Role of Banks in Housing in Finance

Arshad Khan, Muhammad

Pakistan Institute of Development Economics Islamabad Pakistan

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MUHAMMAD ARSHAD KHAN
Associate Professor (Economics),
Government Intermediate College,
NAR Distt. Kotli,
Azad Kashmir.

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Introduction

Housing is one of the basic needs of every one and therefore almost all countries of the world take extra measures for promoting construction and ownership of houses. The importance of this sector in evolving the domestic economic activities can be identified from three points of view: (i) investment in this field is labour intensive; (ii) it can stimulate the production of local building materials; and (iii) it can act as an incentive to mobilize household savings by offering attractive investment opportunities. The market-oriented housing industry has great potential to serve as an engine of economic growth because it generates direct and indirect investment in almost 40 to 60 ancillary industries and 20 to 25% employment opportunities. In the process of housing finance, a variety of factors have combined to create window opportunity such as, macroeconomic stability and low interest rates environment, increased flow of remittances and investment in the housing sector, rupee stability and appreciation and anti-money laundering efforts assisting in the documentation of the economy. In the current economic scenario, the economic revival depends on investment in housing sector. In addition, housing can be a major avenue for bank financing and household investment that can play a leading role in long-term economic growth, a build up of strong foreign exchange reserve and a stable exchange rate.

The housing sector, despite its importance and recognition, remained neglected in Pakistan and has not been able to attract even a modest allocation of public sector resources. Housing is usually the largest single form of household wealth in Pakistan with an estimated worth of Rs.1700 billion. The evidence shows that currently, the housing finance is estimated to be hardly 1% of the GDP because there is no vibrant system of housing finance. By contrast, it is 2.2% in Bangladesh, 3% in Sri Lanka and Iran, and 4-5% in Mexico, Brazil and Tunisia. In Thailand housing finance is 16% of the GDP and is 21% in Malaysia. In developed countries the average housing finance is 25% of the GDP but in USA it is 53% and 36% in EU. The establishment of a sustainable housing finance market would ultimately mobilize substantial capital for housing finance and facilitate the long-term establishment of a strong mortgage-based collateral market to provide housing loans to all sections of the population. The viability of MBSs market in Pakistan may be hampered by the absence of a legal and regulatory framework for securitization. Without such laws the true sale of assets creates uncertainties in securitization. The greatest barriers to the viability of securitization in Pakistan appear to be in the primary and secondary mortgage markets. In addition, high stamp duties for mortgage transfer and foreclosure is costly and time consuming, Credit approval is not standardized and credit appraisal may not be accurate. These problems have caused deterioration in the quality of the mortgage portfolios of the largest HFCs.

The primary and secondary market infrastructure for fixed-income securities trading appears inadequate. The market lacks liquidity and depth because of several factors including: (i) crowding out of private bonds by government bonds due to persistent deficits; (ii) investors wariness of sophisticated saving schemes; (iii) lack of investor awareness; (iv) lack of rating culture; (v) under-capitalization of market-makers and discount houses; (vi) lack of separate trading floor for bonds; (vii) highly leveraged nature of the SPVs; (viii) long tenor of MBSs; (ix) lack of standardization of mortgage loans; and (x) the high default ratio of originators such as HBFC.

The commercial banks are the largest mobilizer of savings in the country. However, the savings mobilized were not being ploughed back to the households for shelter purposes. The reluctance on the part of the banks to extend credit for housing as a regular part of their business was basically due to their perceived role as being limited to financing of working capital needs of commerce, industry and trade. Moreover, banks did not want to tie up their short-term resources in extending long-term housing loans.

The main objective of this essay is to assess the role of banks in housing finance with special reference to Pakistan. The essay is organized as follows. Section 2 discusses the economic rationale of housing finance and its impact on the economy. The housing finance system and the role of commercial banks and non-bank financial institutions in housing finance in Pakistan are discussed in sections 3 & 4 respectively. Section 5 discusses the constraints on housing finance and the need for a dynamic housing finance system. Concluding remarks are given in the final section.

2. Housing Finance and Its Impact on the Economy

There is no dispute that the development of a sustainable housing finance system is of critical importance for economic revival and growth. The economists and the policy makers have realized that the financing of housing plays a major role in the efficiency and stability of the whole economy and financial system (Sheng, 2003). House ownership is a cornerstone of social stability. The importance of housing in the macroeconomy can be illustrated by a few key world statistics. The world investment in housing accounts for 15-35% of aggregate investment or 3 to 9% of GDP annually. Personal residence accounts for 75-90% of household wealth, which is 3 to 6 times their annual income. Residential construction is a major employer often accounting for more than 5% of total employment, while real estate services (including housing finance) constitute 4% of labour force. Housing is an important economic sector with linkages to the real and financial parts of the economy. On average, households typically spend between 15% to 40% of their income on housing services. In USA over 60% of the household wealth is held in the form of housing and mortgages (Sheng,2003; Lamoreaux, 2001; Renaud, 2001). The development and expansion of housing finance would provide opportunities for broadening of the capital market. Due to its low import contents, housing construction is regarded as an important domestic engine of economic growth. In most developing countries construction of low-income housing is labour intensive and housing construction in general has a high multiplier (with a value of' two or three); the latter reflects the large infrastructural investment (i.e. roads, electricity, sewerage and water) that may be generated with supporting housing policies (Erbas and Nothaft, 2002). In all countries, the employment of one worker in the construction sector, including housing, will generate about two additional jobs in other sectors. Investment and employment provide a broad stimulus to the economy. Buckley (1996) argues that an organized housing sector is likely to have a favourable impact on saving mobilization for a number of reasons: (i) return to housing is likely to reward saving by ensuring positive return, and such returns will probably remain high due to rapid urbanization (because of rapid population, housing markets have a large potential growth which could be tapped only with the development of mortgage markets); (ii) housing provides the best and more secure collateral against market fluctuations and other borrowings, and yields a positive rate of return in the long run; (iii) housing prices are less volatile than prices of other assets; (iv) availability of housing increases labour mobility, hence employment potential; and, (v) general subsidies could be better targeted through housing and mortgage markets. The backward and forward linkages of housing finance are examined in Appendix 1 (Chart. 1).

In all developing countries the share of housing investment financed through formal financial intermediaries is very small, and housing finance accounts for only a small fraction of financial assets (Buckley, 1994). The main reason is that, in these countries a home mortgage market is either non-existent or fails to serve the vast majority of home buyers. For example, the ratio of net new mortgage lending from the formal financial sector to the level of housing investment in a number of developed and developing countries indicates that in developing countries a much greater share of housing investments comes from internally generated funds. The average ratio of mortgage credit supplied by the formal sector to housing investment was less than 16% in developing countries (e.g. 10% in India, 8% in Turkey, 15% in Morocco, 11% in Pakistan, Kenya and Tunisia). By contrast, this ratio is about 126% in USA, 50% in Malaysia, 150% in Hong Kong and 85% for OECD (Buckley, 1994; LI, 2001).

International experience suggests that a wide-spread availability of house mortgages has a favourable impact on the quality of housing, infrastructure, urbanization, improving living standards and alleviating poverty. Furthermore, wide-spread availability of house mortgages may enhance savings, promote financial market development, stimulate investment in the housing sector, and upgrade the existing properties. At the same time, housing investment in most LDCs is labour intensive. Consequently, home mortgage availability for lower income groups can also potentially enhance employment through expansion of housing construction and related services, such as real estate brokerage and insurance (Erbas and Nothaft, 2002).

3. Housing Finance System: The Case of Pakistan

After 50 years of existence, Pakistan continues to face the problem of shortage of housing units. The cumulative shortfall in supply of housing equals 7.0 million units according to current estimates and is expected to reach the 10 million figure by the year 2020. This alarming situation basically stems from a widening gap between the demand for housing and the ability of the formal housing finance market to meet this demand. The formal market has so far met only 20% of the needs of the national housing finance market; the informal sector takes care of the rest.

While the growth rate in dwellings continues to be relatively lower in the rural areas, it has been showing an increasing trend in the urban areas thereby indicating greater tendencies of urbanization. The increased influx of population from the rural to urban areas led to the urbanized settlement due to which there has been a tremendous pressure on the existing infrastructure and services. The informal sector has taken over the task of providing for the housing needs of these migrants, the vast majority of whom are housed in slum dwellings or shantytowns called kutchi abadies. A comparison of the household pattern in Pakistan from 1980-98 (given in table. 1) shows that out of total houses, nearly 15.6 million were owned, 1.7 million rented and 2.0 million rent-free. The percentage of owned housing units was higher in the rural areas as compared to the urban areas. However, the percentage of rented houses was significantly higher at 23.3% in the urban as compared to only 2.3% in the rural areas. According to the World Bank, the household size is 6.6 persons and the occupancy per room is 3.3 persons. The total number of housing units increased by about 57% over the 18-year period. From 1981 to 1998, the number of house-owners as a percentage of the total units went up by 8.62%. The total number of housing units required in the country was about 24.3 million by the end of June, 2002, based on the 146 million populations. The housing backlog according to the current estimates is about 5.38 to 6.0 million units. In order to make up for the backlog and to meet the shortfall in the next 20 years, an estimated 570,000 units would have to be built every year from the present

300,000. It is not possible for the government to achieve this target because of its ballooning budget deficit and debt servicing. Hence private sector housing finance companies, commercial banks and other financiers will have to play a major role in meeting this shortfall. The floor area of urban and rural houses (table 2) indicates that urban dwellings are larger on average than village dwellings. However, for the large number of city dwellers living in semi-pucca or kutcha houses, the covered area is smaller than that in the villages.

To reduce the gap between the demand for and supply of housing, the government has always stressed the provision of houses to the lower and lower-middle income groups. However, the public sector housing finance company, HBFC, has not had a very encouraging record in this respect, because almost 77% of HBFC's housing loans have gone to influential people in the upper or upper-middle income groups, and only 23% have gone to the lower and lower-middle income groups.

3.1 National Housing Policy

In 2001 the government formulated the new National Housing Policy in order to encourage and develop a market-based housing system. The main objectives of the NHP include (i) to accelerate housing activity and contribute towards employment generation and economic development; (ii) to facilitate the provision of housing inputs including land, finance, building materials, institutional and legal framework; (iii) to analyze the poverty and force generating ever increasing slums and katchi abadies, including the political, the socio-economic, the bureaucratic and the environmental forces; (iv) to promote ways and means for housing development by enhancing the affordability, the saving capacity, the human tendencies and the potentials; (v) to provide the safeguards against the malpractice, the bureaucratic inefficiencies, the institutional weaknesses and the mafia assaults; and (vi) to develop the indigenous and cost-effective approaches particularly for the low-income groups. According to the approved NHP, the government was to pursue policy and procedures that place housing finance into a market-oriented framework. This would help to create enabling environment for the development of specialized institution for housing finance and motivating commercial banks in playing their active roles. Though an effective housing policy was formulated but its implementation could not be seen so far.

4. Role of Banks in Housing Finance

Throughout the world, financial institutions such as banks and NBFIs have been playing a leading role in the provision of shelter credit. The evidence show that banks account for 29% of housing finance market in Europe and 22% in USA. In these countries the share of mortgage companies is large (e.g. 20% in Europe and 55% in USA) due to their strong links with capital market. In addition, the institutional role is vital in developing sound, healthy and self-sustaining housing finance system.

4.1 The Commercial Banks

Pakistan has a backlog of 5.38 to 6.0 million housing units, which offers big opportunities to the HBFC, the banks and other financiers. Moreover, the total housing demand is close to Rs. 68 billion if commercial banks designed products for construction of at least half a million housing units every year in the country. Furthermore, if a single housing unit's average cost is close to Rs. 500,000 and 50% is the self-financing ratio, the total housing finance demand is close to Rs. 68 billion per annum as against present annual provision of Rs. 3 to 4 billion (Aftab, 2003).

In Pakistan, there is still no organized housing finance system. The vacuum in the institutional finance for housing and other construction activities was felt due to inadequate flow of funds for such activities from existing institutions and the absence of specialized credit institutions to provide funds for the purpose. The need to have a specialized system stemmed from the fact that the housing sector was not only inadequately served in terms of finance for individual loans but also in terms of buildable or serviced land, building materials, effective low-cost technology and other related know-hows. Hence there is a need to establish a specialized housing bank with the responsibility of providing housing loans and developing a healthy and self-sustaining housing finance system in the country. In addition, the commercial banking sector had no pressing priority to do housing finance on any significant level. As a result, the sector has been grossly capital-deficient and the housing shortage in the country has grown alarmingly. The commercial banks are the largest mobilizer of savings and have played pioneering role in providing housing finance and encouraging saving in the country.

However, in the past, housing finance was never taken seriously by the commercial banks which were engaged in traditional and typical core banking activities such as loans and advances against exports, imports and working capital on short-term basis. At present the commercial banks are required to earmark a minimum of 5% of their total advances for extending to the housing sector. But they lack interest in residential mortgage finance due to:

* Attractive returns on risk-free government bonds;
* Better-quality collateral on government bonds;
* Small size of housing finance, which cost more in terms of time and effort to process and administer;
* Do not want to tie-up their short-term resources in extending long-term housing finance;
* Property documentation is complicated and cumbersome;
* Recovery laws are not effective and efficient;
* Legal bottlenecks in foreclosure and high cost of registration of property transaction.

Recently, some banks have opened housing finance windows but their scale of lending is still small. For example the ABN-AMRO and the Citibank initially offered housing finance to their clients and then extended to the employees of selected multinational organizations. They offered a floating mark-up rate of 15-16 %. The MCB launched its housing finance in April 2001 as a consumer-banking product in Karachi only. FWB also introduced house improvement loan for women in April 2001. The other sources of housing finance include the loans against provident fund for construction and purchase of house. Banks and some organizations extend housing loan to their employees at low rates ranging from 3-10%. On a limited scale, micro credit for housing has been extended by two local banks namely, MCB and the FWB to very low income groups in the rural areas of Karachi, Hyderabad and Larkana. The MCB extended loans upto Rs. 50,000 and FWB upto Rs. 35,000 to individuals only for improvement of their existing housing unit at a mark-up rate of 16% for 5-year term. The FWB so far has disbursed over 500 loans with a remarkable recovery rate of 98%. But the main problem in extending credit for housing is the availability of land title documents, unsatisfactory collateral, high mark-up rate and insufficient delivery system.

The mortgage loan as a percentage of bank loans, assets and GDP from 1994 to 2002 (Table.3) indicate that the ratios of mortgage financing to GDP, and to total commercial bank assets are extremely low considering the high demand for housing in the country. Banks advance very small amount against real estate in Pakistan. In the past, the banks lent Rs. 251 million on security of real estate out of a total lending of Rs. 6,286 million. Hence we can say that currently the role of commercial banks in financing housing investment is " at best marginal".

4.2 The Housing Finance Companies (HFCs)

The business of housing finance in Pakistan has been assigned to specialized HFCs. Before the emergence of new HFCs, HBFC enjoyed monopoly in housing finance, as commercial banks were not allowed to enter into these activities. The share of HBFC is over 95% in overall assets of HFCs. HBFC was established in 1952 to cater to the needs of housing finance sector. In 1990s, three new private sector HFCs were set up. CHFC began its operations in the early 1990s but later operations were suspended. A housing finance company was also established by the LTV Group of Companies in 1993-94, but has since closed. The reasons for the failure of CHFC and LTV-HFC include the lack of capital with the sponsors, difficulties in resource mobilization, absence of a secondary market, high defective land titling and transfer costs, legal problems in recovery of loans and the lack of government support for the sector. HBFC was incorporated in 1990 as a public limited company and its statutory monitoring authorities are the CLA and SBP.

Today there are practically only two specialized HFIs operating in the country, one each in the public sector (i.e. HBFC) and private sector (i.e. IHFC). HBFC is the lone and largest public sector housing finance company in Pakistan with cumulative loan totaling Rs. 29.6 billion so far. HBFC's operations used to be financed by the SBP. However, since 1994, it has had to rely on its own loans recoveries to finance additional lending. With excessively high default ratio of 25-30%, IHFC, the private housing finance company, has so far issued loans worth Rs. 396 million at an average mark-up rate of 22% per year. The quality of IHFC's loan portfolio, with a default ratio of just 1%, is much better than that of HBFC, making IHFC a very suitable candidate for any securitization issue, if the legal and regulatory environment for asset securitization exists.

4.2.1 Primary Market Lender

At present, both the primary and secondary markets are weak and lack sufficient depth relative to the needs and the potentials of housing finance. The housing loan market is the primary market. The secondary market is the capital market where housing finance securities are floated and traded both for the investment in housing projects and fund raising by the financial institutions engaged in retail mortgage lending.

Presently HBFC and IHFC are operating as primary market lenders in the formal housing finance market. The share of IHFC in outstanding loan portfolio of' private sector housing finance companies is about 45%. However, it accounts for only 1.5% of the total formal sector lending—still very small as compared with HBFC'S share of over 95%. Together, HBFC and IHFC have a mere 20% of the housing finance market. The informal sector supplies the remaining 80% of financing to the housing sector. Personal savings and remittances from abroad account for over 73% of total housing finance. Lower income groups obtain around 80% of their financing from savings, liquid assets and loans from relatives and friends.

4.2.2 Funding Sources of Primary Market

HBFC received funds from SBP until 1979. After 1979 the funding arrangements became a profit/loss sharing agreement between HBFC and SBP in accordance with the mode of Islamic finances. Funding from SBP started dwindling in 1990-91, and was completely closed down at the end of fiscal year 1994. Henceforth, HBFC derives its funding solely from a revolving fund replenished with the loan repayments of borrowers.

On the other hand, IHFC has derived its funds in the form of equity and debt capital predominantly from sponsors. The company has subscribed and paid-up capital of Rs. 125 million. In addition, it has received 7-year foreign currency loans from International Finance Corporation (¥690 million) and the Commonwealth Development Corporation (£2 million). IHFC rose about Rs. 6 million from COI issue in May 1998.

HFIS have five main funding sources

(i) Equity Capital.

(ii) Debt Capital: HFCs usually borrow at commercial lending rates of up to 17-18% per year which they cannot pass on to most borrowers, as mortgage loans appear to dry up at a mark-up of around 17-18 % per year. HFCs can also issue TFCs, but the yields on these instruments are likely to be even higher than their borrowing rate. The issuance of 30 day to 10 year COIs cannot be a primary funding source for HFCs because of the resulting asset-liability mismatch.

(iii) Repayment by Borrowers: This happens to be HBFC's sole funding source at the moment.

(iv) Local Currency Saving Accounts: In addition to equity and debt capital, HFCs are also allowed to accept local currency saving accounts. However, depositor's mistrust of private sector saving-cum-investment companies has made it impossible for HFCs to raise funds in this manner.

(v) Housing Refinance Facility: To meet liquidity requirements of HFCs and establish secondary mortgage market, USAID, in December 1994, granted a 15 million dollar housing guarantee loans to the SBP, which later opened a HRW for companies. But the refinancing facility has still never been used, because of' high interest rate that would have to be paid to the SBP. Although the funds have been provided to the GOP on mark-up of 7.75% per year, the proposed cost of these funds to HFCs is 19.63% per year (as in April, 1997). This total cost is broken up as Shown in Table 4.

Later on, the cost of funding under this facility rose even further to 22% per year. Borrowing funds at this rate would make the cost unaffordable to end-users and is, therefore, not feasible for HFCs.

Over the years, the HBFC played vital role in the construction of housing. Since its inception in 1952, HBFC has provided over Rs. 29.6 billions financing for the purchase or construction of' over 450,000 housing units throughout the country. The total loans amount includes loans for the reconstruction of over 310,000 units in the flood-affected areas of Punjab and Sindh. In addition, it has lent around Rs. 1.8 billion to 28 Development Authorities including Pakistan Steel and the Lahore and Karachi Development Authorities as well as public and private sector organizations for the development of sites and construction of houses. On the other hand IHFC had lent a total of Rs. 396 million by the end of fiscal year 1998.

Loans for house building are generally long term—nine years for IHFC loans and 20-21 years for HBFC loans. HBFC loans are offered at a mark-up of 12.50-19.00% per year depending on the amount borrowed and the credit-worthiness of the borrower. The rates dropped by about 1% per year from 1997 in line with the government's policy to encourage housing construction. More than 85% of HBFC's loans have been made at a mark-up of 18.45% per year or below. HBFC and IHFC lending rates differ by 3.55% per year on average. The cost of funding and lending rates of HBFC and IHFC (Table 5) indicates that the mark-up is fixed in the case of IHFC but variable in the case of HBFC while the average size, maturity and types of mortgage loans along with their maximum amounts (Table 6) implies that HBFC never writes off any loans as bad debts. Hence the company faces high default ratio. IHFC owes low default ratio than HBFC.

4.3 Measures taken by the GOP and SBP

During the last three years, a host of measures were undertaken to attract and facilitate the housing investment. These include:

* Commercial banks were allowed to float long-term bonds to mobilize funds for housing loans to match assets with liabilities.
* The upper limit for mortgage financing was raised ten times to Rs. 5 million for the maximum period of 15 years.
* HBFC has been authorized to undertake activities of raising funds.
* The banks have been allowed to have an exposure under housing finance to the extent of 5% of their net advances.

* Measures taken to promote HFIs to encourage savings and provide credit from community based finance and other sources.

* The annual disbursement of HBFC loans increased from the existing Rs. 1.2 billion to Rs. 7 billion over the next five years.

* Housing finance facility would attract a minimum debt equity ratio of 70:30.

* Foreclosure laws have been revised so that the banks can repossess the mortgaged property without recourse to the courts.

* Deduction of mortgage interest from taxable income was raised to Rs. 100,000 for commercial banks and HFCs in the public sector.

* SPVs have been allowed to develop pools of asset-backed securities, which can be traded in the market and off-loaded from the balance sheets of the originating banks.

The response of these measures has been muted so far because of the myth of high risk in housing sector and attractive profitability of other sectors, particularly trading. Despite these policy measures, disbursement by HFCs declined from Rs. 858.7 million in 2001 to Rs. 460.2 million in 2002. The business of housing finance has been assigned to specialized HFCs. But the reliance on HFCs has not yet given desired results because of various limitations and constraints.

4.4 Constraints on Housing Finance

There are many constraints and difficulties in expanding housing finance. Hence, it should be possible to identify a set of constraints which need to be resolved.

i) *Absence of a clear legal title to land and property*

This has been a major obstacle to the development of a vibrant housing finance system in Pakistan. Some of these obstacles are the complex legal framework, lack of clarity of title deed and problems in registration, enforcement of contracts, difficulties in eviction of tenants at the expiry of leasing period and frozen rent control laws and prolonged litigation in the court of law. Another impediment is the very high registration charges imposed on transfer of land. If these charges could be lowered significantly, the affordability level could be increased and many people will come forward to construct houses.

ii) *High taxation of property etc.*

High taxation of property transactions, stamp duties and collateral, wealth tax liabilities are other impediments. These are estimated to be around 10% of the value of transaction and are real deterrent for developing a well functioning housing finance system. This high cost is further compounded by corruption, delays and other obstacles that push the buyers and sellers into resorting to misuse of power of attorney and benami transactions. The provincial and local governments will earn higher revenue yield if they make the taxation, assessment, registration, recording and retrieval system customer friendly.

iii) *Inadequate sites and services*

The provision of requisite sites and services is not only inadequate but the attitude of utility companies like WAPDA, PTCL, SNGPL, SSGLLS, KESC etc. is a hindrance in new housing development. There are cost overruns because the basic services such as telephone lines, water, electricity, sewerage and gas etc. are not provided in time. It is in the business interest of these companies that they should expand their customer base and income by reaching out to these new housing schemes. On the contrary, collusion, nepotism and under-hand dealings by some unscrupulous elements have marred the orderly growth of these housing schemes. Keeping in view these realities, there is an urgent need for these utility companies to re-examine their strategy and thus maximize their revenue streams.

iv) *Constraints on institutional investors*

The institutional investors such as pension, provident and insurance funds have not actively explored real estate development and housing markets as an investment vehicle. These funds presently are not allowed to operate in the equities market. The institutional investors should invest in real estate related equities, long term lending and MBSs. It is necessary to develop legal, procedural and institutional framework for the flow of these funds in the capital market. In addition, insurance funds not only play an important role in the development of housing finance system worldwide but these funds have also been invested in the securitization of mortgages and found profitable to set up their housing finance subsidiaries. Insurance companies have played a crucial role in providing attractive packages for deposit insurance, life insurance of borrowers and insurance of mortgage payment, which have facilitated the emergence of secondary mortgage market.

v) Non-access of the poor to institutional finance and other related issues

Poorer people in the country do not have access to institutional finance. It is, therefore, necessary to find out ways in which these people can be brought to the fold of the institutional finance. Although Pakistan has (to some extent) mature primary market, but the efforts of all HFIs and banks including the foreign banks, tend to be focused around the formal sector i.e. on the employee class. To some extent, housing loans are also being accessed by professionals such as lawyers and doctors but, by and large, the informal sector has not even been conceptualized as a target market for housing. Some major institutional and operational problems have also emerged. Some of these relate to interest rate, security for loans, selection of borrowers and credit appraisal, loan processing fee, use of funds and the organizational problems and the SHGs level like the capacity to manage long term loans. These problems should be addressed to find out a meaningful solution before the same could be replicated in the country.

vi) *Time consuming foreclosure mechanism*

Existing foreclosure mechanism is also cumbersome and time consuming. In order to protect the lenders' interests, the existing foreclosure laws should he revised to ensure the effective recovery of loans and advances from the defaulters.

vii) *Non-integration of HFCs with banks*

There is no integration of HFCs with the banking sector. In India there is a close cooperation between the IL&FS and HDFC and among the NHB and IL&FS in promoting real estate mutual fund. Malaysia provides good example of a developed secondary market and close cooperation of borrowers, lenders (financial institutions) and government agencies.

4.5 Dynamic Housing Finance System

For the promotion of housing finance sector there is a need for developing a dynamic housing finance system in the country. It is believed that such a system must be able to increase the level of household savings. HFIs now serve only a limited number of households at a high cost and are unable to mobilize domestic savings.

A host of suggestions have been made to impart dynamism to the housing finance sector. These include tapping the capital market by securitizing housing loans, strengthening and promoting contractual saving schemes, expanding the fiscal incentive base and leveling the playing field between HFIs and other financial institutions. Through these initiatives, the HFIs could take advantage of the country's vibrant capital market and create conditions conducive to the development of the secondary mortgage market. Once the secondary mortgage market emerges, there would be no need for HFIs to depend on budgetary allocations and the allocated credit system.

Several factors have, however, stalled the development of a dynamic housing finance system in the country. These include the following among others:

* HFIs form the core of the housing finance system in the country. They have not tapped either the retail market or the capital, market in a big way to augment and strengthen their resource base. Formal financial intermediaries continue to finance a very small share of the housing investment.

* HFIs have been poorly motivated to seek capital market resources so far, given the high levels of allocated credit.

* There is no innovative financing mechanism to link formal and informal sources of financing. On the ground of low repayment capacity, increased frequency of late payments and default,

difficulties in establishing clear title and lack of a credit bureau, inadequate foreclosure laws, very little attempt has been made to improve access to housing finance for low-income households.

* Housing supply is heavily distorted by onerous legislation and time-consuming procedures. Local authorities impose their own municipal and development rules. Urban land policies restrict the supply of available land for housing and rent control legislation protects existing tenants at the expense of future potential tenants, effectively crippling the rental market.

In this context, the need to develop a dynamic housing finance system must be considered. At present the potential for housing finance is close to Rs. 80-100 billion per annum. If other related investments such as land development and essential offsite infrastructure were taken into account, the financial requirements would be even larger overall.

Meeting financial needs of such a large scale, the financial system will increasingly operate without any form of preferential or dedicated credit and without any interference with the interest-rate structure. HFIs must compete for resources with other equally demanding sectors. To be viable in this environment, HFIs will need strong marketing and other devices to tap domestic savings and the vibrant capital market.

The liberalization of the financial markets has required not only the housing finance system to evolve and adjust but also create an enabling environment for the development of capital markets. To stabilize the financial system and to provide basis for functioning and improvement of capital markets, to assist the development of housing finance industry and to meet its liquidity requirements, the following action programme needs immediate consideration:

1. Developing mortgage market

The home mortgage finance facilities are broadly inadequate and virtually nonexistent for low-and middle-income groups in Pakistan. For example, the outstanding mortgage loans as a percentage of GDP is about 4%. By contrast, the outstanding mortgage loans as a percentage of GDP is about 90% in USA, 58%

in the UK, 30% in EU on average and 25% in Malaysia. Moreover, the ratio of mortgage loans to investment in housing sector is about 11 % in Pakistan. This ratio is about 131% in the USA, 150% in Hong Kong, 85% in OECD countries on average (excluding USA and Turkey) and 74 % in Malaysia (Li, 2001, Buckley, 1994). The mortgage credit in Pakistan is around only Rs. 8 billion per annum at a mortgage rate of around 12%. Due to high cost of funds HFCs are unable to meet the total demand because of prevalent high mortgage rate of around 20% which is practically unaffordable by the low and middle-income groups. Present level of mortgage rate is a major deterring factor, which restricts the growth of home ownership.

Developing mortgage markets and, particularly, extending affordable mortgage facilities through market-based incentives can be expected to have a positive impact on the housing construction without creating any market distortions. Enabling access to affordable mortgage financing by low-and-middle-income groups will have a sustained, favourable impact on growth and employment in the long run.

In Pakistan the housing shortage is so massive and individuals cannot afford to buy a house with their savings. Institutions that engage building activities by providing funds for the purchase of houses must, therefore, be created and strengthened. The availability of loan should be made affordable. To this end there should be a SMM where individuals with surplus investable funds can buy the mortgages of HFIs. Banks, mutual funds and corporate sector could be initial targets for the MBSs. With some changes in the pattern of prescribed investments, insurance companies, EOBI, FBF and provident funds could also be included. In the long run, however, MBSs must be targeted at retail investors. HFIs can convert their primary assets and mortgages into liquid assets to raise funds that they can invest in new mortgage assets. The ability to convert the assets into liquid funds depends on the appetite for fixed-income securities in the market. A strategy for developing and promoting such a market somewhat on the lines of SEC of the USA may be required which may work as an apex institution for regulating the securities markets. In this context the government should establish a MRA that help to develop housing sector in the country. This agency, on the lines of the American Famine Mae, may take the responsibility to issue MBSs for providing liquidity to the primary market and attracting funds from the capital market for the housing sector. Money managers, thrift institutions, commercial banks, trust departments, insurance companies, pension funds, securities dealers, other major corporations and private investors are all players in this market.

2. Need for assets securitization

The major issue in the development of housing finance sector in Pakistan is the availability of long-term resources for the sector. One such source is mortgage securitization which has still not been done in the country. Hence, there is a need to make sustained efforts to launch a polite issue of MBSs by pooling the mortgage loans originated by HFCs. However, in the absence of a conducive legal and regulatory framework, there are certain constraints to design the transaction within the existing legal issues, taxation matters and regulatory framework, leaving scope for certain amount of imperfection.

The mortgage debt in Pakistan is regarded as immovable property, its transfer can be affected by means of an instrument in writing, which requires payment of stamp duty for the instrument to be valid. The mortgage debt can be transferred only by a registered instrument. As securitization envisages pooling of mortgages originated by HFIs, the requirement of registration not only makes the transaction unviable from cost consideration but also impractical. In addition, there are problems in the area of foreclosure of mortgages. In order to tackle the problem of registration, there is need to constitute a "Trust" only in the debt component of the mortgage debt and hold the underlying securities with the originator (or the issuer) with adequate legal safeguards. Hence the government should realize the importance of mortgage securitization and reduce the stamp duty on such instruments. Securitization is a very recent phenomenon. Pakistan's income and other tax laws are not supportive to such transactions. The interpretation of these statutes in their present form makes the transfer liable to taxation if the transfer is without the transfer of legal interest or the underlying asset. These and other related issues are being sorted out with the tax authorities.

There are no prudential norms in Pakistan on transactions involving mortgage securitization. In the absence of such norms, investor acceptability for such products may be limited and may hamper development of secondary markets for such products. These are being addressed too.

3. Developing a secondary market

MBSs can be a viable funding option for HFCs in Pakistan, provided the government and the regulatory authorities create an enabling environment and facilitate the creation of a secondary mortgage refinancing entity to act as a bridge between primary market originators and the capital market. But the present laws and regulations do not encourage asset securitization. Besides broadening the resource base of HFIs, there are several benefits to be gained from securitizing housing loans and developing a secondary market. Securitization will release reserves to enable the HFIs selling loans to meet their capital adequacy requirements. It will reduce the liquidity risk of issuers arising out of a maturity mismatch between their short-term liabilities and long-term loan assets (housing loans)-an area of concern in Pakistan. Securitization will open up the mortgage market to lenders with relatively little capital and also help to increase the amount of funds available for housing loans; allow risk exposure to be shared by much broader range of capital market participants, and thus reduce the cost of' funding to HFIs. In the long run securitization will help standardize loan documents as well as the credit and legal appraisal procedures of HFIs, and facilitate the integration of housing finance with the overall capital market. The existence of a specialized secondary entity will encourage new mortgage originators to enter the housing finance market.

4. Broadening the HFI resource base

The housing sector in Pakistan is vastly undercapitalized. The formal sector accounts for only about 20% of the total housing investment in the sector. In addition, the combined lending to housing sector, (maximum Rs. 2 billion per annum) is less than 1 % of total formal lending. The availability of funds for housing is far outstripped by the demand for housing. As a result, the housing demand has grown at an alarming rate. The formal housing loans largely dependent on HFIs. These HFIs compete with the banks for limited resources in the system. Resource mobilization has consequently become a key issue for market-oriented HFIs.

The resource base of HFIs must be substantially enhanced in a way that they must be able to tap the capital market to expand their mortgage operations. The favourable economic conditions led to the development of capital market and also determine the developments in the financial system of which housing finance is a part.

5. Reducing the cost of funding

The loan originators should be able to mobilize funds at a low cost and reduce lending rate to make housing loans more affordable for house-buyers. This can be achieved through specialization in a particular securitization activity and diversification of risk. Specialization helps to promote efficiency through reduction in transaction cost. It involves various specialists such as administrators, credit enhancers, issuers, and pool issuers. As funds for housing finance come from a broader range of lenders, interest rate on mortgage loans will tend to decline, making the loans cheaper in the long run. Securitization will help HFIs to grant mortgages of longer maturity and to introduce alternative mortgage instruments based on higher LTV ratio, and also make it possible to transfer risks between sectors in order to minimize the cost of risks. In this manner, risks associated with housing finance will be distributed among a greater number of market players as securitization and a secondary market develop.

6. Integration of housing finance with the overall capital markets

Capital from the broader financial system will flow more easily into the housing sector when housing finance is integrated with overall capital markets. The flow will depend on the volume of primary market operations, competitiveness of the investment instruments and the overall return on capital available in the mortgage business. The interest differential between the mortgage market and the capital market will affect the design of mortgage instruments as well as secondary market instruments.

Integration will promote growth through wholesale markets, which will allow economies of scale to operate. As secondary market grows, mortgage lenders will bring a large number of small depositors and raise large trenches of funds in the capital market by selling the pool of loans in their portfolio. This develops the link between housing finance system more closely with the overall economic environment and the macro financial system. It will significantly reduce the cost of funds of HFIs, and lead to the rapid conversion of a largely independent self-financing housing finance system and increase their funds in the domestic and global capital markets. To this end, it is necessary to integrate the housing market with overall capital markets like those in India, Malaysia etc.

7. Need for the establishment of national housing bank (NHB)

There is a need to set up the NHB with the primary responsibility of providing housing loans so that people can own their homes and function as the apex institution in the housing sector. The objectives of such banks should be:

* To promote a sound, healthy, viable and cost-effective housing finance system to cater to all segments of the population.
* To promote savings for housing and make housing more affordable.
* To augment the supply of land and building material for housing.
* To enable public agencies to emerge, primarily as facilitators and suppliers of serviced land.
* To upgrade the housing stock in the country.
* To strengthen the backward and forward linkages of the housing sector with rest of the economy, and to encourage the flow of financial resources for the sector.
* To enable the housing finance system to access the capital market for resources.

6. Conclusions

In this essay an attempt has been made to analyze the role of banks in housing finance in Pakistan. The evidence shows that presently Pakistan is facing a housing backlog of 5.38 to 6.0 million units. This big demand for housing calls for an active role of banks, HFCs and other financiers. The total housing finance demand is close to Rs. 68 billion per annum against present annual provision of Rs. 3 to Rs. 4 billion. The government and SBP have announced various measures, but unfortunately these measures have never produced any significant results. Despite the importance of the housing sector, commercial banks have traditionally shunned mortgage lending because of liquidity, interest rate and default risks. Recently, some domestic and foreign banks advance credit for housing sector but their scale of operation is still small. In addition, the formal sector contributes only 20% of all housing credit, while the informal sector is responsible for financing 80% of credit for housing. The survey of literature shows that mortgage credit as a percentage of GDP, bank assets and bank loans is declining persistently since 1994 because of reduced subsidies to HBFC. In Pakistan HFCs (HBFC and IHFC) are advancing loans for the construction but HBFC has been facing high default ratio of 25-30%. Furthermore, in the absence of organized housing finance system, clear regulatory and legal framework, specialized housing finance bank, high price of housing, high level of taxation and stamp duties, no access to liquidity of HFIs, unaffordability of the low income groups, no private sector housing finance institutions, lack of secondary mortgage markets etc. this sector still remains backward.

Based on the above facts, it is suggested that the authorities should use market oriented housing policies through developing mortgage finance markets and opening up the existing mortgage finance institutions to market competition. Moreover, the authorities must shift the emphasis from public sector housing to market based financial intermediaries and saving mobilization. In addition, improvements in land tenure and property rights legislation, removal of restrictions on mortgage lending and housing construction, mandatory requirements to increase mortgage lending by commercial banks, improving transparency of public sector mortgage lending institutions, mortgage repayment indexation and improvements in recovery of loans, are the major issues and should be addressed in order to make housing sector more viable and efficient. The availability of land is crucial for the development of housing sector. A major constraint has been the availability of land. Similarly the existing foreclosure mechanism is cumbersome and time consuming. For the development of a sustained and dynamic housing finance systems all these and related issues should be considered.

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ACRONYMS

CLA	Corporate Law Authority
COI	Certificate of Investment
CHFC	Citibank Housing Finance Company
EU	European Union
FWB	First Women Bank
GDP	Gross Domestic Product
GOP	Government of Pakistan
HBFC	House Building Finance Corporation
HFCs	Housing Finance Companies
HFIs	Housing Finance Institutions
HDFC	Housing Development Finance Company
HRW	Housing Refinance Window
HH	Household
IHFC	International Housing Finance Company
IL&FS	Infrastructure Leasing and Finance Services
LTV	Loan -to-Value
LDCs	Less Developed Countries
MRA	Mortgage Refinance Agency
MBSs	Mortgage Backed Securities
NHB	National Housing Bank
NBFI	Non-bank Financial Intermediaries
NHP	National Housing Policy
NDFI	National Development Finance Institution
SBP	State Bank of Pakistan
SPV	Special Purpose Vehicle
SEC	Securities and Exchange Commission
SHG	Self Help Group
SMM	Secondary Mortgage Market
TFC	Term Finance Certificate
USA	United States of America
UK	United Kingdom

APPENDIX 1

Chart.1

Forward and Backward Linkage

* Land Reform/Usage * Title/Lien Registration * Taxation * Transfer of Ownership * Foreclosure/Bankruptcy * Subsidies/Incentives * Legal Framework (Real Estate, Banking, Trust, Securitization) * Corporate Governance * Supervision/Regulatory Oversight * Infrastructure (water, electricity, sewerage)	Housing	* Active Construction Industry * Primary Mortgage Lending * Secondary Markets * Securitization * Bond Market Development * Rehab/Improvement Loans * SME Lending * Technology * Peripheral Service (Credit Bureau, Title Insurance, Appraisal, Tax Services).

Table 1

Household Patterns, 1980-98

	1980			1989			1998		
	Urban	**Rural**	**Total**	**Urban**	**Rural**	**Total**	**Urban**	**Rural**	**Total**
No. of households (millions)	3.55	9.03	12.59	5.24	11.14	16.38	6.25	13.45	19.70
No. of household owners (millions)	2.41	7.40	9.87	4.14	10.15	14.29	—	—	15.6
Ratio of house owners to households (%)	67.70	82.60	78.38	79.00	91.10	87.00	32.3	67.7	—

Source: Population and housing census, 1998; http://www.Pakistan-economists.Com/database 1/cover/c2001-40.htm

Table 2

Floor Area of Urban and Rural houses

Domain	Average Dwelling Size (Square meters)	Average Room Size (Square meters)
Pakistan	37.98	15.30
– Urban	41.04	16.47
Pacca (brick houses)	45.00	18.09
Semi-pucca	31.68	12.69
Kutcha	29.07	11.70
– Rural	36.63	14.76
Pucca	41.49	16.74
Semi-pucca	36.00	14.49
Kutcha	34.83	14.04

Source: 21st Century Consultancy and Management Services (Pvt) Ltd; Draft Final Report of Study on Housing Finance, 1997

Table 3

Size of the Mortgage Loan Market, 1994-2002(%)

Year	Ratio of Mortgage Financing to Bank Loan	Ratio of Mortgage Financing to Assets	Ratio of Mortgage Financing to GDP
1994	6.30	1.59	1.45
1995	5.61	1.45	1.27
1996	5.31	1.33	1.17
1997	4.85	1.26	1.07
1998	4.27	1.08	1.08
1999	6.06	1.72	1.51
2000	5.49	1.66	1.40
2001	5.60	1.58	1.31
2002	5.80	1.32	-

Sources: SBP, Annual Report 1996-2002, HBFC, IHFC.

Table 4

Cost of Funds under USAID

Mark-up rate	7.75% p.a.
SBP Service Charges	1.50% p.a.
Foreign Exchange Cover	10.38% p.a.
Total	19.63% p.a.

Table 5

Funding Cost and Yearly Lending Rates of Primary Market Lenders

Institutions	Mark-up		
	Average	Maximum	Cost of Funds
HBFC	18.45%	19.00%	Variable (P/L Sharing)
IHFC	22.00%	24.00%	17.00-17.50%

Source: HBFC, IHFC.

Table 6

Mortgage Loan Characteristics

Institution	Average Loan	Maturity	Type	Max. Loan	Default Ratio
HBFC	Rs. 200,000	20-21 years	Variable rate	Rs. 1, 000,000	25-30%
IHFC	Rs. 800,000	9 Years	Fixed rate	Rs. 10, 000,000	1%

Source HBFC, IHFC

APPENDEX 2

Well-Functioning Housing Sector

For a well-functioning housing finance market World Bank (1993a) established the following criteria/ characteristics (Erbas, S Nuri and Northaftn, Frank E., 2002)

Housing Consumers

- Safe, adequate and separate housing is available for every HH; tenure and transfer of property are safe and protected by due process of law.
- Mortgage is an affordable portion of HH income; housing prices are stable; financing is available at different price ranges to enable the smoothing of housing expenditure over time and to permit HH to save and invest; financing is available to ensure efficient choice.
- Market option between owning vs. renting is available to HHs.
- Households are able to participate in policy decisions that affect housing and neighbourhoods

Housing Producers

- Housing contracts are enforceable; there are no barriers to entry and exit in the sector; government housing regulations, policies and projects are well defined, predictable, efficient and are implemented in a timely manner.
- Adequate supply of residential land is available at reasonable prices; such land has adequate infrastructure or the government is willing and able to undertake developing land by making basic investment in sewerage, roads, electricity, water and communications.
- Building materials, equipments, skilled labour is available at reasonable prices; trade regime does not discriminate against the housing sector imports.
- Adequate financing is available; there is sufficient information about the properties of housing demand; rate of return to housing investment are competitive and sufficient to maintain incentives for housing investment.

Housing Finance Institutions

- Property rights, tenure and foreclosure are well-defined and protected under due process of law to protect lenders
- These institutions operate in a competitive financial market vis other financial institutions and subsidized finance; the role of directed credit is minimized
- Deposits at an appropriate term structure for long-term mortgage

lending are available to enable lending at positive real interest rate with a sufficient profit margin.

- Mortgage lending instruments that are in demand by HH and that provide adequate protection for HFIs are permitted; secondary markets to spread lending risk and appropriate institutions exist to protect HFIs against undue mortgage risk.

Local Governments

- Housing and related infrastructure are of financing quality to maintain public health, safety standards and environmental quality; infrastructure can be extended to new developments in a timely fashion, and sufficient land for new development can be made available as housing demand grows; new developments are within reasonable proximity of existing main networks.
- Communities can participate effectively in housing programs and projects, and in policy decisions and maintaining infrastructure and amenities.

Central Governments

- Housing sector policies are incorporated into the national, social and economic priorities and plans, housing sector and financial markets are monitored
- Housing sector contribution to: -
- Alleviating poverty; targeted subsidies are available to assist HHs that cannot afford minimum housing;
- Generating HH savings and mobilizing HH resources;
- Generating employment and income growth;
- Enabling social and spatial mobility;
- Increasing productivity, investment growth and capital accumulation;
- Developing the financial system;
- Protecting the environment

Those contributions are supported by prudent monetary and fiscal policies.