Housing Finance Sector of Pakistan

by Dr. F. A. Rabbawi

PERFORMANCE REVIEW OF THE EIGHTH PLAN

The Eighth Five-Year Plan (1993–1998) recommended a significant increase in channeling financial resources to the housing sector both by initiating schemes for mobilization of funds from the market and by encouraging the creation of new credit institutions. (See Mid-Plan Review, December 1996, p. 234.)

Private investment in ownership of dwellings at 1992–1993 prices during 1993–1996 was Rs 84.7 billion as against the proportionate target in the Eighth Plan of Rs 73 billion. This represents 116% of the proportimate plan target. (See same, p. 180.) In physical terms, however, the Plan targeted the private sector to increase the housing supply to cover up to 95% of the urban and up to 70% of the rural population by 1998. The programs of Katchi Abadis for improvement of Shelter for the Shelterless, seven marla plots in rural areas, three marla plots in urban areas and for industrial workers were to be geared up to meet these objectives. The performance in physical terms during the first three years has been less than 60% of the targets (see table).

S. #	*Item*	*Target 8th Plan Nos.*	*Target 1993-1994 1995-1996 Nos.*	*Achievement 1993-1994 1995-1996 Nos.*	*Achievement Over 1993-1994 1995-1996 As %*
1	Urban Residential Plots (7 Marla–1 Canal)	1,217,000	460,000	268,000	58%
2	Govt. Servants Housing	20,000	12,000	7,000	58
3	Katchi Abadi Improvement Population		3,000,000	1,700,000	57
4	7 Marla Plots in Rural Areas		1,400	.83	59

The main factor which has constrained the supply of housing is the failure to implement a clear-cut National Housing Policy. The housing sector has always been largely private and will remain so in the future. Much of the private sector is totally unsupported in key areas, such as: construction finance; supply of building materials; clearly defined government policy with respect to land development; regulations for operation of housing finance institutions in the private sector; absence of incentive packages; the ineffective supervisory role of local bodies in enforcing local building control laws; and overburdened special courts unable to provide speedy foreclosure on defaulted mortgage loans, thus slowing the development of a secondary mortgage market. After all, commerce founded in the final analysis on contracts cannot continue unless contracts can be enforced.

Dr. Rabbawi is President of the Association of Housing Finance Companies.

National demand for housing finance in urban as well as in rural areas is so enormous and potential to mobilize resources for the same is so great that a network of institutions would be required to serve the entire country. The nature of housing finance activity demands careful study and framing of ground rules to create an enabling environment within which the entire system can experience orderly growth.

New System Needed

An innovative beginning has to be made in developing a micro model of primary market operations in the field of housing finance with interlinkages to financial and capital markets at home and flows of resources from abroad.

The emerging system has to be flexible, adaptable and responsive to local conditions. Initially the resource pool would rely on various types of wholesale funding, loans from financial institutions, institutional deposits, capital market instruments, etc. The development pattern would have to be towards mobilizing individual household savings as no robust market-oriented housing finance system would be able to develop without the latter. In February 1997 the Corporate Law Authority was given the assignment of preparing ground rules for an effective market-oriented housing finance system.

No organized effort has been made to mobilize savings for investment in the housing sector. There is a plethora of cooperative housing societies of many kinds, most of them relatively unsuccessful. A few private developers mobilize savings. The mortgage lending program of commercial banks is very limited, mainly due to high risks and the time involved in mortgage foreclosures. According to IBRD/AID reviews, less than 20% of housing units constructed in Pakistan are financed from formal sources. House Building Finance Corporation remains the major provider of long-term formal credit to the middle and upper middle income group for construction of 25,000 to 30,000 houses per year at subsidized rates of return. Its lending program, however, is around Rs 1.5 billion per annum; currently it is technically unsound and is far too small to satisfy any major portion of the demand.

The present private finance sector, including commercial banks, does not consider housing finance as a commercially viable venture because of the high rate of delinquencies, lengthy and cumbersome procedures required for foreclosure and enforcement of tenancy laws. Private enterprise will be hesitant to enter this market if HBFC or any other public sector agency continues to provide subsidized funds to it. In order to mobilize finance from the domestic sector and generate confidence of the investing public, enactment of a supervisory body for monitoring their performance is considered necessary. To make a start, housing finance institutions as joint ventures between the public and private sector, with the majority shares held in the private sector, and as subsidiaries of commercial banks and of non-banking financial institutions could offer an immediate solution.

THE FORMAL SECTOR

Like other elements of the financial sector, housing finance is dominated by government rather than private credit. Furthermore, formal sector sources of finance, taken together, have only been able to supply about 20% of the needed credit. Thus, the majority of households must rely on informal borrowing and personal asset liquidation.

The formal housing finance sector in Pakistan is in its infancy. The institutional framework for housing finance in Pakistan is dominated by one state-owned institution namely the Housing Building Finance Corporation (HBFC) established in 1952.

The Housing Building Finance Corporation has functioned for decades as the only primary provider of housing loans in Pakistan. Until June 30, 1994, it received an annual credit line from the State Bank of Pakistan (SBP), which in turn was used to make housing loans. At the end of December 1996, HBFC had an outstanding loan portfolio of about Rs 17.50 billion derived from SBP advances. Since July 1994 HBFC has depended on its mortgage loan repayments to make additional loans. Thus it now has to be self-supporting and self-sustaining. Repayment of advances to SBP has been deferred. Currently, most of HBFC's loans are offered at a mark-up of 12%, which is about half the rate being offered by new HFCs. With great emphasis on recovery, HBFC has been able to raise its recovery level to about Rs 2 billion annually. If advances received from SBP are not repaid, this could be the ceiling for their annual lending since there are almost no chances for HBFC to increase the flow of additional funds from the market.

Other Institutions

Other formal sector institutions supplying housing credit include the Nationalized Commercial Banks (NCBs), government and SBP loans to employees, and housing cooperatives. NCBs tend to lend housing credit to bank employees and customers; rates appear to be somewhat less than market. Loans are generally interest-free to low-paid employees and close to market for higher level officers. Finally, the cooperatives have primarily assisted in financing sales of land and serviced plots.

Another symptom of the lack of an effective housing finance system is the use of advance deposits by builders. Builders generally accept deposits in monthly installments for one to five years during the construction period and they arrange a house building loan from HBFC for the balance amount before giving possession of the structure. The fact that households are ready to deposit large amounts without interest is symptomatic of both high demand for housing and lack of other financing arrangements.

HOUSING FINANCE INSTITUTIONS IN THE PRIVATE SECTOR

The need for HFCs in the private sector was always felt, but it was only in December 1990 that this thinking was translated by the government of Pakistan into a legal framework for the establishment and operation of market-oriented HFCs. The State Bank of Pakistan issued new prudential regulations to regulate the industry. Applications were invited from potential financiers and seven companies out of 24 applicants were given permission to go ahead in 1991. Three companies have started operation—CitiBank in December 1992, International Housing Finance in October 1993 and LTV Housing Finance in 1995. They have a total authorized share capital of Rs. 310 million and have advanced loans amounting to Rs. 510 million up to March 31, 1996, to 873 applicants for the construction/purchase and improvement of houses. (*Economic Survey,* 1995–1996, p. 127.)

The government's purpose in authorizing the creation of a private sector housing finance system was to permit this sector to mobilize private financial resources for investment in long-term mortgage loans. This would not only lead to a significant increase in the supply of housing, thus reducing the housing deficit, but also stimulate savings. Savings are the backbone of a vibrant housing finance market and a healthy economy.

The largest single obstacle the existing HFCs have encountered is a lack of access to capital at rates which will allow a profitable mark-up and an on-lending rate that the ultimate mortgage clients can afford. The HFCs are unable to compete with the government of Pakistan in attracting capital at rates that would permit the HFCs to re-lend that capital to prospective home buyers at affordable rates. This is and will be true whether the rates the government pays go up or down; HFC paper, while arguably of high quality, will always be valued less than government paper. Government paper is the surest investment in the domestic economy and establishes a benchmark or floor for all other papers.

Government Competition Limits Success

The HFCs also are finding it difficult to compete for domestic capital with government-owned and controlled financial institutions. These institutions are well-established, have a track record with the public, and most importantly have an explicit or implicit government guarantee; thus, they are able to attract financial resources at more favorable terms than the emerging HFCs. It can be said that the new housing finance system is paying the price for the failure of the Government/SBP to regulate and control other financial organizations, which, in the past, have frequently mismanaged their funds and/or defrauded the public, the latest instance being the finance companies and cooperatives. The public is rightly wary of putting their trust once again in a new type of institution.

To date, the three operating HFCs are making some housing loans, utilizing their equity capital as the financial source. When this source has been fully committed to mortgage lending, they may be able to have access to their parent companies for additional funding, either in the form of equity or loans. However, these funds are expensive, since the parent companies must re-lend at rates that they would ordinarily make for competing uses. Their resources are limited since the parent companies are not set up to provide long-term loans to subordinate companies. Besides, this defeats the purpose of creating the housing finance system, as the objective is to mobilize new financial resources from domestic markets for on-lending for housing. Lending from an equity base alone is not a viable business.

The limited amount of funds coupled with their high cost means that the market is restricted to borrowers in the higher income brackets. A Rs 300,000 mortgage loan at 20% for 12 years requires a monthly payment of about Rs 5,500, a payment that only a small percentage of families can afford to make. To qualify for this mortgage loan, which is sufficient to finance the purchase of construction of a basic housing unit, a family must have a monthly income of Rs 16,500. This narrows the housing market for affordable mortgages.

The new government installed in March 1997 has set new trends to revive the economy and emphasize the need to mobilize resources interalia through reliable housing finance companies in the private sector. Both, specialized and mixed institutions need encouragement to operate in the field of housing finance. This requires a friendly regulatory framework and an incentive package for creating a working environment for entrepreneurs to enter the field of housing finance. Expeditious sanctioning of HFCs should be done on a continuing basis. Among the mixed institutions, commercial banks should be encouraged to enter the market of housing finance.

In order to ensure the success of the private sector in providing housing finance, instruments and the infrastructure would have to be developed to promote private sector savings. The existing resources for housing finance comprise the following:

- personal funds of buyers;
- savings of overseas Pakistanis;
- government budgetary allocations;
- contributions by international donor agencies;
- commercial bank financing;
- utilization of zakat funds;
- workers welfare fund.

NEED FOR AN APEX HOUSING BANK

There is a need to set up an Apex Housing Bank, as a subsidiary of State Bank of Pakistan, for regulating the HFCs generation of resources and redirecting them to the housing finance sector by:

- Mobilization of funds of overseas Pakistanis for housing;
- Develop secondary market instruments/ mortgage-backed securities;
- Mobilizing surplus funds of insurance companies by setting up HFCs as subsidiaries of insurance companies;
- Creation of housing pension funds;

- Designing and launching long-term saving instruments for individuals as well as corporations;
- Encouraging employers to construct labor colonies and houses for employees.

The success of the resource mobilization efforts depends on the active participation of a large number of private sector housing finance companies. To ensure the participation, an environment is being created where housing finance companies will have the firm and prompt support of the legal system and where the right tax incentives will be provided to encourage private savings to be channelled to these companies. The following measures are under active consideration of the authorities concerned:

Legal Measures

1. Corporate law authority shall facilitate the setting up and operation of housing finance companies and their regulation/monitoring through a friendly legal framework.
2. Executive authority for foreclosure and eviction shall be given to banking tribunals, and immediate steps shall be taken to accelerate their effective working.
3. Revision of the property registration process and taxes on registration, transfer or changes in documents.
4. Simplification and standardization of documentation.
5. Strict penalties for defalcation in the registration of documents.

Tax Measures

1. Tax/Zakat exemption on savings with HFCs to enable them to compete with similar government instruments.
2. Reduction in registration fees for HFCs in cases of hire purchase or foreclosure.
3. Industrialists, HFCs, financers, developers and builders involved in providing building elements, finances, developed plots and constructed houses, etc. may be allowed to pay lower rates of taxes on the portion of business relating to housing activities for low-income target groups.

Other Incentives/Measures

1. Deposit insurance for depositors to be arranged by a central agency.
2. Setting up of credit bureau for individual borrowers.

Market Orientation of HBFC

The House Building Finance Corporation, which has played a key role in providing loans for house construction in both urban and rural areas, is also being converted into a market-oriented institution so that it can also generate funds from the market. HBFC will undertake financing of the special housing program for low-income groups, etc. The subsidy involved in such financing shall be separately worked out in advance and provided to the HBFC.