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How escrow account in real estate is proving to be a boon for home buyers

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The real estate landscape in India has undergone a tectonic shift in recent years, buoyed by major long-term regulatory and structural changes. Contributing ~6-7% of the country's economy, real estate continues to be the second largest employment generators in India, only after agriculture. The Real Estate Regulatory Authority (RERA) has played a crucial role in this development, bringing in stringent regulations to promote trust, transparency and stability in the real estate ecosystem.

One of the key changes implemented by RERA is the imposition of escrow. It stipulates all real estate builders/ developers to transfer 70% of the money received from customers to an escrow account maintained with a scheduled commercial bank. This particular provision prevents developers from using the funds for other projects, and mitigates the risk of insolvency.

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What is an escrow account?

Once restricted to large-scale transactions such as mergers & acquisitions and cross-border deals, RERA has now successfully introduced the concept of escrow as a trust-building mechanism in real estate in India. An escrow account is under the purview of a neutral third party, which is essentially a bank or a recognized lender.

In real estate, the developer can access the funds from an escrow account solely for the purpose of construction of the project to which it belongs. However, the request for withdrawal of funds must be certified by an engineer, architect and a chartered accountant to ensure real estate developer's claims are justified.

The restriction on withdrawals from an escrow account makes it the perfect tool to address the incessant delays in residential real estate projects. To put things into perspective, a recent research report revealed that as many as 220 projects comprising 1.74 lakh homes are completely stalled across seven major cities in India. According to another report, nearly 4.54 lakh units in the country are running behind their completion dates. Against this backdrop, this fail-safe payment system is proving to be a boon for home buyers.

Moreover, the Real Estate (Regulation and Development) Act, 2016 requires all developers to get the escrow account audited, within six months after the end of every fiscal year, by a certified chartered accountant. The statement of accounts will only be verified if it is signed by the same chartered accountant.

On the other hand, an escrow arrangement assures the developer that the buyer has the money to complete the transaction. Essentially, it's a win-win for both the parties involved in the builder-buyer agreement. While the RERA Act mandates the use of escrow for new projects, it is yet to gain momentum in the secondary (resale) property market. This is because unlike the primary market, the resale market lacks a regulatory backbone, rendering the scope for foul play. Without RERA's direct supervision, real estate players continue to ask for hefty cash pay-out in property purchases, forcing customers to drop their plans or shift to other avenues. However, at a time when transaction activity is on the decline and more consumers are seeking ready-to-move options, it's critical that the government incorporates an escrow system in the resale segment as well. Otherwise considered murky in the absence of an effective watchdog, the arrival of escrow can undoubtedly boost the creditability of the secondary real estate sector in India.

The road ahead: Escrow to create a level-playing field in India's rental housing space

With new-age digital escrow service providers offering easy-to-use solutions, the concept is likely to become an integral part of real estate, which happens to be an opaque sector in India. While real estate escrow is still at a nascent stage in India, it holds huge scope for growth. Not only home buyers, the rental housing space can also avail direct benefit from an escrow system in place.

Given the highly unregulated nature of this sector, it is the only way to protect the interests of both tenants and homeowners. The main purpose of a rental escrow account is to ensure the landlord is complying with the legal requirements pertaining to maintaining a safe and healthy environment. This is applicable for making necessary repayments in the rented home. Western countries have already created a successful model for rental escrow, and the same can be replicated in India.

The real estate sector though has been largely impacted by the ongoing economic slowdown and COVID-19. However, regulatory intervention, forward looking measures such as escrow, upcoming new tenancy laws etc will definitely go a long way in creating a positive and structurally sound ecosystem in the times to come.