Housing Finance in Pakistan:
<u>Progress, Prospects and Problems*</u>

I would like to express my sincere thanks to World Bank, IFC and their partner institutions for organizing this two day Workshop on Housing Finance and bringing together a host of domestic and international stakeholders under one roof for discussing operational level issues to streamline measures for the development and promotion of a market based housing finance system in Pakistan. I would particularly welcome the distinguished guests from overseas who have taken the trouble of coming to Pakistan to participate in this workshop.

Before dwelling on operational level issues important to augment mortgage finance, I would like to give an overview of the recent favorable developments at the market place and incremental approach followed at the policy level to reorganize fiscal and regulatory regimes relating to housing finance that are helping in creation of a better enabling environment for origination of housing loans by banks in the primary mortgage market.

There are a number of skeptics in the country who have expressed doubts about the emphasis being given to consumer financing in the country. Their mindsets are still frozen in the traditional way of public sector and government led growth model supplemented by a corporate and industrial sector. I would like to draw their kind attention to the basic economic law (identity) for generating national income in any economy-developing or developed- which stipulates that

GDP = Private Consumption + Private Investment + Public Consumption + Public Investment + Exports – Imports

In Pakistan private consumption is the largest single component of GDP, accounting for 80 percent of the total GDP. Thus it is obvious that any move to boost private consumption will have a much larger impact on the GDP growth than any other

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measure. Mortgage financing and auto financing as key elements of private consumption not only provide strong forward and backward linkages to industrial and services sectors with a multiplier effect of 3 to 4, but also enhances the overall level of private savings. How does this happen? In absence of owner-occupied housing the owner does not have any compulsion or incentive to make any forced saving out of the current disposable income. But in his quest to obtain mortgage financing he has to save at least 20 percent of the total cost upfront as down payment in form of equity. In addition, every month he has to allocate some extra income over and above monthly rental income to meet the mortgage installment. Thus, this action results in forced or compulsory saving and if aggregated across households with identical behavior leads to an increase in level of domestic savings in the country. It is an empirically known fact that countries with well established vehicles such as Mortgage Financing, Pension Funds, Benevolent and Provident Funds, Mutual Funds have higher domestic savings rate compared to those where such opportunities do not exist.

During the last three years, favorable developments at the market place are facilitating origination of housing loans in the primary mortgage market. On the supply side, banks are flushed with liquidity due to reduced borrowing from government, de-dollarisation of the economy and rising inflows of remittances. Consequently, interest rates have reached their lowest ebb and well-established corporate sector firms are able to obtain credit at very thin margins thus squeezing the profitability of the banking system. In this scenario banks are looking for alternate lending opportunities and developing asset-based consumer products. Housing finance provides an attractive opportunity as both profit margins and recovery rates on average are higher for mortgage finance than project and corporate lending. On the demand side, marketing efforts by banks are creating awareness amongst general public for early homeownership through housing finance. The low-level of interest rates and favorable tax treatment are acting as catalyst for encouraging early homeownership as mortgage payments are becoming affordable vis-à-vis monthly rentals. At the same time, billions of investment is locked-up in the existing stock of residential properties and investors are unlocking a part of their investments in real estate through leveraging and resultantly utilizing the unlocked cash for consumption and other investment purposes.

Second, at the policy level, lack of direction has been one of the major impediments in institution of a market based housing finance system. Therefore, in order to provide an institutional arrangement and direction to reform housing finance, a standing Advisory Group has been constituted at SBP to implement the recommendations of the Housing Finance Conference held in December 2002 and take up the practical problems faced in the course of implementation. The Advisory Group has been able to sequence the Reform Agenda required for the promotion and development of a sustainable market-based housing finance system in the country. As a first step, it has been successful in persuading the Government to provide fiscal incentives to housing sector in the Federal Budget 2003-04, in liberalizing credit regime for housing finance, broadening the scope of Credit Information Bureau at SBP, establishing Credit Information Bureau in the private sector for consumer loans, rationalizing stamp duties, registration fee and property taxes, and ascertaining enforcement of Recovery Procedure in case of default by mortgagors.

Third, the fiscal incentives announced in the Federal Budget 2003-04 are quite substantial. Tax credit on borrowing cost of housing loans from financial institutions has been enhanced to Rs. 500,000/- or 40% of the income of the mortgagor, the limit of property income for withholding tax has been raised to Rs.200,000/-, the rate of withholding tax on property income has been reduced to 5%, profit or interest on mortgage of property or other capital charge has been allowed to be deducted for the purpose of income tax, CED on wires and cables has been withdrawn and excise duty on cement has been reduced by 25% to lessen cost of construction. Moreover, banks have been allowed to deduct upto 3% of the income arising out of consumer loans for creation of a reserve to off-set bad debts in this segment.

Fourth, the credit regime for housing loans has been liberalized. Banks' exposure to housing finance has been enhanced to 10% of their net advances, the maximum per party limit has been increased to Rs. 7.5 million with debt equity of 80:20 for a period extended upto 20 years.

Fifth, the response of the banking system to these incentives and measures is encouraging as not only the number of active banks engaged in housing finance is increasing, but banks are also vigorously marketing their housing finance products.

This can be gauged from the fact that during the previous April-June quarter gross disbursements by banks for housing finance have increased by Rs. 600 million. However, I would like to point out that banks are selective in their approach and at present focusing on Outright Purchase and Renovation loans mainly to upper income groups for unlocking their equity investments in housing properties. This trend may continue for some time, but as banks develop expertise in origination, underwriting, appraising and monitoring housing loans then construction finance for middle-income groups would be the major focus of the banks. Presently, banks are funding their housing portfolio through Demand and Time Liabilities, thus running an asset-liability mismatch on their balance sheets by borrowing short and lending long. However, as the primary mortgage market gains momentum and acquire a critical mass then banks would be looking for alternate ways and means to fund their mortgage portfolios. In this regard, banks have already been allowed to float long term mortgage bonds to match their mortgage assets, besides special purpose vehicles have been allowed to develop pools of mortgage backed securities (MBS) which can be traded in the market and off-loaded from the balance sheets of the originating banks.

Let me now look at the future horizon and outline the responsibilities of different stakeholders, which I consider are critical for promoting mortgage financing in the next few years.

The Provincial Governments, district governments and local government authorities have a major role to play. Allocation of land for genuine and approved new housing schemes along with clean title deeds, developer financing, provisioning of infrastructure and individual mortgage financing have to become available in an integrated fashion. I must commend the Chief Minister and the Government of Punjab for developing a model scheme in Lahore following these parameters. This scheme, if successful, will then be replicated throughout other big towns of Punjab. I would urge the Boards of Revenue of the Provincial Governments to adopt a more progressive attitude towards the utilization of land and use it as an income enhancing and growth stimulating tool for the people of their provinces particularly the middle and lower classes rather than sit tightly on the state land or allow it to be taken up surreptitiously by land mafia for illegal encroachment.

The useful experience of Sindh Katchi Abadi Authority in promoting low-cost housing should be replicated in other parts of the province and the rest of the country. HBFC, Khushali Bank, First Microfinance Bank, First Women Bank, Punjab Provincial Cooperative Bank, Bank of Punjab and Bank of Khyber which are well positioned should examine the possibility of participation in financing of these schemes.

Once again the Government of Punjab deserves our gratitude for taking a lead in the computerization of land records in Lahore district. I hope this experiment can be applied to the rest of province. Let me assure you that the impact of this one major step will generate at least 1 to 2 percent addition of the growth rate of Punjab on a permanent basis as illiquid assets and wealth would be turned into productive assets.

High rates of duties and fees still remain a major impediment in property transactions and so far no provincial government has rationalized these on conveyance deeds, despite the covenants of National Housing Policy 2001 and recommendations of Advisory Group on Housing Finance to this end. Only rates of stamp duties and registration fee for mortgage deeds have been brought down in the province of Sindh and Punjab. Therefore, in order to expedite issues requiring implementation by provincial governments, the Advisory Group have evolved a strategy for creating awareness amongst officials of provincial governments by holding seminars on Housing Finance in four provincial capitals with an active participation of the relevant officials of the provincial/local governments and other local stakeholders. Four Focus Groups have already been formed to ascertain continuous follow-up and monitoring housing finance issues relating to rationalizing existing structure of property documentation, automation of revenue records, simplification and standardization of mortgage documents in the four provinces. Moreover, we would approach the Honorable Chief Justices of Supreme and High Courts and request them to issue instructions to law enforcement agencies, courts and registrars regarding the newly promulgated recovery laws and instituting training for speedy resolution of property disputes.

The next group of stakeholders is the housing developer industry. Most of the developers have not yet organized themselves in form of public limited companies or private limited companies with proper accounting and good governance practices. This has stifled their growth and even well respected developers have suffered because of the entry of some unscrupulous individuals and groups into their ranks. It is high time that the developers should allow themselves to be rated by independent credit agencies to assess their financial strength and operational capability. Credit rating will sift out genuine and honest companies and individuals from the 'fly-by-night' and corrupt and bestow an element of respectability to this line of business. Banks will be in a better position to provide credit to developers on the basis of these ratings and thus avoid high-risk exposure to the industry as they have suffered losses in the past.

Now, I turn to the banks, who have moved or have plans to move into this area of business. They should develop expertise in underwriting housing loans, i.e. analyzing information relating to credit risk and making a decision whether or not to accept that risk. The credit-appraisal process requires the gathering and analysis of information about both the applicant and the real estate that secures the loan. In this regard, banks should institute a due-diligence process that essentially comprises of finding out financial capability and future cash flow position, knowing the credit characteristics of the borrower, and ascertaining equity of the mortgagor by appraising value of real estate securing the mortgage. As a measure of providing better information to lending institutions to mitigate credit risk, the scope of CIB at SBP is being broadened to provide negative and positive information below Rs. 500,000. Subsequently, the possibility of inclusion of reputable international credit rating agencies would also be considered.

The State Bank of Pakistan will continue to play its role as a facilitator guide and catalyst. We believe that as a matter of priority provision of training to bank staff is of pivotal importance for creating understanding and developing expertise in originating and underwriting housing loans at the primary mortgage market. In this connection, we are in the process of envisaging an elaborate training programme in association with IBP and NIBAF, besides holding special training sessions for senior officers of banks with foreign experts of housing finance from Malaysia, India and other countries.

The next group of stakeholders I would like to address is the IFC and the World Bank, the organizers of this Workshop. I am glad that they are very keen to assist us in the takeoff of this initiative in a meaningful way. Their international experience of what works and what does not work will be of great help to us. But, instead of the traditional way of a Consultant coming to Pakistan for a short period of time, interviewing every one and preparing a report containing a generalized set of recommendations, we would like them to adopt an entirely different approach if that is possible. As you are all aware we have formed a standing Advisory Group on Housing Finance. The Group may seek specific inputs and advice on a number of issues confronting them from time to time. We would like the IFC and World Bank to respond to those requests promptly. In other words a backstopping arrangement is needed, whereby there is a continuous contact between the Advisory Group and a focal point in either of the two institutions. This person can consult the experts within or outside the IFC and World Bank and obtain their advice or guidance on the issues referred. In some cases, on-site visits by these or other experts may be necessary. Having worked in the World Bank for over 20 years, I know this is not the way the Bank or IFC are organized but they have to change their ways to respond to the Clients' needs so that they can make a difference. We would like them to advise us on funding the housing portfolios of banks through a secondary mortgage mechanism, what are the costs and benefits of choosing either European Model of on-balance sheet financing through issuance of Mortgage Bonds (MBs) or the US Model of off-balance sheet financing through securitization, wherein banks will be able to churn their mortgage loans through issuance of Mortgage Backed Securities (MBS) by creation of Special Purpose Vehicle (SPV). In this connection, SBP and SECP are open to suggestions for bringing about further changes in the regulatory environment to make it amenable and friendly for mortgage financing.

Till such time as the secondary market model assume a critical mass is it possible for us to have a Refinancing Window at the SBP in which the IFC or World Bank provides a reimbursable line of long-term credit in rupees for on-lending to the participating banks at adjustable rates. For example, we can begin modestly with US$ 15 million or Rs. 1 billion and gain experience, sort out teething problems, remove other snags and see if this makes sense and there is a demand for this product. Alternatively, can they come in with partial Credit Risk Guarantees for extending the maturity from 10 to 20 years? But the cost-benefit ratio of this intervention should be such that it leads to sustainability rather than providing artificial crutches for a limited period of time.

The Government of Pakistan has been extremely responsive and I would like to publicly acknowledge the positive leadership role of Finance Minister in accepting and adopting most of the recommendations of the SBP Housing Finance Conference in the 2003-04 Budget. He has assured us that he is open to further useful and constructive suggestions. One of the ways I think the small savers can continue to benefit from the National Savings Scheme (NSS) is to allocate long-term funds mobilized under the NSS in excess of the budgetary requirements to commercial banks for housing finance. This will kill several birds with one stone. First, it will limit the Government borrowing to its anticipated requirements and avoid paying the costs of servicing unneeded funds. Second, the small savers who have confidence in NSS will continue to earn a reasonably high return on their long-term savings and not complain about the erosion of their purchasing power. Third, these savings will be utilized for productive purposes in the private sector and not for financing budgetary deficits. Fourth, the banks will be assured of a stable source of long term funding at realistic rates. I hope the Finance Ministry will consider this proposal seriously.

I would also urge the Finance Minister and the SECP to give priority to the setting up of Private Pension Funds. As he is aware that countries, which have setup such Funds and also encouraged Mutual Funds and Insurance Funds, have seen a dramatic increase in their domestic savings rate. Although these funds have been on the agenda for quite some time I would request the Finance Minister to invite external experts from World Bank or Asian Development Bank to help us in launching these funds on a long-term path.

In the end, let me wish you best of luck in your deliberations during the next two days. I look forward to listening to your recommendations tomorrow evening but I would request you to go beyond the generalities or the issues that have already been settled into the modalities, details and nitty-gritty of things. The devil lies in the details.
