



# ***THE NEWSMAKER***

(Newsletter of DMS Financial Services Co. (P) Ltd., Chennai)

Volume: 19

for PRIVATE CIRCULATION ONLY

May 2010

---

## **CONTENTS**

- A) IMPONDERABLES – THE COMPLEXITY IN RESIDENTIAL COMPLEX DEVELOPMENT** - page 1  
*by Suresh S., Director, DMS Financial Services Co.P.Ltd.*
- B) HOME LOAN SEEKERS - BASE RATE MAY NOT BE ACE RATE** - page 3  
*by Padmalatha S.*
- 

## **IMPONDERABLES – THE COMPLEXITY IN RESIDENTIAL COMPLEX DEVELOPMENT**

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

What happens when a developer of residential complexes finds after he has paid the first instalment in bidding, that the land is not yet ascertained? That the land has not been acquired by the Authorities as the villagers are opposing the construction? That a public road is passing through it and needs to be acquired? That the land is being used even now as a graveyard?

The company needs the possession of the land so that they can market the new Housing project. They need the advance money from customers to finance in part the acquisition. The credibility of the company would be at stake. A decision to defer the purchase would also not be feasible as the tendering rules did not permit. The only option would be abandonment.

This is an interesting case of Eldeco, a group based out of Delhi. The Greater Noida Industrial Development Authority (GNIDA) floated tender to develop group housing projects in a planned township adjacent to Noida, that is, a suburb of a suburb.

**Do give your feedback to us at < [dms.financial.services@gmail.com](mailto:dms.financial.services@gmail.com) >**  
**(web site: [www.dms-finance.com](http://www.dms-finance.com) )**

---

The company had four options:

- Abandon this project and get refund
- Deposit the money and work with the authorities to change the land allocation
- Not make the payment at once but work actively with the authorities to change the allocation.
- Deposit the money, take the land as and when they give, and never mind the graveyard.

The Group's finances were stretched to the limit. Cash flows would get pushed back due to delay in launching the project. Project finance was not forthcoming in spite of attractive economics. On the other hand the company's on-going project, the first in Greater Noida was a resounding success proving that their concept was correct and location excellent.

GNIDA was bureaucratic as expected.

- It said it could not demarcate the plot or construct the peripheral roads and the graveyard problem was an issue.
- It refused postponement of instalments as it could set a negative precedent.
- The letter of allotment was loaded in its favour.
- If it could not grant possession on time, the developer could go for annulment and ask for refund.

Eldeco went ahead with the project and is today a leading developer.

This situation narration is presented on Eldeco website and what's interesting, it is today a case study at Harvard Business School.

#### ANALYSIS OF TREND IN DEMAND FOR HOUSING (FIGS. IN MILLIONS)

YEAR	POPULATION	HOUSING UNITS	POPU.PER UNIT
1999	43226	12608	3.4
2000	69454	19655	3.5
2001	96912	26855	3.6
2002	125804	30355	4.1

The decision was based on the following strong positive factors:

- Greater Noida was going at relatively lower values due to the perceived distance from Delhi
- Direct land allotment from local regulatory authorities would be avoided circumventing a lengthy and cumbersome procedure.
- Payment for the land was to be spread over five years.
- Perceived risk of investing in Greater Noida was high for builders and hence there was less competition.
- NASSCOM had projected the Indian IT industry to become a \$50 billion industry and Greater Noida was expected to get the fallout benefit.
- Greater Noida had 96% occupancy levels with an average family income of Rs. 6 lakhs per annum.

\*\*\*\*\*

**HOME LOAN SEEKERS - BASE RATE MAY NOT BE ACE RATE**  
**by Padmalatha S.**

RBI will be replacing the BPLR by the 'base rate' beginning July 1, 2010. Borrowers may be expecting a bonanza. Is this so?

In its guidelines dated April 9, 2010, RBI has made the following statements:

1. The base rate will be the minimum lending rate for all loans
2. It aims at enhancing transparency in banks' lending rates
3. Banks may choose and disclose any benchmark to arrive at the base rate
4. Banks can use the methodology recommended by RBI or any other 'appropriate' methodology to compute the base rate
5. To the base rate, 'appropriate' customer specific charges can be added.
6. Banks can change the methodology and the benchmark rate at any time up to December 2010
7. The rate will be reviewed at least once in a quarter

The current home loan rates of three big banks – SBI, ICICI Bank and Citibank are as follows:

- The basic rate for SBI is the SBAR, at 11.75% p a since June 2009. The short term rates [sometimes called 'teasers'] are between 8%-9%, while for longer tenors the rates are between 0.75% and 2.75% below SBAR, effectively 9%-11%
- ICICI bank's floating reference rate [FRR] for home loans is at 12.75%
- Citibank's Mortgage Prime Rate [CMPR] is 13.5% and home loans are offered in the range of 8.5%-18.75%

In all the cases, service charges/ processing fees and other charges are additional.

Existing and prospective home loan borrowers are likely to have two questions on the proposed changes - [a] whether base rate introduction would benefit them by way of lower interest rates, and [b] what is the 'transparency' promised and how will it add value to borrowers.

Preliminary computations based on RBI's [rather confusing] methodology indicate that base rates are likely to hover in the 8%-9% range. Remember that this is the 'minimum' rate, and banks can add premiums to compensate for the tenor and risk of the loans. This could effectively imply that there may be little change over the existing rates.

Further, other fees and service charges are at the discretion of individual banks, and these can add to the loan cost.

The assurance of transparency can be valuable provided borrowers are able to [a] understand the pricing computations, [b] verify them, and [c] are able to question them.

Pricing decisions can be complex for financial products due to underlying volatilities. For example, unless borrowers are educated to comprehend reserve requirements, or the possible fluctuations in cost of funds/ deposits, or the nuances in banks' sources of funds, or overheads or profitability, mere transparency may hold no meaning. Further, fluctuations in the parameters

underlying the base rate should be verifiable. Even if verifiable, borrowers can neither influence nor question pricing decisions taken by banks.

The computation methodology provided by RBI makes many simplifying assumptions that could lead to pricing anomalies among banks, thus eroding their market competitiveness. For example, banks that use marginal cost of funds as the basis for calculation may end up showing higher base rates than banks using average cost of funds. Or, assuming 364 day T-Bill rate as representative of SLR return may lead to flawed conclusions. Or, calculating net profit as a proportion of deployable deposits may not reflect banks' return on net worth. There are several such computational issues with the methodology suggested by RBI. On the other hand, banks' own methodologies, where adopted, should be explained clearly to borrowers, and their superiority over existing methodologies should be proved.

Thus, it seems that the 'base rate' might bring more transparency but not give any bonanza other than that.

\*\*\*\*\*

### **Services offered by DMS Financial Services Co. (P) Ltd.**

- **Outsourcing in the financial function**
- **Placement of human resources**
- **Training in finance, sales, operations and soft skills**

**For details, please contact Mr.Karthi on 044-24995672.**