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FACILITATING POLICY CHANGE

DISCUSSION PAPER

# Affordable Housing

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# Affordable Housing

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# Contents

# List of Tables



# List of Figures

# 1. Housing Sector Overview

The housing sector is an important contributor to the economy. It is the second-largest source of livelihood after agriculture, contributing a 5 per cent to 6 per cent share of India's GDP and capital formation. It is perceived as the third most impactful industry in terms of its effects on other industries, as it directly affects 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.

Unlike many developed countries, which face ageing populations and rising dependency ratios, India is experiencing a demographic dividend where the average age of the population is 27 years. The demographics is heavily skewed towards younger people, with 600 million people who are younger than 24. Only around 2050 will India's population start stabilising. These factors combined, with an increasing preference for nuclear families, an increase in the number of double-income families and rising incomes will lead to an increase in 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. In the recent past, rapid growth of the Indian economy, not surprisingly, has resulted in a concomitant growth in urbanisation. The urban population is expected to increase from 377 million in 2011 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 the year 2030, there will be at least 70 cities with more than a million inhabitants. This number stands at 53 as per the 2011 census. Furthermore, the mega metros of today, namely Delhi, Hyderabad, Chennai, Calcutta, Bombay and Bangalore will continue to grow, and will soon have a combined population of over 100 million. The speed of urbanisation henceforth in India will be nothing like we have experienced till date. Yet, there is very little discussion on how we plan to handle this shift. The lack of planned policy responses has resulted in the growth of slums in and around cities and an escalating housing shortage.

# 2. Shortage in Housing

India faces a chronic housing shortage, estimated at 24.6 million units in 2014 in urban areas (Housing for All, 2014). Furthermore, 95 per cent of this shortage was in the economically weaker sections and the low-income groups. In addition to this, it is estimated that

80 million urban Indians live in sub-standard housing. By 2022, it is estimated that an additional 28 million houses will be needed in urban centres (KPMG, 2014).

According to McKinsey Global, 2010, by 2025, India will add 215 million people to its cities, which will raise the urban population share to 38 per cent. Bombay and Delhi will become number two and three in the world ranking with a population of 26.4 and 22.5 million respectively. Rising population and migration will put immense pressure on Indian cities for improved infrastructure and greatly increase the demand for housing stock. It is projected that by 2022, the total housing shortage will touch 130 million units, of which 47 million units will be in urban areas.

Housing shortages are not restricted to urban centres. In the last decade, economic activity in rural India has shown a steady increase. Rural India accounts for 55.4 per cent of the nation's total income, higher than urban India's contribution of 44.6 per cent. Rural markets have become a powerful economic engine. Since 2000, per capita gross domestic product (GDP) has grown faster in rural areas than urban centres. Between 2009 and 2012, spending in rural India reached $69 billion, significantly higher than $55 billion spent by urban India.

Like in urban centres, the housing sector has been unable to keep pace with growth in economic activity in rural areas. Hence, there is also a looming housing shortage in rural India, where almost 70 per cent of India's population resides The Working Group on Rural Housing for the 12th Five Year Plan estimated the rural housing demand at 43.5 million units in 2012, of which more than 90 per cent, again, is for housing among lower income and marginalised groups. In effect, the total current housing shortage in India stands at approximately 80 million units and is likely to increase to 130 million units by 2022.

Housing would not be a major problem in urban India if there was no mismatch between house prices and affordability. However, the increase in the number of vacant houses and aggressive advertising by builders in major cities clearly point to a lack of demand from the target audience. In such a scenario, buyers of new housing stock would already be living in acceptable houses and either plan to upgrade or to move from a rented place to a self-owned one. On the other hand, those living in congested households or slums do not have the income or access to finance to be able to be able to move into these developments.

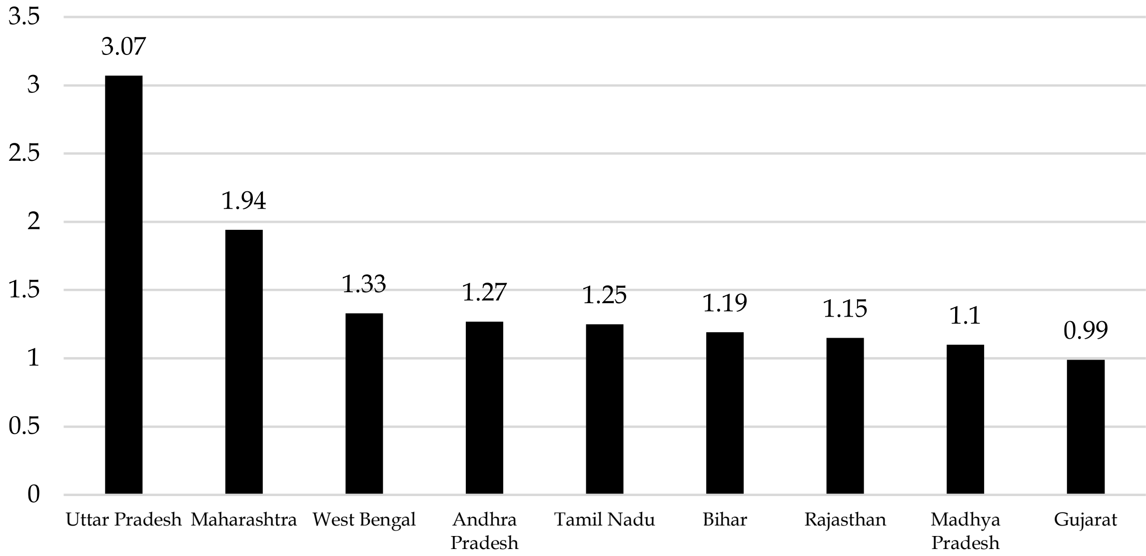
### Table 1: Urban Housing Demand in 2012

| Urban Demand, 2012 | # in millions |
|---|---|
| Non-serviceable Houses | 0.99 |
| Obsolescent Houses | 2.27 |
| Congested Houses | 14.99 |
| Homeless | 0.53 |
| **Total** | **18.78** |

### Table 2: Rural Housing Demand in 2012

| Rural Demand; 2012 | # in millions |
|---|---|
| Homeless | 1.48 |
| Temporary Houses | 26.69 |
| Congested Houses | 30.28 |
| Obsolescent Houses | 3.55 |
| **Total** | **62.01** |

### Figure 1: Shortage of Urban Housing by State (2012, millions)



The state wise data on urban housing shortage showed that both rich and poor states have a housing shortage. UP has a shortage of 3 million houses followed by Maharashtra, which has a shortage of 1.94 million houses. This suggests that it is not just in the Tier 1 cities that India is facing a housing shortage. Tier 2 and Tier 3 cities in states like Uttar Pradesh, West Bengal, Andhra Pradesh are all facing housing shortages.

## 3. Affordable Housing – Objective and Evolution

That there is a shortage of housing in India is not in contention. Clearly, despite a considerable increase in the housing stock, it is the supply of affordable housing that is the biggest challenge in India's urbanisation. The type of housing is broadly classified into economically weaker sections (EWS), low income group (LIG), middle income group (MIG) and high income group (HIG). As land and housing are state subjects, the classification of income groups varies from state to state.

**Table 3: Classification of Income Groups for Maharashtra**

| Classification | Income |
|---|---|
| EWS | Up to Rs. 16,000 per month. |
| LIG | Rs. 16,001 to Rs. 40,000 per month |
| MIG | Rs. 40,001 to Rs. 70,000 per month |
| HIG | Above Rs. 70,001 per month |

The EWS and LIG category together account for more than 95 per cent of the housing shortage in urban India. For LIG, an "affordable house" would cost (on the higher side) INR 25 lakh, approximately 5 times the gross annual income of the income group, making it unaffordable. Thus resulting in increased dependence on either subsidies or government constructions as a means of bridging an ever-increasing affordable housing gap. China's mega-cities have seen a five-fold increase in property prices over the past decade. Yet despite these astounding increases, property prices in Beijing and Shanghai are still only half those in New Delhi and Bombay; while the quality of life and infrastructure are much better in the former.

India's excessively high property prices reflect a combination of two archaic practices: reserving large parcels of valuable urban land for government use and outdated and overly rigid building codes that discourage concentrated development of commercial activity and housing in the core of cities. This pushes development to the outer suburbs, making it difficult to realise the agglomeration benefits that drive productivity gains. Correspondingly, people have to either commute huge distances for work or live in expensive and sub-par housing or slums; as these are illegal colonies, they do not have any civic amenities like drinking water, sewerage, electricity etc. It was this stark reality that formed the genesis for the vision of "Housing for All" by 2022.

# 4. Costs of Construction

Real estate developers usually concentrate on the luxury and high-end segments owing to better margins. But high land prices, archaic building laws, delays in project approvals, and unfavourable banking regulations make low cost housing uneconomical. There are five reasons for high cost of construction.

## 4.1 Land Cost

The high population density of urban India puts a huge premium on land. Outdated regulations have restricted the availability of land and the amount of construction. While one often hears of Indian cities being compared to international centres like Shanghai, what is often missed is that the tallest building in Shanghai is 632m tall while the tallest building in India is 254m tall because a 1990s regulation restricts the maximum height of a building in India to 300m.

The floor space index (FSI), which defines the multiple of ground area that can be constructed, is abysmally low in India. The FSI in South Bombay is capped at 1.33, which means that at most a builder is allowed to construct one story above the ground. Developers have to go through multiple regulatory loopholes to be able to build higher, for example by constructing slum rehabilitation projects. This increases the cost of projects immensely.

### Table 4: FSI in Various Cities in India

| City | Area | FSI |
|---|---|---|
| Bombay | South | 1.33 |
| Bombay | BKC | 4 |
| New Delhi | Delhi | 3.5 |
| Bangalore | City | 4 |
| Kolkata | City | 3 |
| Kolkata | Salt Lake | 5.95 |
| Chennai | City | 3.5 |

**Table 5: FSI in Global Cities**

| Country | City | FSI |
|---|---|---|
| USA | New York | 15 |
| USA | Chicago | 12 |
| Bahrain | Bahrain | 17 |
| China | Hong Kong | 12 |
| China | Shanghai | 13 |
| UAE | Dubai | 34 |

There is an immediate need to review many of the existing archaic regulations like the Rent Control Act for example, which deter development of rental houses and redevelopment of old properties. FSI, zoning, development plans and other regulations should also be revisited to increase the supply of housing in India and bring down the cost of construction.

## 4.2 Funding

If a builder has to construct a building, he has to get multiple clearances. Financing continues to remain a major hurdle. Regulation prohibits bank lending for acquisition of land, which forces builders to either use their own capital or seek funding from private equity players to finance land acquisition. Since the IRR requirements of private equity investors is higher than bank interest costs, the funding cost of housing projects are much higher than most traditional infrastructure projects, which banks are willing or allowed to finance. Hopefully, the newly bestowed infrastructure status should provide some respite.

## 4.3 Approval Procedures

Once land is procured by a developer, the proposal for construction has to pass through more than 150 people in 40 departments from the local civic body to the central government (Corruption and Transparency in Realty, 2015). This process can take anywhere between 29-43 months. While the time taken to grant these approvals is in itself disturbing, it is the cost incurred during this period that is a matter of serious concern. One must bear in mind that during the whole time of waiting for approvals, the developer is being financed by private equity at rates that are as high as 20 per cent. This accounts for almost 25 per cent of a project cost.

## 4.4 Input Costs

For affordable housing projects, construction costs account for about 50 per cent of the total selling price of a house. Raw materials like cement, sand and other input prices (except steel) have been rising in tandem with inflation in India. Owing to the success of MNREGA, construction also faced a shortage of unskilled labour leading to an increase in labour costs. A price floor was established for the cost of unskilled labour at the MNREGA daily wage rate. The increase in costs of construction because of this was an unforeseen consequence.

### 4.5 Import Duties

Construction in the 21st century is not like construction in the previous century. Lighter and stronger materials and a greater proportion of steel and glass are used in construction. As land is scarce, one automatically looks to expand vertically rather than horizontally. However, vertical expansion requires hi-tech equipment that India does not currently manufacture, necessitating the import of heavy engineering equipment. The tax and duties charged on this equipment either make it impossible to import or drive up the price of construction. In this regard import duties are highly regressive. The actual taxes charged for construction equipment are the following.

- Landing charges (1 per cent CIF)
- Countervailing duty (30 per cent)
- CESS (3 per cent)
- Additional Countervailing Duty (4 per cent)
- CEX (Education & Higher Education CESS)

## 5. The Pradhan Mantri Awas Yojana (Gramin and Urban)

The origin of Pradhan Mantri Awas Yojana can be traced back to the wage employment programmes – the National Rural Employment Programme (1980) and the Rural Landless Employment Guarantee Programme (1983) – under which construction of houses was allowed. The Pradhan Mantri Awas Yojana was launched on June 25, 2015, and has become a flagship programme for the incumbent government. The scheme has two components, Pradhan Mantri Awas Yojana – Gramin (PMAY-G) and Pradhan Mantri Awas Yojana– Urban (PMAY-U).

Affordable housing for all has been an important policy agenda of the incumbent government, as it seeks to create an enabling and supportive environment for expanding credit flow and increasing home ownership. The ambitious target is to construct 20 million houses in urban India and 40 million houses in rural India by 2022 in three phases of implementation.

- Phase 1: Under phase one, housing units will be created in 100 selected cities in the period from April 2015 to March 2017.

- Phase 2: The next phase will cover about 200 cities for housing development between April 2017 and March 2019.
- Phase 3: The final phase of Pradhan Mantri Awas Yojana will be implemented in the remaining cities between April 2019 and March 2022.

This calls for investments of more than $2 trillion by 2022 (current investment stands at approximately $120 billion), which would require an immediate improvement in financing mechanisms. Of this, 85-90 per cent of the total investments will be required for urban housing. The bigger challenge is meeting the requirement of 1.7 to 2.0 lakh hectares of land for urban housing by 2022.

## 6. Other Government Initiatives in Affordable Housing

It was in the Union Budget for 2016 that the details of the Housing for All scheme was outlined. The guidelines allowed for a 100 per cent deduction of tax on profits on undertaking housing projects for builders. It was also the first time that affordable housing had been defined on the basis of the size of house and not on the value, which allowed greater flexibility to builders. By way of tax incentive to home buyers, a deduction of an additional interest of INR 50,000 per annum for loans up to INR 35 lakh was sanctioned in 2016-17 for first time home buyers, in cases where the cost of house does not exceed INR 50 lakh. The policy also introduced an interest subvention scheme for housing loans implemented through scheduled commercial banks and housing finance companies (HFCs). This came under the purview of the Jawaharlal Nehru National Urban Renewal Mission (JNNURM) programme under the Ministry of Urban Development.

During FY2013-14, projects worth INR 417.23 billion were sanctioned by the National Housing Bank (NHB) for building 1,569,000 houses for economically weaker and lower income sections of the population. In addition, the government also promoted rural housing finance in the low and middle income (LMI) segment through the Rural Housing Fund, Golden Jubilee Rural Housing Refinance Scheme and Special Refinance for the Urban Poor Scheme.

Many new initiatives specifically focused on lending for housing were also introduced. The biggest highlight was bringing housing loans of up to INR 50 lakh under priority sector lending (PSL), against loans of up to INR 25 lakh earlier. This was heralded as a positive for the housing sector as it was expected to bring in many more dwellings into the ambit of PSL lending. The RBI's decision to increase loan-to-value (LTV) ratio to 90 per cent for loans up to INR 30 lakh or less was another positive step that enabled HFCs to lend more to LMI customers.

As tax incentives, the government abolished any pre-payment penalty on floating rate housing loans in 2014, aimed to be a shot in the arm for developers and to increase demand for housing. An increase in the tax deduction limit on interest payments on home loans to INR 2 lakh also provided prospective home buyers an additional incentive. The rationalisation of taxes of real estate investment trusts (REITs) is expected to provide another source of funds mobilisation for developers engaged in commercial real estate. The government also relaxed foreign direct investment (FDI) norms in the construction and housing sector and eased the exit process for global investors.

# 7. Impact of Infra Status

Budget 2017 granted infrastructure status to affordable housing. Infrastructure status grants special borrowing privileges to borrowers in accessing banks. For starters, it provides for more relaxed financing in terms of debt-to-equity ratio, repayment periods, and moratorium period for loans. It will also mean that developers get an income tax benefit on their profits for 10 assessment years. The direct impact of this will be the following.

## 7.1 Access to Credit

The ease of access to loans from banks is due to compliance concessions given to banks, like banks being allowed to raise long term capital by issuing bonds to finance infrastructure projects.

- These bonds are exempt from computation of net demand and time liabilities (NDTL) and, therefore, are not subject to CRR/SLR requirements.
- These bonds are also exempted in the computation of adjusted net bank credit (ANBC) for calculation of PSL

Credit exposure to a single borrower can exceed the exposure norm of 15 per cent of the bank's capital funds by 5 per cent (i.e., up to 20 per cent), provided the additional credit exposure is on account of extension of credit to infrastructure projects. Credit exposure to borrowers belonging to a group can now exceed the exposure norm of 40 per cent of the bank's capital funds by an additional 10 per cent.

### 7.2 Tenor of Credit

Banks are allowed to have an amortisation period up to 80 per cent of the concession in case of infrastructure projects. Financing can be raised for a maximum tenor up to 25 years, with an option to refinance the same at the end of five years (once the project viability has been established).

### 7.3 External Commercial Borrowing (ECB)

The 2015 ECB policy permitted infrastructure companies to borrow in foreign currency in the external market. However it specifically prohibited usage of funds for real estate or onward lending to other entities for use in real estate or purchase of land. With the classification of affordable housing as “infrastructure”, this restriction has been removed. For infrastructure and Greenfield projects, funding up to 50 per cent (through ECB) is allowed. Borrowers can use 25 per cent of the ECB to repay rupee debt and the remaining 75 per cent should be used for new projects. NBFC - IFCs and NBFC - AFCs are allowed to raise ECB only for financing infrastructure. The ECB limit under the automatic route is 75 per cent of their owned funds, including outstanding ECBs.

### 7.4 Financing Options

Insurance and pension funds and alternate investment funds (AIFs) will now be able to deploy money into the affordable housing sector.

### 7.5 Withholding Tax

Withholding tax for infrastructure bonds is 5 per cent. This makes them attractive to offshore investors.

## 8. The Role of Housing Finance Companies

Granting infrastructure status is likely to reduce the costs of construction, but the cost of acquiring a house continues to be high. The objectives of Housing for All cannot be met without a robust housing finance sector. Financing for the end consumer must be considered along with financing for construction of affordable houses. If financing is not made available to consumers, the objective of affordable Housing for All will be defeated.

In this context, non-banking financial companies (NBFCs) have played a vital role in the Indian economy over the years and HFCs have been at the forefront in catering to the financing needs of the sections of society

**Figure 2: India's outstanding housing finance loans (INR lakh crore) (2010-2016)**

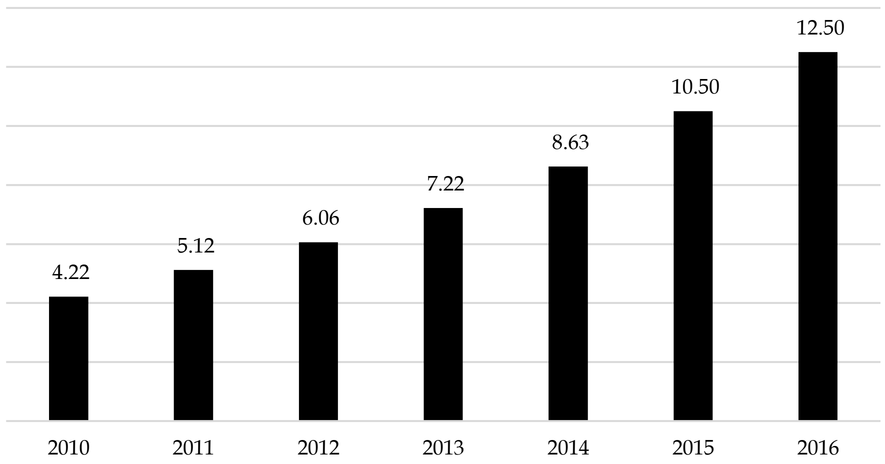
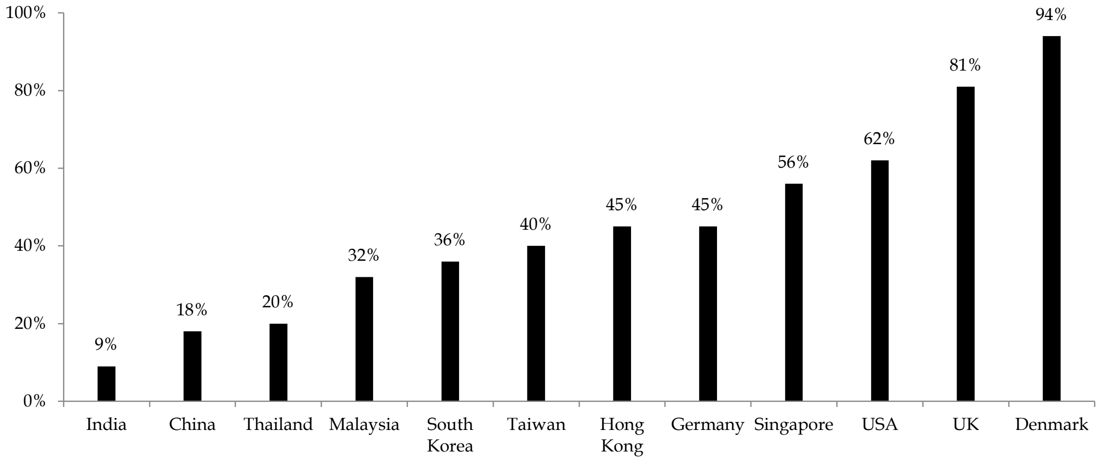



**Figure 3: Mortgage-to-GDP ratio of select countries (2015)**



that struggle to get loans from banks. This is true for both rural and semi-urban areas. Over the years, HFCs have been able to gain market share due to their strong origination skills and focused approach.

The Indian housing finance industry is growing fast. The outstanding loans of HFCs, have increased at a CAGR of 26 per cent between 2010 and 2016. During the same period, the growth in total loans outstanding of both banks and NBFCs, was approximately 20 per cent CAGR.

Despite strong growth in outstanding housing loans in India in recent years, the penetration of housing finance is low compared to other advanced economies. The mortgage-to-GDP ratio was a low 9 per cent as on March 2016, one of the lowest in the world. In sharp contrast, developed economies have ratios between 80 and 100 per cent of GDP. India's Asian peers have also performed much better.

The most important role that HFCs play is in being able to reach out to the un-banked, rural or LMI customers who require customised products and services. Banks often do not cater to these customers, mostly because the cost of acquisition is high. Hence, banks end up serving more customers in the upper socio-economic strata (especially in urban areas), who are more profitable on account of lower distribution costs and higher loan amounts. This (and of course the lower cost of funding) allows banks to offer more competitive rates of interest for housing finance. Urban, high-income customers, who have access to banks, enjoy the benefits of lower rates of interest, while HFCs, who cater to the low and middle income customers, are forced to charge a higher rate of interest to those who should have access to lower interest rates.

Nevertheless, HFCs are better positioned in acquiring customers who might actually be unattractive to banks. HFCs are also better placed to serve these customers as their specialisation allows them to develop a deeper understanding of the needs and risks in lending to these customers. That HFCs have lower NPAs when compared to banks, despite over 50 per cent of HFCs lending to the sub INR 25 lakh category, is testament to this fact.

# 9. Way Forward

## 9.1 Availability of Land

Government, government organizations and the military occupy prime parcels of land in many cities. Most of these properties are under-utilized. It would make sense for government enterprises to make use of their unwanted land stock by either monetizing it or by developing it. Similarly, the army has no business in occupying prime property in the centre of cities like Bombay, Bangalore or Calcutta. They should be moved out of cities and placed in cantonments outside the cities. Unlike the Air Force which needs access to airports and other supporting infrastructure.

## 9.2 FSI easing

Indian FSI regulations are the most restrictive in the world. State governments and local bodies should take note of this and liberalize these norms as soon as possible.

## 9.3 National Housing Bank – The New Development Organisation

The National Housing Bank (NHB) is tasked with regulating and developing housing finance. The refinancing responsibility of NHB is linked to this objective. NHB is also tasked with regulating HFCs. RBI, on the other hand, regulates bank housing finance. The Financial Sector Legislative Reforms Commission (FSLRC) has spoken of creating a unified regulator. The merger of SEBI and FMC was the first step towards this. The merger of NHB and RBI will be a step in the right direction. Currently, the regulator functions of NHB mirror those of RBI on most counts. Having a single regulator for housing finance will ensure better growth for the housing finance sector.

The NHB must transition from being a regulator to becoming a single point development institution for housing finance, much like how IIFCL is structured. While IIFCL offers development support, credit guarantees and credit enhancement to large scale infrastructure products, NHB can cater to the housing market, especially the affordable housing market. Housing involves multiple local bodies, financing companies and end consumers. Local bodies and infrastructure companies are occupied with raising finance, which happens at the cost of developing affordable houses.

NHB can help with raising capital through refinancing and credit enhancement. Converting NHB from a regulator to a development organisation will ensure a more co-ordinated, cogent and structured approach to affordable housing.

There is already a regulator and regulation for housing finance in the form of the RBI. What the sector desperately requires and lacks is a financial institution that can focus purely on developing the housing finance sector and it is this gap that NHB can fill admirably.

## 9.4 Resource Flows into HFCs

The infrastructure status accorded to affordable housing is crucial. The affordable housing sector certainly stands to gain, as do banks, who are willing to fund these projects. However, the benefits of this announcement must also extend to loans of HFCs that go towards funding affordable housing. This means relaxing all existing caps for bank lending to HFCs. This will also mean allowing HFCs to access the ECB market for lending to affordable housing.

The growth in mortgage-backed securities (MBS) will be important for HFCs. Allowing mutual funds to invest in these instruments will further deepen the market. Similarly, banks must also be allowed to actively participate in this market. Credit enhancement and credit guarantee will also be crucial to the development of the secondary market for securitised home loans.

Infrastructure bonds, masala bonds and green bonds are all excellent ways of raising money for long-term funding. Tax incentives (discussed later) will certainly help in attracting both retail and institutional investors. Additionally, Budget 2017 has announced the expansion of the basket of financial instruments into which investments may be made for receiving exemption on capital gains tax arising out of sale of property. Infrastructure bonds and green bonds can immediately be added to this basket of financial instruments. This will not only ensure an immediate inflow of retail funds, but also long terms funds for funding affordable housing and even for refinancing HFCs.

## 9.5 Ease of Acquiring Houses

The process of acquiring an affordable house must be simplified. One must keep in mind that the target group for affordable houses are often those with limited or no knowledge of finance. Copious paperwork and complex procedures can be very intimidating and can act as deterrent to home ownership for this group. It is therefore important to create standard operating guidelines in terms of documentation, legal approvals and other beneficiary related paperwork to ensure that loan approvals and disbursements, and home ownership is a seamless process for the EWS and LMI group.

Stakeholders must explore various models for a clustered approach towards developing large resettlements of informal housing, especially urban slums. These should proactively involve developers, urban local bodies and HFCs for end-to-end solutions that work in tandem.

## 9.6 Tax Incentives

Tax incentives have always been used as a successful instrument for attracting investors and for deepening and broadening markets. The following tax incentives will do the same for the housing finance market.

In order to attract institutional investors into the market, withholding tax on infrastructure bonds, masala bonds and green bonds must be abolished. This will immediately spur investments into these instruments. When the withholding tax was reduced from 20 per cent to 5 per cent for infrastructure bonds, there was an increase in the number of issues of and collections from these bonds. As new instruments for financing affordable housing, they have large potential to attract external inflow of funds.

In order to attract the retail investor, infrastructure bonds can be made tax free and can be brought under 80(c). With volatility in the equity market persisting, retail investors are more open to investments in bonds. A tax-free status to these bonds and bringing them under the 80 (c) bracket, or at the least, providing for an additional income tax exemption (as was done before for infrastructure bonds) will go a long way in attracting retail investors.

Currently, special provisions relating to tax on distributed income by securitisation trusts given to its investors is chargeable at 30 per cent on the income distributed to persons other than an individual or HUF. This is a big hurdle to setting up a securitisation market. If this is abolished,banks and insurance companies will participate freely thereby bolstering the MBS market.

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