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Affordable Rental Housing

As India struggles to house a burgeoning urban population, this Quarterly examines affordable rental housing as a more cost-effective and flexible solution to house low income families than providing low cost units on an ownership basis. Barely a handful of schemes exist in the public-private and purely private spaces. To develop an adequate supply of housing for rental will require mandating inclusionary housing and carefully thought out incentives. Creating an enabling environment for agencies to manage the housing will require support of risk mitigation strategies and appropriate legislation.

Introduction

The 12th Plan Working Group on Financing Urban Infrastructure estimates the urban housing shortage in the country at nearly 29 million units. Most worrisome is that approximately 26 million units pertain to the Economically Weaker Sections (household average monthly income up to Rs. 5,000) whereas 3 million is the shortage in the Low Income Group (household average monthly income of Rs. 5,000-7,500). An inadequate supply of affordable housing is a key reason why up to half or more of population in larger metros live in slums or other informal accommodation.

Table 1: Social rental housing in developed countries

	Percentage of total housing stock*		Percentage of social housing stock by**	
Country	Social rental	Private rental	Pure public sector	Housing Assoc (Limited profit / non-profit)
UK	20	10	54	46
Ireland	7	11	90	10
USA	3	29	31	69^
Australia	5	22	85	8
Canada	6	28	34	66
Austria	23	17	43	53
France	16	24	Some	90^
The Netherlands	35	12	1	99
Denmark	19	18		100^
Germany	6	51	18	Some^
Switzerland	6	59	Some^	Some^
Singapore	<10		100	
Republic of Korea	9	35	Some	
Hong Kong	31		100	

Source: International experience in providing affordable housing, IDFC 2011
Note: Housing associations are for-profit, non-profit or limited profit organizations that build and/or manage low-cost or 'social' housing
*Remainder of total housing stock is predominantly ownership
**The social housing stock includes both social rental and ownership units
^Include some for-profit associations, co-operatives, moderate rent agencies and regulated private landlords. Some associations have tenant shareholders

To date, government housing policy has focused on home ownership with little success (See Box 1). In contrast, many developed economies have emphasized affordable or 'social' rental housing which constitutes up to 20-30 percent of their housing stock (See Table 1). Most of the social housing is provided by government or by limited or non-profit housing associations that utilize government incentives. Therefore governments have generally had a large role to play in promoting social housing.

Why focus on affordable rental housing?

Low income households:

- typically cannot afford to buy homes and cannot get home loans also due to lack of credit history. Smaller monthly rent payments suit their variable income profile
- in rental accommodation can move more easily as income or work allow/demand

For government:

- subsidy outlays for rental housing, such as on rental allowances, are lower than subsidizing house ownership
- housing asset remains with government so it can be used by multiple households over time

Box 1: Six decades of ownership-focused housing policy has had limited impact

In the two decades post Independence, housing policy focused on handing over finished housing units to EWS or LIG families. Only a small fraction of the country's total budget was allocated to housing programs and since this intervention was costly it benefitted very few. Moreover, where market value of the units was high, many low income families preferred to sell off the assets to middle and higher income groups (MIGs, HIGs).

By the 1970s and 80s government turned its attention to enabling, not providing, home ownership by using sites and services and slum upgrading programs. These required beneficiaries to contribute some of their own capital towards building housing on government or regularized slum land. These outcomes were also poor as the serviced sites were generally in peripheral areas and more suitable for MIGs and HIGs who bought them off LIG families.

From the 1990s, enabled by the growth of the housing finance industry, government increasingly sought to incentivize the private sector to build LIG housing stock using FSI, tax exemptions and other tools. While this approach reduced government outlay, the emphasis on ownership remained. Moreover, greater availability of finance benefitted mainly construction companies and aspiring MIG, HIG homeowners.

Ironically two key pieces of legislation aimed at affordable housing instead greatly distorted land and housing markets. The 1960 Rent Control Act was intended to protect tenants from eviction and increases in market rents. However, in doing so it killed all future investment in rental housing. The 1976 Urban Land Ceiling Act (ULCRA) (repealed in 2005) put caps on the amount of land that could be held by private entities and gave the state the right to acquire 'surplus' land at a pittance to provide low income housing. Unfortunately widespread corruption led to less than 0.5 percent of the land declared surplus being used for housing and the perceived scarcity this legislation produced pushed land prices up further.

The majority of low income persons in urban areas end up renting accommodation in the informal sector under a variety of arrangements. In Mumbai, slum households often build an additional room to rent. Tenure here can be uncertain as there is no formal protection for the tenant. *Chawls* also offer rental housing under arrangements that range from payment of a large upfront deposit to advance payment of 11 months' rent. In other cases, single people may share a rented room in dormitory type arrangements, or in the extreme, take shifts to share a bed in rented rooms.

In contrast to this there is barely any government-provided rental housing. This Quarterly examines two affordable rental housing initiatives. One is a nascent government attempt under the Mumbai Metropolitan Regional Development Authority (MMRDA)'s Rental Housing Scheme which incentivizes private builders to construct rental housing for MMRDA. The second is a purely private sector initiative in providing dormitory style accommodation.

MMRDA's affordable rental housing scheme

In 2008, at the behest of Government of Maharashtra, MMRDA launched an affordable rental housing scheme that aimed to build 5 lakh, 160 square foot (sqft) homes in 5 years without any capital or land contribution from MMRDA. This stock is intended to be a crucial step towards making Mumbai slum free by addressing both existing shortage (20 lakh units) and projected growth of EWS/LIG migrants.

The scheme is based on relaxing Floor Space Index (FSI) restrictions for private builders in order to cross-subsidize the construction of low income rental units. MMRDA offered two options – an FSI and Transferable Development Rights (TDR) model – though the bulk of projects have come up on the former. Under the TDR scheme, developers build rental housing on a plot they own, and receive the incentive FSI as TDR to be used on a project north of the rental housing plot.

The FSI scheme is applicable to most of the Mumbai Metropolitan Region (MMR) with the exception of the island city, Navi Mumbai and a few other areas. Zones which lie outside any municipal corporation or council jurisdiction and are marked as "urbanizable" (U1/U2) on the development plan are also included. These zones have an FSI of 0.40 compared to 1.33 for the island city and other MMR areas.

Under the scheme, developers receive an FSI of 4 if they use 1 FSI to build rental homes on one-fourth of their plot. These rental flats are handed over for free to MMRDA to allocate. 3 FSI is to be sold as market rate residential homes though 15 percent can be sold as commercial space.

MMRDA proposes to rent the units they receive at between Rs. 800-1,500 per month. Eligible applicant households must have monthly income over Rs. 5,000, have lived in Maharashtra for 15 years and not own a home in the MMR.

Besides land and construction, developers' costs include an infrastructure charge between Rs. 250-1,000 per square meter (sqm) of which 90 percent goes to the local municipality towards upgrading the external infrastructure and 10 percent is kept with MMRDA towards rental housing maintenance. Developers are generally able to finance the construction from the pre-sale of market units.

In the projects under construction we visited, the plot sizes are approximately 15-20 acres to allow for adequate separation between the rental and market housing. Market housing units range from 800 to 1400 sqft and include amenities like a swimming pool, clubhouse or tennis courts.

This scheme is highly profitable (see Table 2). In the normal course, profits would be around Rs. 548 crores on a 17 acre plot. With additional FSI, even though developers must construct and hand over rental units for free, profits are around Rs. 1,292 crores. Given average project costs, the break-even sale price for this scheme is roughly Rs. 3,200–3,500 per square foot (psf). This makes it particularly attractive in higher priced areas like Thane, Panvel and Kalyan where sale prices range between Rs. 4,200-10,000 psf.

Table 2: Comparing private developers' returns: with and without FSI scheme on a 17 acre plot in Thane

	Only market housing	Under MMRDA scheme	
		Rental housing	Market Housing
Costs on built up area (Rs. psf)			
Land cost	1,579	525	525
Construction cost	2,600	1,700	2,600
Infra fee	-	50	50
Cost (Rs.cr)	411	168	705
Total cost (Rs.cr)	411	873	
Sale price (Rs. psf)	7,500	-	7,500
Total profit (Rs.cr)	548	-	1,292
Profit/Cost Ratio:	**1.33**		**1.48**

Source: Interviews with developers, IDFC analysis

Assumptions: For the plot, land cost is Rs. 2,100 psf. Loading on FSI (for amenities, common space) is 30 percent for market housing. Construction costs cover the cost of infrastructure and financing. For FSI scheme infrastructure fee is Rs. 500 per sqm. Time value of money is not considered.

The project received a good response initially with 215 applications to build over 9 lakh rental units. Of this, 50 applications were approved for 2.6 lakh units. Thereafter 11 developers' applications expired, were cancelled or withdrawn, some due to delays in getting government clearances. The remaining projects will deliver just under 90,000 units of which 37,000 units are under construction in 17 projects. The first 2,500 units are due at year-end.

Recently, modifications to the scheme have been proposed by the Asthana Committee, some of which undermine the very basis of an affordable rental scheme. For instance, the Committee proposes that only 15 percent of affordable units be rented. The rest would be sold on the open market or used by ULBs and the state government. Like previous ownership schemes, the units are likely to end up with MIGs. Another proposal is to increase the unit size to 320-400 square feet. This size appears more geared to sale. Developers are requesting to remove the requirement that 15 percent of the rental FSI be built as commercial space to be rented to low income families. This proposal would deprive low income families of shops catering to them as well as valuable income generating opportunities.

Key issues with MMRDA's rental housing scheme:

- *Enforcement:* There is no penalty for delay in delivering rental units. On the other hand, there are no streamlined processes to expedite government approvals.
- *Rental management*: MMRDA is considering outsourcing maintenance and management of the properties to third party rental management associations (RMAs). MMRDA proposes three models all of which entail the RMA paying a fee to MMRDA for the right to manage the property (see Box 2). However, the private sector may be reluctant to enter the rental management space if they perceive risk of government pressure that will not allow them to revise rents over time to cover costs, or evict defaulting tenants.
- *Limits to scalability:*
    - o the use of FSI is highly location-dependent as property prices need to be high enough to cross-subsidize
    - o developers will compare this scheme with alternative FSI-linked ones such as slum redevelopment or parking schemes which might be more lucrative
    - o the *ad hoc* use of FSI is distortionary and creates pockets of density without commensurate infrastructure that the city cannot support on a large scale. Moreover, given FSI's high scarcity value, such schemes generate avenues for rent-seeking

Box 2: MMRDA's proposed private rental management models

Surplus model: Management companies will bid competitively to maintain rental homes. The company that offers the highest share of their revenue to MMRDA will win.

Lease model: Rental management companies lease the properties from MMRDA for 99 years for a lease premium.

License model: In this model, rental management companies pay a license fee to manage the rental housing for 9-10 years.

In all cases, allotment, determination of rents and eviction is undertaken by MMRDA.

Government needs to explore other mechanisms to increase the supply of affordable rental. Other countries have used a number of incentives other than FSI to deliver rental housing stock (see Box 3).

Box 3: International experience providing affordable rental housing

Many developed nations provide incentives for building affordable homes. For example, builders of low income rental housing receive grants, tax subsidies, low interest loans, or additional FSI to make the housing cost viable. In France, the government assists in land acquisition or provides government land for the construction of public rental housing. In many instances, housing vouchers given to tenants or private rental owners help to subsidize the cost of a market rate rental unit.

The housing is largely provided by limited or non-profit housing associations (LPHA or NPHA) (see Table 1). These associations might be run by non-profit organizations or have pension investors willing to accept a limited return on their investment. The associations make use of the various incentives offered by their governments.

The concept of 'inclusionary housing' is used extensively in countries such as Spain, US and the UK whereby it is mandatory for a private developer to provide affordable housing as a condition to receive planning permission for any development. The number of units to be provided can vary but the housing is to be mixed in with higher value development. In the UK, developers typically have to build 25 percent of their proposed development as affordable units, while in Spain the requirement can go up to 50 percent.

Source: Australian Housing and Urban Research Institute, "International measures to channel investment towards affordable rental housing" 2010

A purely private affordable rental initiative: Aarusha Homes

Privately provided rental for families does not exist in the formal sector on a commercial scale because of concerns over rent control regulation. However, there are a few nascent initiatives in the formal sector to provide single person accommodation on a shared basis.

One such initiative, Aarusha Homes was established in 2007 by three entrepreneurs as a private limited company to meet the low income housing needs of urban residents and migrants. They currently run 10 dormitories in Bangalore and Hyderabad with a total capacity of 1,500 beds and offer shared accommodation (including meals) for singles. Going forward, Aarusha aims to cater to families.

Aarusha is one of nearly 6,000 hostel operators in Hyderabad that cater to 3.5 lakh students and employees at price points ranging between Rs. 2,400 to 4,500 per month. However, Aarusha is one of the few who operates formally.

Risk mitigation: To reduce payment risk, Aarusha prefers to rent to formal sector workers as far as possible. It has also tied up with some companies to house their employees. Rent is collected at the beginning of every month and sometimes 1-2 months' rent is taken as a deposit.

Cost structure: Aarusha's most significant cost is rent for leasing their properties. In fact, at 85 percent occupancy fixed costs are very high at 60 percent of their total cost.

Table 3: Aarusha financials for employee hostel in Hyderabad (Rs/month)

	Occupancy levels		
	90%	85%	75%
Revenue	660,330	623,645	495,248
Costs			
Operating costs	540,240	526,903	484,576
Trade license fee	6,875	6,875	6,875
Bulk garbage collection fee	13,750	13,750	13,750
Total cost (pre-tax)	560,865	547,528	505,201
Profit (pre-tax)	99,466	76,117	(9,954)
Pre-tax returns	18%	14%	-2%
Income tax @ 33%	32,824	25,119	(9,954)
Post-tax returns	11%	9%	-2%

Source: Interviews with hostel providers, IDFC analysis

Assumptions: Average rent charged is Rs. 2,900 per bed per month. Hostel is 16,000 sqft, has 253 beds and uses 150 KL of water and ~7000 KwH of electricity at published commercial tariffs. 35 percent on water bill is charged as sewerage cess. Operating costs include rent to landlord (including property tax), maintenance, utilities, food and staff costs. It also includes fixed investment costs of 20 lakhs amortized at 12 percent interest over 10 years.

Returns: Margins are low which makes returns highly sensitive to occupancy levels. At an average 85 percent occupancy, Aarusha's pre-tax returns are 14 percent and post-income tax returns 9 percent. If the service tax provisions of the latest Budget are applicable on the rent landlords get from Aarusha, then Aarusha's pre-tax returns fall to 8 percent. Service tax will apply only if Aarusha is classified as an intermediary providing a commercial service under tax laws. Being a commercial entity Aarusha is also liable to pay a trade license fee and property tax, water and electricity at commercial rates. These costs raise Aarusha's costs relative to an informal hostel. Just by avoiding taxes and fees, Aarusha can get higher margins (see Table 4).

Table 4: Incremental cost of being formal (Rs./month)

	Informal hostel	Formal hostel	Incremental cost over informal operations	Increment as per cent of operating costs
Op costs	419,700	419,700		
Utility costs	54,292	59,365	5,073	1%
Municipal fees	-	20,625	20,625	5%
Property tax	13,600	96,000	82,400	20%
Service tax	-	16,680	16,680	4%
Income tax	-	40,039	40,039	10%

Sources: Interviews with hostel providers, IDFC analysis

Assumptions: Baseline op costs for formal and informal hostels include rent without property tax, maintenance, staff and food costs. Municipal fees are the trade license and bulk garbage collection fee. Informal hostels pay residential (Rs.0.85 psf) and not commercial (Rs.6 psf) property tax and use water and electricity at residential rates. Other assumptions as in Table 3.

Given the high risk and low returns, it is not financially attractive to enter this market as a formal player. Therefore hostel operators prefer to operate unofficially where they can cut costs, avoid regulations and taxes and protect their margins. Indeed, several hostels provide similar accommodation (though lower quality), located in the same area at a similar price range of Rs. 2,500- 3,100 a month.

Key challenges to private low income rental providers:

- High fixed costs make margins extremely sensitive to occupancy levels and inflation.
- Formal sector hostels also face taxes and charges at commercial rates.
- Given high land and rental fixed costs, it is difficult for a private operator to provide really low cost rental accommodation, unless it is an old building that is long

depreciated. MMRDA can afford to charge lower rents as they do not have to recover any investment.

Recommendations

Given that it will take time to build up a substantial affordable rental stock and facilitate the development of RMAs, in the short term slums will continue to provide affordable accommodation. Providing basic services to slum dwellers can play a crucial role in improving their quality of life and health. For developing affordable rental some recommendations are:

- *Reform the Rent Control Act:* As mandated by JNNURM states must complete reforms to their Rent Control Act to balance the interests of landlords and tenants and create a conducive atmosphere for private rental.
- *Mandate inclusionary housing:* Every new development must have a certain share of units as affordable rental. Rajiv Awas Yojana (RAY) requires that 20-25 percent of developed land in all new housing projects be earmarked for EWS/LIG housing.

  Recently, Maharashtra took the initiative to mandate inclusionary housing by making a unilateral modification to the Development Control Regulations as allowed under Section 154 of the Maharashtra Regional and Town Planning Act, 1966. This modification requires all developments over 2,000 sqm to provide 20 percent of the built up area as EWS/LIG housing. However, the modification was challenged and overturned in the High Court. The regulation has now been reintroduced under Section 37(1AA) of the same Act that requires a process of public consultation before the modification can be reintroduced into the Act under 37(2).
- *Provide incentives to private low income rental:* Low income rental operators should be eligible to avail of:
  - property tax rebates and utility charges both at residential rates
  - exemption from trade license fee where applicable
  - income and service tax exemptions for the landlords renting out the premises, for the low income rental providers and developers who build such properties. Units and rents must be below a certain size threshold
  - Capital grants and soft loans from government
- *Retain elements of the original MMRDA rental scheme:* Units should be rented not sold, and the 15 percent commercial space in rental housing retained. Even if unit size is increased, rent should not be raised otherwise the housing would not be affordable to EWS households.
- *Consider revising eligibility and rent downwards to target EWS:* Minimum household income of Rs. 5,000 per month excludes EWS households who are in most dire need of housing.
- *Introduce parallel processing of approvals to expedite:* Currently approvals are processed sequentially.
- *Facilitate development of private RMAs:* For RMAs to develop, they will need payment security and assurances against political risk. To mitigate payment risk, a ring-fenced account can be set up with the 10 percent of the infrastructure fee given to MMRDA as a corpus.

Overall, it appears that while models do exist to deliver low income rental housing, there should be clear political commitment to create an enabling framework for rental. This will require interventions to create housing stock, through inclusionary housing, and also to facilitate rental management through RMAs.

Policy Group – News & Events

- New Assignments:
  - Signing agreement with MoRD for **publication of the India Rural Development Report by the IDFC Rural Development Network** (IDFC,CESS,IRMA & IGIDR)
- Events organized:
  - **Water quiz** in prime colleges based on India Infrastructure Report (IIR) 2011 **on Water.** The IIR is IDFC's flagship annual thematic publication on the infrastructure sector in India.
  - **Writers' workshop** for the IIR 2012 **on Education**.
- Presentations and participations:
  - Presentation on **Role of private sector** at the workshop on **Climate change, urban vulnerability and adaptation planning** jointly organized by IIT Bombay and SIMSR in Mumbai.
  - Roundtable discussion on **Electricity for all: Challenges and approaches** organized by Prayas in Pune.
  - Presentation on **Role of private sector in low carbon strategy options for cities** at the workshop jointly organized by BHC, AILSG, IIM-B and NextGen in Mumbai.
  - Panelist at the **India sustainability conclave 2012** on **water & sanitation** organised by FICCI in New Delhi.
  - Roundtable discussion on **Potential financial policy instruments for promoting large scale solar power in India** organized by UK FCO, NERA Eco Consulting and PwC in Mumbai.
  - Panelist at a discussion on **Issues in sewage management** organized by the Ministry of Urban Development, Govt. of India and Indian Chamber of Commerce in New Delhi.
  - Participation in a closed door discussion with the Staff of Commission chaired by CERC on **Review of the imported coal escalation index used for competitive bidding** in New Delhi.

We are now on and

For details, visit http://www.idfc.com/foundation/policy/philosophy.htm

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