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Pain ahead for realty, housing finance players

INSIGHT

DEVANGSHU DATTA

The real estate sector is seeing the exposure of certain common malpractices. One model for raising money is for developers to pre-sell unbuilt houses. The deal is, the buyer takes a loan and hands over the amount to the builder. The builder pays the equated monthly instalment (EMI) until the house is delivered for possession.

This way, the builder gets cheaper capital (home mortgages are at lower rates than commercial real estate loans); the lender can lend more easily (banks have high-risk weights for real estate and sector limits for real estate exposure and the "benami" loan bypasses that); the homebuyer is happy since the developer picks up the EMI-tab.

All's well if houses are delivered for possession. What happens if the developer goes bust and doesn't deliver? The lender will now try to squeeze money out of owners of houses that don't exist. The house of course, is unlikely to ever exist in such a case of bankruptcy. The lenders will take a huge haircut on their exposures.

In such circumstances, it's rational for the debtor to default on the mortgage even if that destroys the CIBIL score. Although lenders will try to scare them into paying for non-existent property, most such "owners" will eventually default on flats they realise they will never see.

This is the story that's unfolding with Jaypee Infratech and other builders in the NCR. There will be added complications of course. Irate house-owners have gone to court, asking for stay orders on pre-delivery EMIs, alleging that over 300,000 mortgages in the NCR face this risk and asserting that over half of those mortgages are taken out by people who will never get possession of a flat.

The problem here is, there are two loans being taken against one surety and one notional surety (an unbuilt flat). There are variations of this malpractice where two loans can be taken out against the same single surety. For example, the developer may take a loan to build a project and also pre-sell the unbuilt homes to people who take out mortgages (and pay EMIs themselves). Here too, if the builder goes bankrupt, there will be many lenders laying claim to both the real estate and to (unbuilt) flats.

Similar stories will unfold with other real estate developers who are debt-stressed, given the multitude of unfinished projects. New regulations like RERA may lead to less in the way of such absurdities, but the overhang of such malpractices will continue to plague the sector for a long time, given that Indian court processes are very slow. Whatever the courts decide, lenders and borrowers will both lose a lot of capital during this process, not to mention opportunity costs.

If market forces work, this real estate will eventually be seized and auctioned at massive discounts, and the unbuilt or half-built flats will perhaps, be completed. That could be a decade later. This process could cause a crash in real estate prices - that could cascade into problems for other projects where builders find they can't get the prices they need. Or there may be a segregation where projects completed on time get a premium while "zombie" projects die.

What does this mean for real estate stocks and the mortgage market? A few more such instances could result in downgrades across developer stocks. Mortgages constitute around 20 per cent of annual credit expansion and it's the major revenue stream for many of India's best NBFCs. It's a big enough pain-point and politically sensitive enough for emergency policy action. But it's anyone's guess if there will be a bailout and if so, what sort of bailout. It could be a wait-and-watch situation for investors.