The problem of lending in developing countries

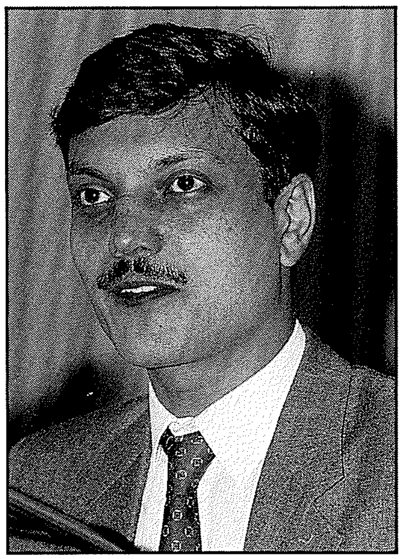
By Pradip Shah

This paper is based largely on the nearly 10 years of experience I have had in India in lending for housing, from the time I started working on the establishment of Housing Development Finance Corporation Limited (HDFC). I will therefore briefly outline the role HDFC is playing.

HDFC was set up in October 1977 as a specialised housing finance institution which would provide loans to individuals and companies. Before it was established, individuals had limited direct access to housing loans; for example, policy holders of the Life Insurance Corporation of India (LIC) could obtain relatively small amounts of funds from the LIC against their policies.

Although its principal business is life insurance, the LIC did — and does — provide a large amount of housing finance for the government-owned Housing and Urban Development Corporation (HUDCO), apex co-operative societies and state governments and state government organisations for housing, in addition to the modest amount it provides to its individual policy holders. HUDCO supplemented the availability of housing finance from LIC and other insurance companies by issuing bonds guaranteed by the Government.

All these funds reach individuals indirectly. Thus, an individual buying an apartment constructed by a state housing board could get the benefit of a hire purchase facility, the funds being made available to the state authorities from LIC/HUDCO. Individuals could also obtain finance from apex co-operative housing finance societies out of the funds raised by these societies from LIC.



However, individuals had to approach these apex societies in a group organised as a primary co-operative society. Therefore, individuals were not able to obtain housing finance in accordance with their needs. Further, there was no attempt at channelling private savings directly for housing; all primary savings reached borrowers through a chain of intermediaries.

However, HDFC started providing housing loans to individuals in accordance with their needs and based on the repayment capacity of each individual. To spread its resources to as many people as possible, HDFC imposes a loan ceiling. Also, it charges progressively higher rates of interest for larger loans so as to assist small borrowers with housing finance at lower cost. The term of the loan can extend up to 20 years for small loans, again with the aim of helping low income individuals.

HDFC does not provide housing finance for the acquisition of a second dwelling unit, also with the idea of channelling assistance to people with greater housing need.

The environment for lending

The environment which existed when HDFC started operating, and which continues to exist, is not unlike that found in other developing countries. The principal problem in lending in developing countries arises from the paucity of affordable housing. In the recent past there has been rapid inflation, especially in the construction sector.

Unfortunately, incomes, especially of salaried workers, have not grown at the same pace, resulting in a much reduced capacity to save. With interest rates also going up in this period, housing has become less and less affordable. The response of house buyers has been to reduce costs by going in for smaller dwelling units than what they would otherwise have acquired, accepting a more distant location with the attendant transportation problems, and cutting down on specifications. In fact, the specifications are often reduced to a level where the life of the dwelling units is severely affected.

What is imperative in the current situation is to increase the availability of affordable housing. In India, we have the misguided Urban Land Ceiling Act which froze vacant land and caused an artificial scarcity that has jacked up house prices. Very little effort is made to increase availability of land for housing through infrastructure development or mass transportation facilities.

Rent control, another misguided legislative measure, effectively prevents redevelopment of old and decaying areas in prime localities. Approvals from local authorities for commencement of housing projects take inordinate time. All these delays result in higher costs. Also, developers exploit shortages and the net result is that individuals are deprived of housing at reasonable costs.

In most developing countries there is the further problem of a heavy political involvement in any discussion related to a social issue like housing. Politicians and governments are particularly keen for all lending to be directed at "low income

'Importance of need-based approach'

borrowers." To my mind, it it more important to adopt a need-based approach than to fix a cut-off level of income. For instance, a family not having appropriate accommodation in relation to some basic requirements such as a supply of water, sanitation facilities, or minimum space with regard to size of family and privacy, should be as much a target of housing finance policy as a family which falls within an absolute definition of low income.

However, because of the existing political leanings, a lending institution usually finds it is required to target its effort more towards "low income borrowers" even though the housing needs of other categories of individuals would be as great.

The legal system in developing countries, too, is usually discouraging for lenders. The implementation of foreclosure laws almost always favours the borrowers. Frequently the process of law takes an inordinate amount of time, sometimes as much as 15-20 years. In the face of this difficulty, lenders are forced to rely heavily on their own system of appraisal of the cash flows of the borrowers, which itself is a problem, as discussed later.

The financial environment in developing countries usually reflects a paucity of long-term funds, accompanied by a high interest rate structure. The interest rate structure is often an administered one, with "softer" rates for borrowing purposes that are preferred by the government.

Housing does not often get favoured treatment, being perceived as a consumption expenditure rather than a development one. Housing finance institutions have therefore to direct their lending policies and systems with regard to these factors and this only makes it more difficult for individuals to acquire residential units.

At the same time, there is a tendency for the government to address the problem of affordable housing through the financial function — by exhorting lenders to provide cheaper housing loans (without giving the concessions which would make it possible for interest rates on housing loans to be lower), or to make repayment periods longer. Given these factors, financial institutions have to structure their loans to get them back as rapidly as possible and to attempt to operate on a very fine margin, which does not always provide sufficient reserves for loan loss or for growth.

Problems in lending

Turning to lending, one of the problems that HDFC has encountered is in assessing applicants' incomes. Self-

'Many borrowers evade taxes'

employed individuals with small incomes are not required to pay income tax and so there is no possibility of verification of income from their tax returns. There are no specialised agencies offering credit reports on individuals.

HDFC has resorted to innovative techniques for this purpose. For instance, while lending to a co-operative society of small traders in a small town in Gujarat, our credit officer had to spend hours with vegetable vendors and small grocers at their stalls by the roadside to estimate their incomes.

HDFC has occasionally found that such people do not even have bank accounts; they have then to be encouraged to open an account and deposit a regular sum every month to enable them to service our loan conveniently. Many borrowers evade income taxes and disclose lower incomes in their tax returns while asking for loans that can be serviced only if their incomes are substantially

'No uniform language'

higher, causing a dilemma for the lenders. Other applicants disclose higher incomes than they actually earn, in the hope of getting a larger loan as their repayment capacity would be seen to be higher.

Many of these borrowers are not literate and are not even in a position to complete an application form for a loan. The problem is further compounded because there is no uniform language for communication. HDFC has to assist individuals in deciding on the loan amount to be sought as well as in filling out the forms.

More importantly, individuals have sometimes to be educated about the obligation to repay the loan in a timely fashion. In the past, there have been various occasions when government and government agencies have provided loans, especially in small towns and rural areas, which have then been written off for political gain, resulting in individuals developing the belief that loans need not be repaid.

While assessing the value of the dwelling unit for the purposes of credit appraisal of the borrower, HDFC often finds that the appraised value is higher than the disclosed

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cost, because developers collect part payment in cash (and thereby avoid income tax) and the borrower arranges such cash payments from other lenders, affecting his repayment capacity. Credit appraisal of borrowers thus becomes a tricky exercise.

An interesting problem encountered by HDFC concerns collection mechanisms in respect of borrowers whose income arises irregularly, as in certain self-employed cases, or on a daily basis, as in the case of workmen. For instance, HDFC has provided loans on a pilot basis for a housing project in a tribal area of Valod. The loans range from Rs1,000 ($100) to Rs3,000 ($300) per dwelling unit and the cost of the dwelling units is a maximum of Rs5,000 ($500). The borrowers include agricultural labourers earning about Rs10-12 per day during the sowing and harvesting seasons and possibly nothing for part of the year.

'Saving on a daily basis'

Together with a local voluntary agency in that area, HDFC is encouraging these individuals to save on a daily basis out of their incomes. With other agencies it is looking into the possibility of setting up a service agency in each village which would be responsible for collection of the loans for a small fee.

In many instances HDFC has arranged for the loan instalment to be deducted by the borrower's employer from his salary. The employer then sends HDFC one cheque to cover all the instalments. This system works with employers in the organised sector; with smaller employers it can be the case that the employer uses the amount withheld for his working capital purposes, and fails to remit it to HDFC!

Frequently, delinquent borrowers have to be approached personally, the legal notice often being seen as an empty threat. HDFC therefore often had to resort to the additional security of personal guarantors. In other cases, HDFC does not get a proper mortgage because the stamp duty for creating the mortgage would be untenably high; again, HDFC has to innovate and find alternative security.

As there is no system of construction finance, HDFC has to provide the borrower with finance for progress payments even before the dwelling unit is ready, which means that a mortgage is not available. The security is, therefore, more of a psychological factor rather than something upon which HDFC can rely.

All these factors greatly increase the cost of servicing loans. Coupled with this is the fact that the loan amount is small and the repayment period long. The profitability of loans is therefore not very attractive. In case of arrears in repayment of such loans due to illness or loss of employment, the lending agency would have little choice but to reschedule such loans.

Possible lending policy initiatives

The key characteristic of borrowers in developing countries is their low savings capacity. There are several possible lending policies which would make it more convenient for such individuals to acquire a house.

Reducing down payment. As a result of their limited ability to save, low-income individuals have only a small accumulation of savings. Reducing the down payment required by lending agencies would help in facilitating such individuals in acquiring a dwelling unit. In developed countries the down payment has been reduced to as little as 5% with the help of mortgage insurance.

In an inflationary environment such as is prevalent in almost all developing countries, I submit that even without mortgage insurance it should be possible to reduce the down payment substantially. However, in the context of relatively high housing prices, reducing the down payment by itself will not help the large majority of people who are limited by their repayment capacity in the loan they can obtain.

Longer term. One way of enhancing the loan available is by increasing the term of repayment of the loan. In India, we currently lend for a maximum period of 15 years; in the case of low-income individuals, HDFC stretches this period up to 20 years. Further increasing the term would help in increasing the loan amount.

Paradoxically, one way of enabling lending institutions to increase the repayment period is to permit them to compete effectively with commercial banks for savings accounts. The housing finance institutions can encourage savings by individuals, and these savings are relatively more stable and larger in amount than government budgetary support or borrowings from the capital markets. As a sibling of the commercial banking industry, the housing finance industry can even be given a small competitive advantage to enable it to attract savings which can be transformed into long-term loans. Adjustable rate lending instruments would protect the housing finance industry's competitive advantage.

Unfortunately, in many developing countries the central banks do not permit housing finance institutions to offer saving accounts, reserving them for the commercial banks, and the commercial banks do not wish to lend for housing because of low profitability and the long-term nature of these loans.

'Competing with the banks'

Lower rate of interest. Reducing the rate of interest would similarly enhance the amount which could be lent. For this purpose, HDFC is implementing a contractual scheme on the lines of the German savings and loan scheme under which individuals save at a low rate of interest, say 6%, and, after qualifying, can obtain a housing loan at 8%. This scheme can operate in a free market environment. However, fiscal incentives for such a scheme would be of great help to small savers.

The viability of this scheme depends to some extent on such fiscal incentives and also on the manner in which it is implemented. In India, informal credit unions and "chit funds" (mutual associations of savers) have always flourished. Their suitability for housing is limited because of the difficulty in lengthening the term for which the savings are available.

Step-up future repayments. In the case of young borrowers, whose future income is expected to increase, HDFC is trying out a repayment plan where the loan instalment increases in steps every few years. This plan enables an individual to service a larger loan as his income rises.

Various other possibilities exist for enhancing the mortgage loan. One of the practices adopted in many countries is cross-subsidising interest rates, with higher income borrowers subsidising lower income borrowers. This practice is fraught with problems. Any subsidised programme cannot last indefinitely, even where a government is subsidising a programme. What is not viable in a market environment should be adopted only with great caution.

Suggestions are often made for accepting a higher percentage of income toward repayment of a housing loan. HDFC has selectively attempted to do so where the past savings history of an individual justifies it; in other cases it would put needless strain on the borrowing family, coupled with unacceptable risk for a lending institution. However, flexible loan instalment plans, especially those using balloon payments out of accumulated savings (as distinct from repayment capacity based on income), have considerable merit.

One approach that needs to be developed further is to encourage individuals to move upwards in housing as their financial circumstances change. Where land availability is not a constraint and individuals can build single family dwelling units, a lending institution can encourage them to build modular-type dwelling units which can be expanded as and when their financial circumstances improve. Alternatively, mobility from one dwelling unit to a better one should be encouraged. Thus an individual can acquire an affordable dwelling unit, and, later on, as circumstances improve, move to a better unit.

A government-assisted refinancing institution can help in making funds available at a reasonable price for low-income lending. The assistance from the government need not come by way of direct funding of an institution. Instead, such assistance can be by way of a government guarantee which would make funds available to the institution at a relatively low rate of interest. These funds could be earmarked for the purchase of packages of loans made to low-income individuals.

However, an intermediary of this type would further add to intermediation costs. I would prefer an approach, as indicated earlier, where housing finance institutions are allowed to mobilise savings and are given a slight competitive advantage.

Mortgage insurance would help in the development of a secondary market and, more importantly, encourage lending institutions to lend to low-income families. As I have said, I do not believe loans to low-income individuals are unacceptable risks. However, mortgage insurance would reduce the perceived risk in low-income lending. Mortgage insurance would necessarily add to the cost of the loan to the individuals; it should be a requirement for lending only when the total population of insured borrowers is fairly large, so that the cost of insurance is kept to a minimum.

HDFC has been encouraging housing for low-income families through the provision of financial assistance to companies which provide housing for low-income workers, usually in less developed parts of the country. An innovation that HDFC has introduced is to lend directly to such workers with the assistance of the company's guarantee. Many companies are required under agreements with their labour unions to provide housing loans to workers. These loans can be channelled by a housing finance institution through a company helping a large number of such low-income individuals to avail themselves of housing loans.

Conclusion

The principal problem in lending in developing countries arises from the shortage of affordable housing. Housing can be made more affordable by taking steps that would help increase the supply of housing, such as removing legislative hindrances that restrict land available for housing and modifying rent control laws; encouraging innovation in construction techniques, building materials and design of dwelling units; and designing the flow of relatively lower cost, stable funds for long-term housing loans.

Development of special techniques for low-income lending such as a higher loan-cost ratio, step-up repayment plans and innovative collection mechanisms is a less difficult but nevertheless important requirement to increase lending for housing to individuals in a prudent, pragmatic and socially desirable way. Government and non-government agencies have to work together in this task. ■

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