FICCI

PAHLE INDIA FOUNDATION
FACILITATING POLICY CHANGE

Restructuring the Secondary Real Estate Market in India

Restructuring the **Secondary Real Estate Market** in India

July 2018

Authors:

Nirupama Soundararajan
Senior Fellow, Pahle India Foundation
nirupama.soundararajan@pahleindia.org

Karan Bhasin
Research Associate, Pahle India Foundation
karan.bhasin@pahleindia.org

Neerja Singh
Director - Infrastructure, FICCI
neerja.singh@ficci.com

Contents

1. The Lay of the Land 7
2. Interlinkages in the Real Estate Market 7
3. What Ails the Markets 8
4. Enabling Regulations 10
   - 4.1 Goods and Services Tax (GST) 11
   - 4.2 Real Estate Regulation Act (RERA) 11
   - 4.3 Benami Transaction (Prohibition) Amendment Act 12
   - 4.4 Insolvency and Bankruptcy Code (IBC) 14
   - 4.5 Land Titles 14
5. New Technologies 15
   - 5.1 Blockchain 16
   - 5.2 Other Technologies 16
6. New Financial Arrangements 17
   - 6.1 The Use of Escrow Accounts 17
   - 6.2 Real Estate Investment Funds 18
   - 6.3 Capital Gains Tax 19
7. Model for Rental Housing 19
8. Recommendations 23

References 25

1. The Lay of the Land

The real estate sector is an important contributor to the economy. It is the second-largest employment generating sector after agriculture, contributing about 5 per cent to 6 per cent to India's GDP share and capital formation. It is perceived as the third-most impactful industry in India in terms of its effects on other industries, as it directly impacts over 250 ancillary industries such as cement, steel, transport, construction, paint, brick, building materials, and consumer durables. It is expected to soon overtake other industrial sectors in terms of GDP contribution.

The Indian real estate sector is broadly categorised under the heads of housing, retail, hospitality and commercial. As businesses grow, the demand for office space and commercial spaces is expected to go up. Infact, in the last couple of years, the demand for office spaces has shot up by almost 20 per cent, not just in metro cities but also in tier two and three cities. Any growth in the retail sector in complemented by growth in both front end and back end infrastructure. Even as e-commerce burgeons, while front end real estate may not necessarily grow, back end real estate in the form of space for distribution centres and warehouses is on the rise. Similarly, the focus on special economic zones (SEZs) has also spurred the growth of real estate sector, largely from a land acquisition point of view and subsequent construction of office spaces and factory floors.

However, the champion of the real estate sector has been and will continue to be the housing sector, which makes up around 75-80 per cent of the real estate sector, and this will only continue to grow. India's demographics is heavily skewed towards younger people with 600 million people who are younger than 24. It will be another twenty five years before India's population starts to stabilise. These factors, combined with increasing preference towards nuclear families, double income families, and rising incomes will lead to an increasing demand for housing in India.

The rapid pace of urbanisation is another driver of demand for housing. According to Census 2011, approximately 377 million Indians, i.e., about 31 per cent of the country's population, live in urban areas. Urban population is expected to increase from 340 million in 2008 to 590 million in 2030, which means that approximately 40 per cent of India's population is expected to reside in urban areas. It has also been projected that by year 2030, there will be atleast 70 cities with more than a million inhabitants as against 53 as per the 2011 census.

2. Interlinkages in the Real Estate Market

The real estate market in India has been typically an informal market characterised by informational asymmetry and other bottlenecks that have hindered the formation of a formal market for the real estate. Vaidyanathan (2014)[1] estimates that approximately 60 per cent of the real estate sector is "non-corporate." The choice of the phrase "non-corporate"

[1] Vaidyanathan, R. (2014). India Uninc. *Westland*

is deliberate because there is a difference between the non-corporate and the informal sector; the informal sector is a subsect of the non-corporate sector. There are strong interlinkages between the formal and non-corporate sects of the real estate industry, and between primary and secondary real estate markets. Infact each sect complements and fuels the others growth.

A further dichotomy that exists in the real estate market is the presence of a primary and a secondary real estate market, both large in almost equal parts in India. Primary real estate market is defined as the market whereby freshly created real estate assets are put for exchange. This means that big developers are actively involved in the primary market as a major share of the production is attributed to them. Secondary real estate market is defined as the market where all existing or already built real estate assets are put for the purpose of exchange. Thus, freshly built houses are not considered as a part of this market. Typically, in a secondary market one property owner sells to prospective owner.

Though the markets comprise of different sellers, when we look at the demand side of it, the demand in general is for real estate assets irrespective of whether it is in the primary or the secondary market. This implies that though there is a distinction on the supply side of the market but the demand side has no such distinction.

The secondary market witnesses a greater amount of participation of investors on the supply side and it would appear that it is predominantly for speculation. An investor will in general participate in the primary sector with the purpose of speculation. Upon acquiring a newly built property, the investor has a choice to either put it in the rental market or the sale market. This implies that there is significant interaction of the two markets due to lack of differentiated demand and the functioning of one market would have several spills over effects on the functioning of the other market. The slowdown in general in the secondary market results in a significant amount of reduction in demand by investors in the primary market which in turn would also result in stagnation of supply of secondary market real estate assets due to the general supply gut in it. This implies that a supply glut in the secondary market would soon spill over to the primary market and cause a similar supply glut there. As a consequence of these interlinkages, a well-functioning secondary real estate market is instrumental in terms of facilitating a vibrant primary sector real estate market that is conducive for the long-term growth of the real estate sector as a whole.

3. What Ails the Markets

The secondary market as an institution is highly disaggregated. The fundamental role of the market is to aide price discovery for similar assets but due to product differentiation, poor levels of transparency, and many invisible costs, there is no scientific method for markets to determine prices. There is a lack of formalisation of the secondary market for real estate and this problem gets amplified due to the diverse nature of the product which is to be exchanged here. With differentiated housing and other real estate products in the offering, it is often difficult to actually associate the differences among the product to the differences in pricing of these goods. This in a way hinders the price discovery. Furthermore, speculative demand for real state (which is significant) tends to drive up prices. The risk of asset bubbles is a constant cause for concern to any country, especially post the sub-prime crisis.

Another limitation is the prevalent information asymmetry in the market. For any kind of efficiency to exist in the market, information asymmetry must be kept to a minimum. For real estate, this is not the case. The lack of information and clarity dampens the functioning of the market, affects general demand and supply, and affects price discovery. Given the lack of information and no product standardisation, it makes it imperative to ensure that any market exchange is in itself a well-defined contract that can be enforced and any breach of contract on account of opportunist behaviour can be deterred or atleast held accountable.

High dependence upon brokers to match buyers with sellers results in brokers acting as the market makers for the secondary market. This implies that the typical function of market for matching buyers and sellers is dependent upon intermediaries such as brokers and property dealers. While online portals to some extent have removed the need for brokers, ground realities suggest that brokers serve the purpose of helping with paperwork, which, for real estate is cumbersome.

Another consequence of asymmetrical information is the mismatch between rental and purchase prices. Prices are usually rigid due to poor forward and backward linkages. The result is a delayed adjustment of the market even as there are changes in demand. This results in significant costs since properties, once built, have to be held for a longer periods of time due to lack of price adjustment.

Real estate transactions have always been underreported and it is important to explore why this takes place. It has been long argued that the principle reason behind the underreporting is largely the fact that the stamp duty charges and registration charges tend to be exceedingly high (Table 1). In contrast, other emerging economies have low stamp duties. For example, Vietnam (2 per cent) and Philippines (1- 1.5 per cent) have some of the lowest stamp duties. Very few countries have duties exceeding 5 per cent. High stamp duties in India have proved to be counterproductive as they have only resulted in subterfuge transactions. The end result may well be a loss in revenue for the government because of high stamp duties.

There have been instances where one stamps a document in anticipation of execution but the deal falls through and the document is not executed. In such cases, if the absolute value of the stamp duty is high (although admittedly ‘high’ is a relative term that will vary for different income groups), then most states provide for claiming a refund. There is a specified period within which such claims are to be lodged, and supporting documents would have to be provided. The specified procedures are expected to be strictly followed. However, the process of actually realising any refund is slow and bureaucratic. One must be prepared for a long wait.

Nevertheless, it is important for one to consider the secondary market and the important role that it can play in terms of strengthening the overall sector as a whole. The secondary market implies the resale

Table 1: Stamp Duties Across Metros

City	Stamp Duty Charges	Registration Charges
Bangalore	5% of the total market value of the property	1% of property value
Delhi	4% if the owner is woman 6% if the owner is a man	1% of the total market value of sale deed plus INR 100 pasting charge
Mumbai	4% of the total market or agreed value of the property for rural areas 5% for areas that fall under the Municipal Zone	1% of the total market or agreement value of the property or INR 30,000 whichever is lesser
Chennai	7% of the total market value of the property	1% of the market value of the property
Kolkata	5% of the total market value of the property if it falls in Panchayat area 6% of the total market value of the property if it falls under Municipal Areas Additional 1% stamp duty charge is levied if the market value of the property is more than INR 40 Lakh	1% of the total cost of the property

Source: Collated by authors

of existing real estate assets or in other words the fundamental role of the secondary market is to facilitate a change in ownership at the appropriate price of an existing asset. The term existing asset is important as no new real surplus value is created as such except for any capital gains (or loss) that may come from the exchange.

This implies that the secondary market becomes significant as it provides the liquidity which is needed in order to further strengthen the functioning of the primary market. An important aspect to consider here is that by facilitating greater liquidity and ensuring a formal institution such as a secondary market, the overall demand for fresh houses can also be augmented. Citizens would be more likely to invest in real estate if they foresee greater predictability of future value of the asset and if the sale of the asset could be easy so that money can be realised easily.

4. Enabling Regulations

While on the one hand, the importance of the secondary real estate market is evident, it has not been easy to integrate the transactions into the formal financial system. For instance, according to the Tarun Ramadorai Committee Report of RBI, the average Indian household invests almost 77 per cent of its wealth in real estate. This is an exceedingly large proportion of wealth in one asset class. This also reflects the importance of real estate (and mainly housing) in the savings basket of the average Indian. Clearly, a big part of this investment stems from the secondary market. The mismatch in demand and supply of houses discussed earlier is testament to this. It is unfortunate that in a country with escalating property prices, the revenue generated through sale of real estate is not a large contributor to the exchequer. This is however not surprising. The real estate sector has been tainted by the presence of many illegal transactions, hoarders of black money, and benami transactions. The recent distress in the banks and the twin balance sheet problem for the real estate sector has not helped either. The incumbent government has systematically addressed many of these issues through a slew of enabling regulations.

4.1 Goods and Services Tax (GST)

GST has been heralded as one of the most significant reforms undertaken, since probably liberalisation. The real estate sector has, in the past, been riddled with many taxes that have driven the costs of construction, and therefore property prices, significantly high. While GST may not be in a position to reduce the price of property meaningfully, since the cost of construction is still mainly driven by high cost of land, it has brought into the sector a considerable amount of transparency in payments. While the large and medium players have mostly been organised, GST has pushed the smaller developers to also organise themselves better. This not only means transparency in pricing and dealings, it also means that the smaller developers can now access credit more easily.

There is little doubt that GST brings with it many advantages, but the true merits are yet to be realised. Irrespective of short run or long run, GST will make little difference to a property owner simply because it has not had any discernable impact on prices. This can be attributed to three aspects. First, land prices and cost of land acquisition is expensive. Second, registration costs and processes are still tedious and prohibitively expensive. Third, stamp duty rates are almost irrationally set, varied across states, and an added cost. These limitations are particularly important in the context of affordable housing, which is where one expects to see growth. Notwithstanding interest rate subsidies and low costs of borrowing, the cost of down payment, registration costs, and stamp duties is sufficient to render even an otherwise affordable house unaffordable. Clearly, GST is more likely to have a positive impact for developers than for consumers.

4.2 Real Estate Regulation Act (RERA)

In principle, there are two major reasons behind in-formalisation associated with any industry- over or under regulation. In this particular case, the lack of regulation could be cited as a principle reason behind why the market for secondary sale of real estate has not developed despite a shift towards formalisation in the primary market for real estate. Another reason would be the taxation costs associated with formalisation. The mismatch between the circle rate and the market rate is largely to have a significant component of cash in the transaction thereby hiding the value of transaction from the eyes of the government. As a direct consequence, the primary role of a market in determining price is hindered as the price of the sale is not recorded.

The real estate sector had been for long an unregulated sector. It is maybe because of this that both developers and property owners are in their current predicament. Again, RERA was expected to bring in some discipline in the real estate sector. Developers are expected to work under prescribed timelines, but most importantly, RERA is expected to make developers and other real estate stakeholders accountable. It also acts as a one stop shop for any kind of grievance redressal. Maharashtra has been one of the most proactive states in setting up the RERA. Only four other states have a functional regulator and portal[2].

The non-corporate real estate firms do not fall under RERA as they develop land under the 500 square meter threshold or they develop less than 8 apartments per project. As a result, they are not subject to the regulations of RERA and are not mandated to register their projects. From an affordable housing point of view, this is unfortunate. Those who buy affordable housing are the ones that require protection and yet, they seem to be the band of home owners with little or no recourse to any formal grievance redressal mechanism should there be a problem.

The secondary sale of real estate assets would be different for assets that are registered under RERA and assets that are not registered under RERA. This implies that existing assets that are developed by big builders which would ordinarily be under RERA may not be subject to RERA if the occupation certificate for a particular project has been issued. This would indicate a better means of market based price discovery and price setting.

For projects registered under the RERA, there is greater clarity as far as information associated with the property is concerned and thus, a secondary sale of the asset may not face such informational issues as such. However, the issue of regulation and enforcement would still be required to be adequately addressed. For projects that are not under the RERA, the secondary sale involves numerous issues in the sense of information in addition with the regulatory and enforcement issues. If the impact of RERA must be truly felt, states will have to be more proactive in setting up the regulator and the portal. It may well be worthwhile to include the setting up a fully functional RERA as part of Ease of Doing Business (EoDB) rankings issued by the Department of Policy and Promotion (DIPP) as a way to expedite the process.

4.3 Benami Transaction (Prohibition) Amendment Act

The Benami Transactions (Prohibition) Amendment Act, 2016 brought in important changes to the original Benami Transactions (Prohibition) Act, 1988. While the 1988 Act outlawed the buying and selling of ‘benami’ (‘no name’ or untitled) property, the Amendment Act made punishments under Section 3 more severe, thus increasing both the cost and opportunity cost of using ‘benami’ transactions as a tool for laundering money. The Amendment Act also expanded on the definition of ‘benami’ to include not just property held under proxy names, but also under fictitious names. This effectively reduces loopholes that most people try to use to their advantage, in the hope of clearing out stocks of black money.

---

2 “The Indian Real Estate Sector – Annual Handbook, 2018” Grant Thornton

While the Amendment Act of 2016 focuses on tightening the net around black money, the law has an adverse effect on real estate transactions on a broad scale. The sale and purchase of real estate, whether in the form of plots of land or constructed areas, is often carried out with the use of black money. At least this is the premise based on which the 1988 Act and the subsequent Amendment Act of 2016 were passed. While the amendments gave the law more teeth, implementation would determine whether this truly helped achieve the objective of more transparent transactions.

The Amendment Act 2016 helped the government detect and investigate high numbers of benami property transactions within nine months of its implementation. In fact, maximum transactions were detected in 5 states which include Gujarat, Tamil Nadu, Madhya Pradesh, Karnataka and Goa[3]. Maximum property attachments have been found in Tamil Nadu, followed by Rajasthan, and Mumbai. In terms of property valuation 28 properties under investigation in West Bengal are worth a cumulative INR 478.87 crores and 58 properties in Mumbai are worth INR 336.87 crores[4]. A grand total of 381 properties across states with a total worth of INR 1353.38 crores were attached by the government by August 2017[5]. A further 627 cases of benami properties were pending investigation as of the end of 2017[6].

All the above cases are examples of the effective implementation of the Amendment Act 2016. However, while the real estate market has slowed down in the past two years the factors contributing to it are not limited to just the Benami Transactions (Prohibition) Amendment Act 2016. The Real Estate (Regulation and Development) Act, 2016 (RERA 2016), demonetisation in November 2016 and the passage of the Goods and Services Tax (GST) in May 2017 all contributed to the real estate market not being able to pick up pace[7]. A lot of these measures were aimed at cleaning up black money and ushering in transparency. However, despite predictions of a healthier market spurred by the newly infused transparency and accountability in transactions, real estate transactions stagnated in both 2016 and 2017. The slowdown seems to stem from people's hesitation in declaring higher levels of income or asset holdings and attempts at evading the high costs of legal proceedings. This is owed in large part to the above legislation increasing both transaction costs and opportunity costs.

---

3 Suchetna Ray, "Benami Act impact: Taxman attaches 381 properties worth Rs 1300 cr in 9 months", Hindustan Times, 16th September 2017. https://www.hindustantimes.com/india-news/benami-act-impact-taxman-attaches-381-properties-worth-rs-1300-cr-in-9-months/story-CzG0j2lWEcUW4gFz21XbkO.html

4 Ibid.

5 Ibid.

6 Ibid.

7 Ashwini Kumar Sharma, "This was a year of reform for the real estate sector", Live Mint, 28th December 2017. https://www.livemint.com/Money/ADthO7UvUmB4cfYudonzFL/This-was-a-year-of-reform-for-the-real-estate-sector.html

The Amendment Act 2016 is a good move in the fight against corruption and illicit activities. It does not incentivise greater real estate transactions. Given enough time and with proper implementation, investor confidence in real estate may pick up. However, the market shows no positive signs thus far.

4.4 Insolvency and Bankruptcy Code (IBC)

The real estate sector is a capital intensive sector as it requires enormous investments for acquisition of land and working capital. The downturn in the availability of credit has resulted in a general slowdown in the sector. This slowdown has resulted in delaying completion of existing projects which have often led to perfectly viable projects also become as NPAs due to the escalated costs. The lack of capital to finish projects poses the problem for consumers of real estate assets as they are often stuck with holdings of existing real estate assets that are yet to be finished and delivered. Given that high prices of real estate, for most households investing in residential projects, it is a major share of their wealth and savings and thus when a project gets stuck, wealth and savings of significant number of households often gets struck.

As a result, the Insolvency and Bankruptcy Code becomes a game changer as it introduces a mechanism whereby debt can be taken over by other equity capital. This has two advantages. First, it ensures that banks are able to recover some amount of capital stuck in the project via the bankruptcy proceedings, and second, consumers tend to gain as now the project is more likely to be completed given the fresh infusion of equity capital and change in ownership in management. Given that the law is still in its early days of implementation, more and more functional changes are bound to come to strengthen the consumer interests in the sector. One such measure is taking consumers who have already purchased unfinished assets in a project to be at par with creditor of the company. This strengthens the rights of consumers as it gives them a right to recovery in the form of claims to liquidation proceeds and it gives them a right even in the procedure of liquidation process. Therefore, it can be safely assumed that the Bankruptcy Code can help resolve eminent issues that are bogging down the sector in the short to medium term.

4.5 Land Titles

In India, land ownership is primarily established through a registered sale deed (a record of the property transaction between the buyer and seller), and not by a government guaranteed title. Other documents validating ownership include the record of rights (ROR), a document that details the property ownership, property tax receipts and survey documents. During a property transaction, the onus of checking the past ownership record of a property is on the buyer and not on the government. Therefore, land ownership in India is presumptive in nature, and subject to challenge.

Policymakers in India have long argued moving towards conclusive land titles. The Land Titling Bill was introduced in Parliament in 2011, but did not receive much traction from the states since it was allegedly far off from ground realities. The Bill subsequently lapsed. What was acknowledged to be a more pragmatic approach was to improve the quality of land records in the first place.

In spite of the computerisation efforts of the government since late 1980s, the key challenge that remains is one of ensuring real-time accuracy, that is, up-to-date land records, beyond mere formalities of computerisation and digitisation. The integration of textual records with spatial records is a significant problem in every state. Estimates of disputes pertaining to land vary, but reportedly 80 per cent of civil disputes in Indian courts are related to land (GoI 2012). A recent survey claims two-thirds of civil cases in district courts are related to land or property (Daksh 2016).

The Rajasthan Urban Land (Certification of Titles) Act, 2016 was recently passed, making it the first state titling legislation on urban land records. This act ostensibly makes the state guarantee land titles. It is assumed that such a measure would reduce litigation, improve ease of doing business and smoothen the process of land acquisition in urban areas, but it is debatable whether the act would indeed deliver, or instead lead to further litigation on land. This is pertinent since the judiciary continues to be the key arbiter of disputes that trace back to faulty or inadequate records.

What is also important is, to provide legal sanctity to technological interventions for improving land records management systems. Electronic linking of registration and titling databases is necessary to avoid duplication. Legislative amendments in Gujarat and Karnataka were almost simultaneous with technological efforts, while Bihar has new laws for mutation and surveys that institutionalise the use of electronic processes and resources. States should adopt best practices from existing land record modernisation efforts in other states (for both urban and rural areas). A recent study on the impact of land record digitisation for Rajasthan, where the process is being carried out for rural Rajasthan, indicates a benefit cost ratio of 25. This means, for every rupee spent on just digitising the land records, the benefits are twenty five times more[8]. It is also necessary to acknowledge the need to reflect the accurate real-time spatial situation on the ground and work out mechanisms that improve coordination among people, institutions, and databases.

The real estate market in terms of fresh sales of newly built houses has gradually shifted towards greater formalisation due to the trinity of demonetisation, GST, and RERA. Several industry leaders have appreciated this trinity and have highlighted how they would be instrumental in long term sustained growth of the industry (Jain, 2018)[9]. However, the shift towards formalisation is far from complete as only big reality developers are embracing the formalisation while the smaller players are still trying to survive the glut in the demand for housing.

5. New Technologies

Technology has had its impact on all sectors, and real estate is no different. It began modestly like most sectors; online sites that aggregated information

8 "http://pahleindia.org/pdf/EODB%20in%20Rajasthan.pdf

9 Jain, S (2018). RERA and GST: Reforms showing results in reality. Deccan Herald. Retrieved From: https://www.deccanherald.com/opinion/panorama/reforms-showing-results-realty-668298.html

(99acres, MagicBricks). These became more and more sophisticated with years. Concomitantly, the government has been trying to ensure all approvals and paperwork happen online. This has had limited success because in almost all cases, human intervention is still a must. When processes are more dependent on human intervention, it leads to inefficiencies in operations and an increase in propensity for rent seeking. Blockchain, augmented reality (AR), virtual reality (VR), big data, artificial intelligence (AI) can change all of this.

5.1 Blockchain

With the advent of blockchain technology commercial real estate industry is expected to undergo a paradigm shift across the industry operations. While it is true that complete adoption of the technology will require much more than automation and data top-ups, there is no dearth of real-time applications of blockchain in the sector, for example, in digitisation of land title, recording of transactions in secondary market, and even in tracking approvals for projects. Since it is impossible to modify the data on a block, room for tampering of historical attributes of the asset are minimised.

Currently, there are a lot of land records that date back to pre-independence era, with ambiguous title deeds and ownerships. This perpetuates fraud and long-winded litigations. Loading the details on a ledger, which is time stamped and cannot be modified in future, seals the details for all future purposes. This would seem as an automatic next step to digitisation of land records. An up to date, ratified public document will ensure there is uniform point of reference, no asymmetry of information and a universal data bank of India's real estate assets. All stakeholders including governments, brokers, buyers, and sellers, all have the same information, in a read-only format. This also minimises the fraud risk, something that real-estate buyers in India are exposed to, even after the completion of the transaction.

In the next phase, services such as smart contracting, notary services and due diligence attributes may also be added to the ledger, enhancing the efficiency of the process. When one is not shuttling between the record-keeper and the lawyer, the process time needed to complete a land transaction in a secondary market will reduce drastically. The transaction can come down significantly from its current minimum of 53 days for purchase of land. However, on must note that merely introducing blockchain will not solve all problems, since the outcome will be as reliable as the data entered in the system. Ability of blockchain technology to reduce process time is critically dependent on user acceptance and regulatory support.

5.2 Other Technologies

Other technologies including AR and VR will help enhance buyer experience. The easiest market to appreciate this would be the non-resident Indians (NRIs) desirous of buying property in India. Ever since the Reserve Bank of India (RBI) has allowed for NRIs to buy residential and commercial property in India, it has drawn the interest of many Indians residing outside. However, property purchase still requires personal visits and inspections before a selection is made. Repeated trips are not feasible. VRs will help NRIs, and for that matter, any Indian who wishes to either buy property in another part of the country, or in fact just save time, will be more than willing to avail this service. AR and VR will also come handy in the rental market. The technology can help capture not just the house, but the ambience of surrounding areas too, which also plays a huge factor in selection.

Big data analytics will help solve the problems of demand supply mismatches. China's ghost towns have been cited often to dissuade developer from building houses that have no takers. Even though India's demand mismatch is not as severe as China's, the problem does exist. Stories of stocks of unsold inventory are as true as the vast number of first time home owners who apply for any state run housing development complex. Real time data capture and more importantly, suitable data capture will help in mapping those who want to buy property to those who are willing to sell. Technology will help facilitate a single large real estate market in India.

6. New Financial Arrangements

6.1 The Use of Escrow Accounts

Informational asymmetry between buyers and sellers is largely responsible for disputes arising from market transactions of real estate assets. Disputes tend to result in litigation which is in itself is a time-consuming process. Another aspect that requires adequate attention is the fact that real estate transactions are of high value and thus, any dispute blocks vital capital until a dispute is resolved. Knight Frank estimated that USD 3 billion is the value of real estate assets since 2006 that are currently disputed. This figure in itself illustrates the problems that misinformation or lack of information can cause.

This problem of assets being under dispute and transactions being stuck can be largely resolved using escrow accounts for such transactions. In most simplistic terms, an escrow account is a special purpose deposit account which facilitates a transfer of funds from the depositor to the seller of the asset once the sale is processed and the transaction is complete. Thus, it often requires the buyer to block the money required for transaction upfront, although it ensures that the buyer has an exit mechanism in place and can ensure that the transaction is complete as per all his/her expectations (or mutual agreement) before the funds are transferred. For the seller, the escrow account ensures that he/she is aware of the fact that requisite funds are already in place and would be transferred once as per all the terms of contract, the transaction takes place.

Thus, the escrow account provides a safety net to both the buyers and the sellers. Most big developers that operate in the primary real estate market are required under RERA to set up escrow accounts for each individual project. This is to ensure that a major share of proceeds from sale of assets from one project are utilised to complete the project thereby preventing any diversion of funds by the developer to initiate fresh projects. This is done with the intention of protecting the consumer interests as delayed deliveries by developers have often imposed huge costs on the home owners who are yet to take delivery of their homes, let alone move into them.

While RERA looks at the issue of protection of primary real estate consumers, there is no widespread adoption of the escrow account mechanism for the secondary real estate market. A major reason behind this is the huge dependence of the secondary real estate market on the broker network. The conventional real estate sector relies upon a broker to match buyers with sellers. Under this ecosystem, the broker has a huge social network in terms of long term relationship amongst the society which translates into trust. Using this trust, the broker provides twin functions - the broker matches the buyers and the sellers, and at the same time, facilitates the transaction. Given that the broker matches the buyers and the sellers, in a way the broker acts as the market maker here without whom such transactions may not take place. Thus, in the absence of a formal secondary market, there is a huge dependence upon the broker to create a market for exchange of assets for which the broker charges an additional fee for the service post facilitation of the transaction. Since the broker is paid upon the completion of a transaction, most people view the costs of an escrow account as an additional cost over and above the brokerage charges. Therefore, lack of formal secondary market for real estate assets severely hinders the process of adoption of escrow accounts for such transactions in real estate.

6.2 Real Estate Investment Funds

The real estate sector attracts many investors. It is considered as a lucrative asset class. The downside to this is that speculative demand has far deeper ramifications than merely skewing demand figures. The worst impact of speculative demand is that it tends to create asset bubbles and drives up the cost of property. In a market that is already plagued by asymmetrical information and poor price discovery, speculative demand only deepens these fissures. Furthermore, most real estate investments stay outside of the financial system.

The Real Estate Investment Trusts (REITS) are a way to encourage formal investments in the real estate sector[10]. Recognising the potential benefits of these products SEBI has been proactive in easing of norms regulating these products. REITs are a good way to allow smaller investors to invest in the real estate market. The REIT, like mutual funds, pools the money from all investors across the country. The money collected from the REIT funds will subsequently be invested in commercial properties to generate income. The market for REITs is very nascent in India. However, with the growth of the economy and the middle class, and the need for housing and infrastructure, the scope for these investment vehicles is immense. In 2016, the government removed the dividend distribution tax (DDT) on special purpose vehicles which was a major hindrance for the development of the market. Rules for REITs have also been relaxed and the investment cap in under-construction projects raised to 20 per cent. Special purpose vehicles (SPVs) are now allowed to have holdings in other SPV structures and the limit on number of sponsors has also been removed.

Challenges in REITS however persist. The value of the commercial real estate is a factor of rental yield. However, the value of residential real estate is dependent on eventual capital value of the asset. For this reason, REITs stay more focussed on commercial properties rather than residential. Furthermore, the Indian mentality is not used to the concept of long term residential rental leases. In the specific context

[10] Taken from “Financial Sector Seminar Series – Policy Brief 3,” Pahle India Foundation - http://pahleindia.org/pdf/April-June-2017.pdf

of REITs even though we are yet to see any significant issuance, a big challenge could be with regard to Lease Rental Discounting (LDRs). When these occur at high rates, it results in higher yields, almost at 10-11 per cent. However, in the recent past, these have fallen and hence yields too have dropped to 7-7.75 per cent, which means the cap for REITs, if they come in would be even lower at around 6 per cent. At these cap rates, the investments would hardly be attractive to investors.

One of the biggest benefits of promoting REITs is to help banks. Currently, India is hugely dependent on banks for funding of long term projects, especially infrastructure products. While banks have lent money, they do so unwillingly in most cases because of the huge asset liability mismatch. Insurance and pension funds are also absent from the market on account of regulatory restrictions. REITs can fill this gap by providing long term investment. For this reason alone, it is important that these products success.

6.3 Capital Gains Tax

As a way to raise long term funding for infrastructure projects and as a respite from paying capital gains tax, in his budget speech for 2017-18, the Finance Minister announced significant changes to the capital gains tax to encourage transactions in the secondary real estate market. The tenure for consideration for long term capital gains was brought down from three years to two years. Similarly, the base year for indexation was also moved up from 1981 to 2001. Furthermore, it was announced that the basket of products in which capital gains may be invested was to be expanded to allow for other financial instruments, so as to not pay tax. There has however not been any notification to specify what these products will be. Releasing detailed notifications on this will help the real estate market.

Developers' access to credit has been muted on account of the banking crisis. The real estate sector has contributed significantly to the nonperforming assets (NPA) in the banking system. While the IBC may help banks recover some of their money, their drop in confidence levels in the sector has resulted in a significant drop in credit dispensed to the real estate sector. This has resulted in a vicious cycle where non NPA accounts have become NPAs. Demonitisation only added to the existing pressure on the real estate sector. The crux of the problem lies in the fact that the real estate sector relies only on banks for funding. This is largely due to a nascent bond market and an asset liability mismatch in funding options. However, if the basket of financial instruments are expanded, this would allow for a new stream of income that could be invested in bonds that could be deployed in the real estate sector.

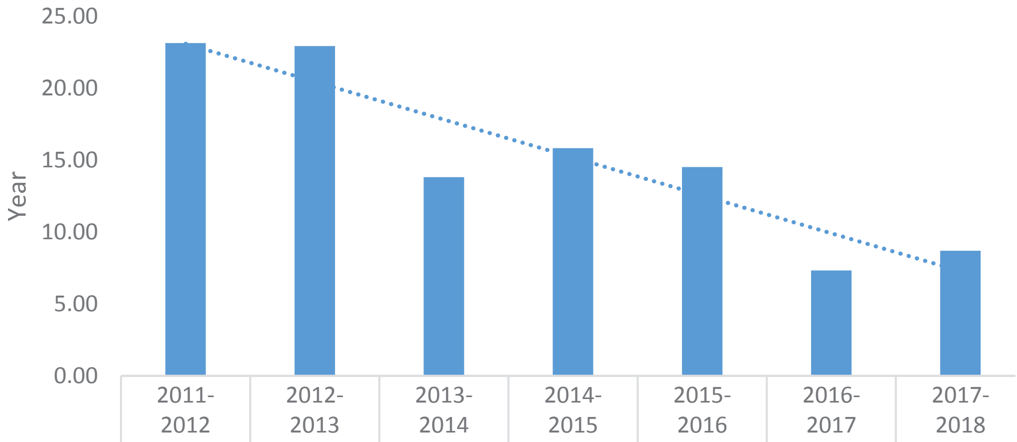
7. Model for Rental Housing

Over the last few years while the market for real estate assets was slowing, there was a shift towards renting houses rather than owning them. An ideal scenario would have thus meant that with greater demand for rental housing, rents would increase while the slump in the demand for ownership of houses would bring the prices of real estate down till an eventual point whereby both these would be almost equal after accommodating for depreciation of building. There is ample literature that has argued that there is a process of price adjustment when there is excess demand for rental housing (Blank and Winick (1953), Maisel (1963) and Fair (1972)).

However, the validity of the price adjustment process has been questioned by several authors such as Ekanem (1971), Eubank and Sirmans (1979), and Lowry (1981). In the context of India, the process of price adjustment did not happen during the last couple of years. One possible explanation is that houses tend to be simultaneously up for grab in both rental and ownership market at the same time. This means that the supply of houses in the rental market must have increased to offset any increase in rents due to the greater demand for rental housing. The increase in supply in the rental market could be attributed to investors who were unable to sell their assets and thus resorted to renting their property. Hence, while the property prices remained high, the increase in supply of rental housing only kept the rents low thereby making renting a more feasible alternative for most consumers.

Using the data from RBI's Housing Price Index (Figure 1), it is evident that there has been an annual change in the housing prices, however the percentage of change has been declining. This demonstrates how property prices are no longer growing at the rate at which they were growing a couple of years back. One caveat that must be mentioned here is that real estate asset transactions are often associated with a cash component to avoid taxation. Thus, whatever value the HPI is calculating is only for the value which is actually captured during the transaction and it leaves out any changes in the cash component of the transaction. Never the less, this demonstrates that price adjustment due to accumulation of inventories is not taking place or in other words, real estate prices are rigid downwards.

Figure 1: Annual Percentage Change in HPI



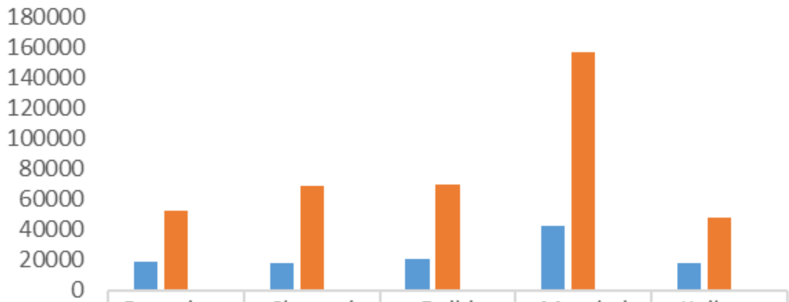
	2011-2012	2012-2013	2013-2014	2014-2015	2015-2016	2016-2017	2017-2018
Annual Percentage Change	23.14	22.93	13.81	15.83	14.52	7.33	8.70

Source: Handbook of Statistics on the Indian Economy (2018), RBI

Possible argument for this is that the prices are determined by costs of construction and thus, there is little scope for adjustment for at least low-mid cost real estate products.

The implication of this is that so long as housing prices remain high, there remains a significant advantage of renting of property than ownership if costs of ownership is significantly high. With rents being low compared to the high property values, there is a disadvantage in terms of investing in property which further results in a weakened demand for ownership of assets. In the context of India, the real estate market depends heavily upon investors who speculate on real estate assets. The low rental value offers a lesser return on investment which results in a general slump in the demand for houses. Those who have already invested in property and are unable to sell it would eventually put it up for rent to be able to generate at least some return until the demand for housing picks up. On an average, the rent to buy ratio acts as an important indicator in assessing whether an individual consumer would be interested in renting a house or in purchasing of a house. With the rent being a bit higher than the average out of pocket expenditure on ownership of house (monthly) it can be easily argued that it is worthwhile for any individual to purchase rather than renting the apartment.

Figure 2: Cost of Ownership and Rent of Property



	Bangalore	Chennai	Delhi	Mumbai	Kolkata
Average Out of Pocket Expenditure (Rent)	19176	17911	21094	42084	18174
Average Out of Pocket Expenditure (Buy)	52280	68908	70115	156887	47737
Rent to Buy Ratio	0.37	0.26	0.30	0.27	0.38

Source: Arthyantra (2017)[11]

[11] Buy vs. Rent Report, Arthyantra (2017)

In the context of India, the rent to buy ratio is below 1 which reaffirms the point being made earlier about costs of ownership being higher than costs of renting a house (Figure 2). In fact, based upon the data it becomes apparent that for different states, the costs of renting a house is just 25-40 per cent of the cost of purchase of property. As a result, renting a house appears to be a much more feasible and practical option available to most people.

Besides costs, renting also offers greater convenience and flexibility which is often considered as an important determinant of the decision regarding whether to buy a house or to rent it. With the greater mobility in labour market, employees are not sure about whether they would be working at the same place or city for long enough to invest in a fixed asset such as a house in the first place. Further, the Housing Rent Allowance and relatively low cost of maintenance makes renting more attractive than ownership of a house. This implies that there is a combination of factors both price and non-price that are instrumental in determining the decision of renting of home rather than ownership of home.

This assumes much significance as ownership of homes are seen as an asset for the household and thus, in general people should prefer ownership than renting of property but the factors in play lead to a completely contradictory situation. Additionally, with rents being low, there is a problem of return on investment for investors in the real estate who are unable to experience any capital appreciation and end up holding illiquid assets that deliver a significantly low return on investment. This means that fewer people would be willing to own property and the supply glut in market for ownership would spill over to the rental market.

In this context, it is important to also talk about the natural rate of vacancy in the rental market. With the general increase in the trend of renting over ownership, it must mean that the natural rate of vacancy should also reduce. This implies that there has to be a price adjustment that should take into account such changes. Rosen and Smith (1983) have discussed how there is a natural vacancy rate that exists in terms of rental housing and how changes in this natural vacancy rate can have effects on the price of rental housing. In the context of India, it is apparent that there has not been any change in the rental pricing to offset any changes in the natural rate of vacancy.

This implies that fundamentally, there is immense rigidity that is preventing the price adjustment to actually take place. The only other adjustment mechanism is quantity adjustment and it does appear that quantities are adjusting gradually as the market is shifting towards a new kind of real estate product that are affordable. Affordable real estate products are significantly different compared to the luxury real estate products that have been historically constructed over the last couple of years. What is immensely important is to nudge developers who are holding inventory to offload them for long term leasing arrangement, this would serve two purposes. First, it ensures that the inventory is put to use and generates cash-flow for the developer and second, it facilitates a long-term relationship between the leaser and the lessee which could be further leveraged to facilitate an eventual change in ownership.

As far as corporate spaces are concerned, the trend is skewed in favour of renting rather than ownership. The reason behind this is that rental space often reduces the capital expenditure, provides for greater flexibility and expansion opportunities to firms. It also results in significant savings in terms of maintenance costs. In this context, a vibrant market for rental space may facilitate greater flexibility for firms to scale up their operations and meet the requisite requirements of space.

In the context of rental housing in India, it is important to consider that ownership of assets must be encouraged rather than people switching towards rental housing. The general glut and interlinkages of market complicate the matter in terms of economic analysis and this limits the mechanism to correct for the prevalent situation. Quantity adjustments take time and price rigidities are dampening the process of ownership of asset and thus, providing incentives in terms of ownership of asset as tax breaks and credit Linked Subsidy Scheme (CLSS) extension would help in bridging the gap between costs of rental and costs of ownership. Furthermore, a new model must be envisaged such that unsold houses of developers can atleast be put on rent, preferably long term leases.

8. Recommendations

The secondary market becomes significant as it provides the liquidity which is needed in order to further strengthen the functioning of the primary market. An important aspect to consider here is also the fact that by greater liquidity and a formal institution such as a secondary market, the overall demand for fresh houses can also be augmented. Investors in real estate would be more likely to invest if they foresee greater predictability of future value of the asset and if the sale of the asset could be quick to recover the money as and when required. Obviously, to maximise such gains from a secondary market would require strengthening and institutionalising it as a formal well-functioning market.

As indicated earlier, a strong, formal, dynamic and robust secondary market is critical towards ensuring greater liquidity, predictability and asset valuation transparency which could further augment the demand for real estate assets in India. This would help in a systematic rundown of accumulated inventories of real estate assets and further strengthen the industry and the entire economy in the medium to long term. In order to restructure the current real estate market, the following recommendations are suggested for the consideration of policymakers.

- Facilitate long term rent contracts as a model to reduce the glut of real estate assets in the ownership market
- Encourage conversion of rent contracts to ownership/transfer of asset by rebate/exemption of partial stamp duty, registration charges and long-term capital gains tax
- Enable and encourage builders to lease out existing unsold inventories using credit incentives based policy measures
- Extend RERA to all real estate projects beyond a threshold transaction value rather than space based threshold limit
- Facilitate greater information transparency through standard disclosure agreements associated with all property contracts
- A regulatory regime to be set up with the aim to monitor, facilitate and strengthen the secondary sale of real estate assets

- Rationalise stamp duties across the country and work towards bringing them close to 1-2 per cent at par with other economies that prioritized the real estate sector and the housing sector
- Simplify and standardise contracts based regime for all resale (and sale) of property
- All such sale contracts to be digitally stored and mandatorily registered with the regulator to facilitate complete trail of ownership of real estate assets
- All contractual disputes for secondary sales to be considered under special tribunal with the approved regulator
- Incentivise the use of technology in viewing, sale, and property rentals
- Incentivise the use of blockchain by developers
- Issue notifications on the new financial instruments for investment of capital gains arising out of sale of property
- RERA to incentivise the movement of the permitted 30 per cent of money in REITS that can be invested in other projects to move from commercial assets to REITs so that it would provide a flush of funds into the investments and help developers maintain liquidity
- Include the setting up of a fully functional RERA as part of the list of reforms under EoDB indicators issued by DIPP

References

Chaurasia, V. (2017). Exemption from registration of real estate projects from RERA. Tax Guru. Retrieved from: https://taxguru.in/corporate-law/exemption-registration-real-estate-project-rera.html

Dasgupta, M. (2016). Moving from informal to formal sector and what it means for policymakers. IFMR. Retrieved from: http://blogs.worldbank.org/jobs/moving-informal-formal-sector-and-what-it-means-policymakers

Dhawan, S. (2018). Builders rush for occupancy certificates to duck the new real estate act. Economic Times. Retrieved from: https://economictimes.indiatimes.com/wealth/real-estate/builders-rush-for-occupancy-certificates-to-duck-the-new-real-estate-act/articleshow/58380574.cms

ET Bureau (2017). Home loans are becoming cheaper: Should you buy or rent a house? Economic Times Retrieved from: https://economictimes.indiatimes.com/wealth/real-estate/should-you-buy-or-rent-a-house/articleshow/56389410.cms

Glaeser, E. L., & Luttmer, E. F. (2003). The misallocation of housing under rent control. American Economic Review, 93(4), 1027-1046.

Kumar, S. (1996). Landlordism in Third World urban low-income settlements: A case for further research. Urban Studies, 33(4-5), 753-782.

Singh, K. R. (2015). Why renting a house in India is better than buying one? Quartz India. Retrieved from: https://qz.com/524780/why-renting-a-house-in-india-is-a-better-idea-than-buying-one/

Established in 1927, FICCI is the largest and oldest apex business organisation in India. Its history is closely interwoven with India's struggle for independence, its industrialisation, and its emergence as one of the most rapidly growing global economies. A not-for-profit organisation, FICCI is the voice of India's business and industry.

From influencing policy to encouraging debate, engaging with policy makers and civil society, FICCI articulates the views and concerns of industry. It serves its members from the Indian private and public corporate sectors and multinational companies, drawing its strength from diverse regional chambers of commerce and industry across states, reaching out to over 250,000 companies. FICCI provides a platform for networking and consensus building within and across sectors and is the first port of call for Indian industry, policy makers and the international business community.

For more about FICCI, please contact:

Shaily Agarwal
Assistant Director
Real Estate & Urban Infrastructure

www.ficci.in
facebook.com/ficciindia
@FICCI_INDIA
+91 11 23738760-70

Pahle India Foundation (PIF) is an FCRA certified, not for profit policy think tank, established in June 2013 as a Section 8 company. PIF's motto is "Facilitating Policy Change." The motto guides all our activities. At PIF, we undertake research and disseminate its findings to contribute to the necessary paradigm shift in development thinking and practices in India. PIF is committed to enriching the public discourse and also to influence policy formulation that will help India successfully complete its triple transition in economic, political and social fields.

Our aim is to emerge as a credible, trustworthy and neutral bridge between economic agents like firms, farmers and professionals on the one hand and policy makers on the other and to contribute to bringing the three principle stakeholders viz government, industry and academia on the same page and pulling in the same direction - a key condition for ensuring India's success in global markets. PIF currently has an analytically strong team of dedicated researchers who are self motivated. PIF's highly qualified team specialises in analyzing India's political economy and its engagement across verticals that are relatively underworked areas that will permit PIF to create a niche for itself in the research and think tank space in the country.

www.pahleindia.org
facebook.com/pahleIndia
@pahleindia
+91 11 41551498, 26519889

FICCI

PAHLE INDIA FOUNDATION
FACILITATING POLICY CHANGE