Expanding Frontiers of Financial Access in Pakistan

State Bank of Pakistan

Karachi, July 1, 2008

Expanding Housing Finance to Lower Income Groups

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Outline

I) Why Low Income Housing Finance

II) The Fundamentals are of the essence

III) LI housing Finance does not equate Subprime Lending

IV) Conditions of a Sustainable Frontier Expansion

I) Why Low Income Housing Finance?

1. For the People
   - Individually: immediate access to decent housing
   - Collectively: prevention of slums

     "Cities are built the way there are financed"

2. For Developers & Lenders
   - Diversification of risk

   Otherwise, concentration on a thin up-scale market layer more subject to saturation and price cycles
   - Volume based profitability

3. For the government
   - High cost of, and limited capacity for, substituting for failing market forces
   - Leveraging public assistance by financial market resources = multiplied impact

II) Fundamentals are even more fundamental

1. Weak titling systems contribute to high housing prices
   - Blurred property rights encourage speculation & encroachment with high social costs
   - Legal insecurity and litigations increase the cost of developments
   - Informality and unreliable registries → no proper property taxes, → weak infrastructure finance capacities

     → new infrastructure cost incurred by developers

     → passed on to new housing purchasers through prices

2. Inefficient mortgage collaterals tilts lending towards high income segments

3. Long maturities and fixed mark ups of special importance for lower income groups
   - In terms of repayment:

     20 year 10% = 10 years 3%
   - Low income levels = no cushion against interest / mark up fluctuations

III) Subprime Lending does not equate LI Housing Finance

The US Subprime market crisis

- The core phenomenon: relaxation of lending criteria in market segments that require extra caution
  - High LTV - incl. piggy back lending- at the very peak of the price cycle. 2006: 38% of subprime loans with Combined LTV > 100%
  - Artificial affordability boost:
    - Large predominance of ARM (only 31% of conventional mortgages in 2006) generally with initial teasers rates
    - Surge of “2/28” or “3/27” implying a repayment spike
    - Numerous IO payments for the first few years
    - Payment option loans involving negative amortization
  - Widespread practice of stated-income loans (1/2 subprime: Low/No doc)
  - Incentives to fraud : “liar loans”, brokers' control of appraisers
- Moderate income mortgages exist beside Subprime:

>90 day delinquencies, end 07:	Subprime	FHA
- Overall	15%	6%
- Floating Rate Mortg.	20%	9%

Source: Mortgage Bankers of America (rounded figures)

The Subprime crisis: Capital Market Push

- The secondary market drive
  - 80% of subprime mortgages were sold to investors ($500 Bln in 2005 & 06 , 1/3 to 45% of private MBS conduits):
  - the fall of interest rates and the hunt for higher yield assets
  - the huge development of leveraged structures on the capital market (hedge funds, CDOs)
- Unbundled market structure
  - Mortgage bankers and brokers = agents for capital market investors in the generation of high-yield assets
  - Misalignment of incentives: up-front compensation –fees or sale prices- vs portfolio quality

The Subprime crisis: Oversight issues

- Half of originators are not federally regulated
- Lack of prudential concern for non-deposit-taking institutions

The under-capitalization of liable entities generated systemic risk:

repurchase obligations in case of "Early Payment Default" → over 25 mortgage banks bankruptcies in first ½ 2007

- Institutional dispersion
  - Federal Reserve Board – regulates large bank holding companies
  - Office of the Comptroller of the Currency – regulates Federally chartered commercial depository banks
  - Office of Thrift Supervision – regulates Federally-chartered savings and loans ("thrifts" - now really commercial banks)
  - Department of Housing and Urban Development – regulates real estate transaction disclosures
  - State banking regulators – supervise State-chartered banks
  - OFHEO regulates Freddie Mac & Fannie Mae
  - Federal Housing Finance Board regulates Fed. Home Loans Banks
  - NCUA regulates Credit Unions
  - Federal Trade Commission – Regulates consumer disclosures
  - Securities and Exchange Commission – Regulates securities disclosures
  - State consumer and professional regulatory agencies – License and regulate mortgage brokers and mortgage bankers

IV)

Conditions for a Sustainable Frontier Expansion

- **Supply side**
- **Lending policies and practices**
- **Government support**

Supply Side

- Auto-construction: a prevalent approach in LI segments
  - Building process to be customized
  - Quality to be ensured → technical support
- Large scale developments achieve lower costs, but caution must be paid to:
  - quality norms
  - Ghetto dynamics
- Benefits of social mix
  - Cross subsidization
  - marketability
- Levers to develop the supply of mixed projects
  - Regulation
  - Higher Floor area ratios
  - Development agreements
  - Tax incentives – but risk of capture by developers high

  Ex.: Ex: US 10 year tradable tax credits (rental housing) if > 40% of units for HH < 60% Median Income, or > 20% of units for HH < 50% Median
- Need of secured developer lending
  - Adequate developer finance especially important (purchasers advances+ existing rent more difficult in LI segments)
  - Guarantee schemes: Algeria, South Africa (NURCHA)

Security of Developer finance - Ex. - South Africa NURCHA

(National Reconstruction and Housing Agency)

- Risk sharing mechanism for construction finance to ensure the sustainable flow of finance for low income housing, community facilities and infrastructure
- Partnership GoSA/Financial Institutions/Donors
- Lending through intermediaries or guarantees
- Programs:
  - New or small developers
  - Established developers
  - Subsidized housing
  - Affordable housing (<$30,000)
  - Infrastructure projects

Lending Policies and Practices

1. Lending norms / Products
   - Budgetary approach

     (DTI ratios not absolute indicators)
   - Prior savings requirements, especially for non-salaried

     (build downpayment, assess ability to repay)
   - Prudent assessment of collaterals

     (Collateral values are not independent of borrowers' situation)
   - Awareness of time bombs

     (Initial affordability enhancement features)
   - Additional guarantees:
     - personal guarantees
     - payroll deduction
     - mortgage insurance if clear market need
     - mortgage payment protection (UK)
2. Distribution channels
   - Use grass root lenders (financial cooperatives, credit unions…)
   - Generally need of strengthening and of linkage with mainstream FIs

Solutions being tested in India
($150/300 per month incomes)

- Adequate supply : land, construction cost, quality standards , facilitation of developer finance
- Core proposition to limit risk and reduce cost: integrated business models Linkage from the onset households-developers-lenders
  - demand aggregation
  - customer pre-qualification
  - streamlined business processes
- A variety of applications:
  - Employer centered approach
  - Financial Cooperative members bases
  - MFIs , lenders' agents
- Specific guarantee scheme for informal sector borrowers
- Protection against interest rate fluctuations
- Consumer education
- Technology solutions for managing small payments

Govt Support - Consumer Education & Protection

- Especially important for LIG: key to build
  - Awareness
  - Confidence
- Needed balance creditors' rights / borrowers protection,
  Especially when non-judicial foreclosure is available
- Principle of responsible lending in some countries
  Prevention of overindebteness / reckless lending (lack of understanding)
  Ex.: UK, France, South Africa
- Minimum components
  - Information disclosure, incl. comparison tools
  - Right to debt counseling (fees not paid by lenders)
  - Right to language
  - Oversight

Government inducement to LI Lending

- State lending is not a good solution to bypass market failures
  - High opportunity costs
  - Economic and social inefficiencies
  - Basic issues unaddressed
- Credit direction is not optimal
  - India: priority sector lending
  - USA: Community Reinvestment Act (CRA, 77)

  Prevention of geographic discrimination by depository institutions

  Limited enforceability (mostly when change of license is requested)
- Contractual approach: South Africa Financial Sector Charter 2004-2008
  - Contractual agreement on serving low/low middle income groups
  - Housing finance = one of the most ambitious target (USD 6Bln /5 years)
  - Commitments from government

  (Fostering housing construction, interest rate hedge)
  - Lags in achieving objectives, a majority of pension backed loans
- Best practices
  - Incentives through indirect financial support

  Mexico SHF, LI quotas on Fannie Mae/Freddie Mac investments (FHEFSSA 1992)
  - Risk sharing schemes
  - Mobilization of market resources through public assistance to LI borrowers