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FLOATING RATE BORROWERS – PIGGY RIDE THE INTEREST WAVE

by Suresh S.

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

- The spate of interest rate reductions announced by several Housing Finance companies is welcome news for new borrowers.
 - Old ones – persons who borrowed earlier on Floating rates, and find they are paying much higher rates compared to what is being offered now can ask for lowering of their rates.
 - Floating rates vary considerably from company to company from a low of 9.0% of Bank of Baroda to 11.75% of Can Fin Homes for a 20-year term.
 - The existing borrowers have therefore two options: **(A)** whether to continue with the same Housing Finance company (called 'present' hereafter) but to request them to apply new rates (called 'reset'), if necessary by paying them 'service charges', or, **(B)** to migrate the loan from 'present' Housing Finance company to another (the new company being called 'proposed' hereafter).
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- ❑ The first option entails only payment by borrower of a one-time charge on the present outstanding loan amount and if this amount is less than the interest saving, the borrower would be advised to make the request.
- ❑ In the second option, there are likely to be two charges (i) the pre-closure charge levied on the outstanding balance by ‘present’ company, and, (ii) Processing fees which ‘proposed’ company may levy when they take over the loan from ‘present’ company.
- ❑ To make the comparison rigorous, let us assume there is a 1.5% ‘reset’ charge as applicable to the first option, and a 2.0% Prepayment charge and a 0.5% Processing fee for the second option.
- ❑ The illustration is of a borrower who has a term of total 20 years and has so far finished 5 years. He has opted at the time of applying for loan for Floating rate of interest which is presently at 10.25% (for convenience, we assume the same rate from day 1). The illustration considers Original loan amount of Rs.1.00 lakh. His EMI would be Rs.982.
- ❑ According to the schedule, now 5 years after availing the loan,he would have as on date a loan amount outstanding of Rs.90063 (based on annual rests), with Rs.9937 repaid towards Principal, Rs.48962 paid towards Interest both of these totaling to Rs.58898. (EMI of Rs.982 paid for 60 months is Rs.58898).

‘Interest saved’:

Option 1: WHEN THE LOAN IS ADJUSTED WITHIN THE SAME BANK (Reset)

ASSUME THAT LOAN WAS TAKEN FIVE YEARS BACK (Rs. 1 lakh for 20 years):

Figures in Rupees

YEAR	INT. @ 10.25%	INT. @ 9.0%	DIFFERENCE
6	9108	7985	1123
7	8821	7706	1116
8	8503	7400	1103
9	8151	7066	1085
10	7761	6701	1061
11	7330	6301	1029
12	6851	5864	988
13	6322	5385	937
14	5735	4862	873
15	5086	4290	796
16	4367	3664	703
17	3570	2979	591
18	2688	2231	457
19	1711	1412	299
20	629	516	113
TOTAL	86635	74360	12275

The Processing fee @ 1.5% on Rs. 90063 is Rs.1351

Loan of Rs.	Interest saved	Processing fee	Net savings
1 lakh	12275	1351	10924
10 lakhs	122750	13510	109240
20 lakhs	245500	27020	218480

Option 2: Switch company:

Suppose the ‘present company’ is not offering ‘reset’ facility, or, offers ‘reset’ but competitors are offering you better rates. As a borrower if you switch loyalties, you are likely to be charged lower Processing fee as compared to a loyal borrower who opts for ‘reset’. Therefore we could assume the Processing charge is only 0.5% of the loan amount being taken over by the ‘proposed company’. However the ‘present company’ would be charging foreclosure charges. This is likely to be 2 % of the loan amount outstanding.

It's worthwhile to ‘switch’.

For a loan of Rs.20 lakhs the Interest saved is Rs.245,500 (Prepayment charges Rs.36025 and Processing fees Rs.9006). The borrower thus incurs totally Rs.45031 in expenses but Net Savings is Rs.200469.

THIS MAKES OPTION 1 BETTER THAN OPTION 2.

“Cashflows saved based on lower EMIs”:

- ❑ Instead of assessing ‘Interest saved’ as done above, one can work out the difference in EMIs between a loan with 10.5% and loan with 9%, and assess the Present Value of reduction in EMIs paid. This is an alternate method of evaluation.
- ❑ The loan with 10.5% interest has an EMI of Rs.982 whereas a loan with 9% interest has EMI of Rs. 913.5. Per month your outflow is less by Rs. 68.5. Hence per year the outflow is lesser by 12 times 68.5 or Rs.822. Place this in a Recurring deposit at the end of the year for 14 years earning 6.5% pa. Next year you will place for 13 years and so on. The Present value of this investment is Rs.8462. To get this benefit, you have paid a fee/s as outlined above (Option 1 and Option 2). Under Option 1 you pay Rs.1351 (being 1.5% of Rs.90063), hence the Net Present Value of the investment is 8462 minus 1351 i.e: Rs.7111. This saving is 7.1% of the loan amount (Remember, Rs. 1 lakh was taken five years back and on it the present outstanding is Rs.90063).
- ❑ Under ‘switch’ option, (Option 2) the Processing fee @ 0.5% and Foreclosure fee @ 2% is Rs. 2252 totally. The Net Present Value of Option 2 is Rs. 6210 per lakh, i.e: 6.2% of the loan amount. ‘Reset in same company’ option is a better choice than ‘switch company over’ option.
- ❑ It's party time for new customers. If you are an old borrower don't expect invitations to the party. Just gatecrash. All you need to do is make a few visits to your company and organize some paperwork – that is, mint money- risk-free!

BANKERS' DREAM –AN NPA-FREE WORLD!

by Padmalatha S.

The recovery of loans has always been a problem for banks and financial institutions. The recent financial crisis is a result of lax lending standards by many banks. A major part of the solution lies in taking enough precautions at the credit appraisal and monitoring stages

Ask the most lion-hearted banker the three letters in the alphabet he dreads most, and the reply would be spontaneous. NPA. These three letters stand for 'Non Performing Assets', a euphemism used to describe difficult-to-recover bank loans

The NPA rule says simply this: when interest or principal amounts due to a bank remains unpaid for more than 90 days [effective 1st April 2004], the entire bank loan automatically turns a 'non-performing asset'. This arithmetic makes automatic the classification of a loan as performing or non-performing. Once classified as 'Non Performing', the assets cease to add to the earnings of banks. Thus the NPAs impact the bank's financials directly.

The provisions of the Securitization Act provides some relief to bankers. Asset Reconstruction Companies [ARC], can take over NPAs of banks and deal with them on merits within the framework of the Act. The securitization process, which essentially consists of bundling financial assets and 'selling' them to the ARCs, would increase the liquidity of banks and their capacity for creating fresh assets without hampering their capital adequacy.

However international norms for capital adequacy and provisioning for NPAs will be tightened once the Basle II norms are implemented by central banks the world over.

The recovery of loans has always been a problem for banks and financial institutions. A major part of the solution lies in taking enough precautions at the credit appraisal and monitoring stages. Barring wilful default and force majeure events, most loans can be prevented from turning into NPAs if bankers desist from certain kinds of decisions they have been used to taking in the past.

Take a look at the following categories of credit decisions or approaches to credit monitoring

1] The ' I have the authority to thrust it down your throat' decision

Many a time, decisions to lend are taken by an individual, vested with the requisite financial powers or, sometimes, in excess of his financial powers. The decision is based more on the decision-maker's personal equation with the borrower than on a thorough credit analysis. In many cases, money demanded as credit is also released. The documents and papers are subsequently tailored to suit the situation. This does not imply that all borrowers who get their credit lines disbursed through personal equations with the Banks' top management are potential

defaulters. But the probability of default in such cases is high if norms and procedures are flouted. After the borrower has got his money, it would be a difficult proposition for the credit analysts of the Bank to point out flaws in the borrower's business model or revenue flows or legal standing. The Banker on the field would then be on the defensive, trying to save the money lent [and his skin!].

2] The 'I don't care what happens, I need business' decision

They become the feted lot, temporarily. The blue eyed boys [or girls] of the Bank's management. After all, are they not garnering business for the Bank, left, right and center? Are the business statistics not soaring under their aggressive business development tactics? Two or three years down the line, the same blue eyed boys are on the mat, being hauled up for not recovering funds lent by the Bank. Where are the borrowers? Apparently not traceable! Where are the reports that periodically review the borrower's operations that should have normally given an inkling of the shape of the borrower's business? Apparently not sent to the reviewing authorities! Or have the reviewing authorities not insisted on the reports or taken stern action on the lapses in credit sanction/ monitoring? NPAs, like stars, are not made overnight; they don't hit you one fine day like a bolt from the blue. The danger signals keep flashing all the time, provided the banker has the time and the inclination to spot them and take immediate action.

3] The 'I trust the borrower, I don't need systems' approach

'Trust' of course, is one of the most important ingredients of a credit decision. However, if 'trust' alone were the ingredient, we wouldn't need systems. Money, especially borrowed money, is such a powerful temptress that very few can resist the urge to spend it for purposes other than what it was intended. Whatever be the jargon we employ in calling the money lent - retail, wholesale, consumer finance, or structured finance - the lender's objective is very clear. He has lent cash, and he has to recover cash. When systems for monitoring the cash flows of the borrower are given a go-by, the chances are very bright of NPAs looming large on the horizon

4] The 'What will the borrower think if I ask too many questions' approach

The time of taking the credit decision is the time to avoid a potential NPA. Many bankers shy away from probing the borrower's operations for fear of turning him away, especially if he is perceived as a lucrative business proposition to the Bank. Borrowers, especially those who flaunt their political clout or their proximity to the powers that be, are capable of employing arm-twisting tactics to get funds from the bank. The few bankers who dare to stand up and protest may not be appreciated. Despite these threats to the banker's integrity, if the right questions are asked to get the borrower and his dealings in the right perspective, a future NPA can be averted. Many credit decisions go awry at the operational stage just because the requisite amount of probing had not been done at the time of loan sanction and disbursal

5] The 'lazy to inspect' approach

Inspection is always construed to be a post facto operation, designed to find fault.. Inspection of the borrower, his residence, his assets, his encumbrances and verifying the truth of his claims are

very much part of pre-sanction due diligence. There are numerous instances where even the place of business turned out to be different from what was stated in the initial application, the name of the borrower different, the very business different from what was intended to be financed by the Bank, the securities and assets declared were found to be fictitious, the financial statements were found to be fabricated...the list could be endless and imaginative. Where does this leave the banker? An NPA for the Bank, and punishment for those apparently accountable for the NPA. Even if the borrower had been truthful in the initial stages, the banker's paramount duty is to ensure that the amount lent is recovered. The primary weapon available with the banker is the inspection machinery, which gives him the right to inspect without notice the borrower's business, records, accounts and everything that has a bearing on the advance granted. There's always a sense of déjà vu when an NPA sprouts out of seemingly normal transactions...'if only we had....'!

Conclusion

Credit decisions can make or mar banking business. The recent financial turmoil has thrown up a peculiarity where we see Banks restricting creation of credit, and turning to investments in less lucrative but safer avenues in G-secs et al to be called a 'profit making bank'. This does not augur well for the economy since creation of credit has a multiplier effect on fresh investment and hence economic growth.

So what is the remedy? Get back to serious banking business where ethics, prudence and regard for systems play a major role. Will the real banker stand up and cheer?

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