from varying degrees of cost over-runs. In the past it has been observed that inadequate planning and design are one the most common reasons. Attempts to save time and money on initial planning and detailed definition could turn disastrous. When cost over-runs do occur, desperate measures are resorted to. The Project Managers panic since they fear that when actual costs substantially exceed estimates their career might be impacted. Therefore they resort to cutting intangibles such as quality or testing which can ultimately cripple the project. This paper outlines possible measures that can be instituted when project managers face serious cost over-runs.

Heard of the ‘Concorde syndrome’? In the UK, this is the name given to the disease prevalent in many projects – in honor of the airplane project that overshot its estimated budget by several thousand percent! Surely, this disease is not restricted to airplane projects alone. All technology projects suffer from varying degrees of this syndrome.

New projects, especially those involving technology, are prone to cost [and time] overruns, that may end up exceeding estimates by several times. Such occurrences leave companies facing nightmare situations that refuse to dissolve even when the companies struggle and somehow manage to finally prop up the projects and run them. Desperate measures are taken to stem the hemorrhage of funds, such as cutting back on essentials such as contingency programming or employee welfare, which can ultimately cripple projects permanently.

What factors cause cost over-runs?

What are the factors that lead to these nightmare situations? Pioneering studies¹ done in the past on various industries have listed one common thread that characterizes these struggling projects – inadequate design at the start of the projects. The studies have also shown that as the level of project definition and the data support to quantify this project definition increase, the cost overruns of the project decrease perceptibly. Attempts to save time and money on initial

¹ The Rand Corporation study on pioneer process plants, and the PIMS study, both done in 1981

planning and detailed definition, because of haste or an inadequately staffed or trained design team, more often than not, turn disastrous for the project.

The above quoted studies show the sequence of events once expenses on the project start getting out of control. Reactions from project managers are predictably similar. As cost overruns mount, they panic. The studies say that the panic is understandable, since overruns on new technology projects could double, triple or even quadruple the original estimates, cost the company substantially, and may even ruin the careers of those responsible. So the managers start looking for corners to cut. Where projects have not built in enough slack, cost cuts only exacerbate the problem. The project economics therefore flounders. *What the project and the company face in such situations is a gross underestimate of project economics, misunderstood as a cost overrun!*

However, in practice, project managers faced with ‘cost overruns’ do start cutting costs. They believe they cannot cut ‘hard’ costs – building, material or other equipment. So they cut down on those whose benefits are not ‘tangible’ enough – typical examples are managerial and design overheads, process control software, quality assurance programs and testing procedures. The studies remark that it is ironical that these are the very areas which could have been underestimated even at the budget stage! These are probably the least understood and quantifiable parts of the project plan, and are therefore not given their due place in the estimation. The result – the project plan that should have been a control measure is turned into a speculative exercise. Intangible systems and processes gone awry can unfortunately have quite tangible [and adverse] results!

What is to be done in the case of over-runs?

- Recognize the overrun at an early stage. Denial of the overrun cannot simply wish it away. The first 10% of slippage should be the warning signal.
- Use the Critical Path Method judiciously to identify areas of slack. Sensitivity Analysis can be used to high-light areas of risk.
- Accept that something has to be done about the overrun. The typical actions are the four ‘R’s – retrench, retrieve, revise and review. However, all these actions may not be suitable for all situations.
- Verify the nature of the problem. When the first signs of failure appears, the easiest way out is to search for the scapegoat. This is not going to help either the project manager or the scapegoat. Instead, being open about the problem and seeking a solution with the team will lead to greater commitment within the team
- If the situation is serious enough to warrant a revision of the estimates or a reengineering of the whole project, do it. The client might be unhappy initially, but will soon realize the value that early recognition of cost overruns brings in. Patch up work later will lead to more serious trouble for the project manager and the client.

- Be aware of the areas where underestimation is possible. As given above, process control measures could be the most underestimated area. Learn from the mistakes of underestimation in past projects
- Track changes in actual project cost over estimate, and ‘re-cost’ if necessary. This can be done by an independent and objective team. The client can be convinced of the need to re-cost if solid reasons and calculations are shown.
- The company needs to create an environment of honesty and transparency, so that project managers can take decisions in the best interests of the company.
- Sometimes, project estimates are deliberately kept low to win the bid for the company. Both the company and project managers should be aware of this fact, and not cut corners or compromise on quality once the project is won.
- Sometimes, the strategy would be to win the bid on the first phase of a project by deliberately keeping the estimates low. This implies that the company might lose on the first phase, but would be able to make money on the subsequent phases. This aspect should be kept in mind and advised to the project team even when the first phase of the project is launched, so that the team is motivated enough to deliver the quality that would ensure that the company is awarded the subsequent phases of the project.

Conclusion

MURPHY’S LAW ON PROJECT COSTS!

‘Any project you try to do will take longer and cost more than you thought!’
 ‘If everything seems to be going well, you don’t know what’s going on’!

Let us defy Murphy’s Law by being aware of the merits of proper project planning and management. Simple steps such as the ones suggested above could do the trick even in the case of overruns!

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