

# Reorganizing Housing Banks: A Case Study of the Fiji Housing Authority

by Dr. Jack Guttentag

## INTRODUCTION

Housing banks are government-backed home lending entities that usually have subsidized fund sources and usually lend at subsidized rates. With the possible exception of the Housing Bank of Thailand, their performance has been uniformly poor. Subsidized funds have protected them against the discipline imposed by markets, which encourages inefficiency. Subsidized loan rates have often resulted in the intrusion of politics and favoritism into the borrower selection process. Credit losses have been high because of reluctance to enforce liens, along with a tendency of borrowers to confuse loans from a government entity with grants.

In recent years the failures of housing banks have become increasingly evident while the availability of subsidized funds has declined. The result has been a search for new directions and new mandates. The Housing Authority of Fiji (henceforth "HA") has been one of those caught up in this ferment. Visiting HA as an advisor in 1997, I had an opportunity to evaluate their existing reorganization program and to recommend the more radical changes that seemed to me

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to be required. This article is based on my report to HA.

## CURRENT APPROACH TO A NEW MANDATE

HA was originally established "to enable workers to purchase or lease dwelling-houses at a reasonable cost." The Public Enterprise Act of 1996, however, requires HA "to operate as a successful business and, to this end, be as profitable and efficient as comparable businesses which are not owned by the state."

This new mandate created a conflict between the social objective of HA and the new requirement of profitability. The 1996 law recognizes the potential for such conflict and states that the agency "will be appropriately compensated for its non-commercial obligations and any funding will be made apparent."

In response to its new mandate, HA has taken the position that the cost of its "social and welfare-related tasks" consists mainly of the larger provision for bad debts than would have been needed had HA made all loans on a commercial basis. In 1997 it estimated the incremental provisioning cost and billed the government accordingly.

## Blurring Commercial and Non-commercial Lending

If HA distinguished operationally between commercial and non-commercial lending,

then loss provisions could be estimated separately for non-commercial lending, and this approach might be workable. Even in this case, however, billing the government for subsidy cost after loans have been made rather than before could prove problematic. The government is going to want control over subsidy expenditures before the expenditures are made. Under an approach where housing subsidies are based on loss provisions, government receives a bill after the assistance has been provided.

The fact that HA has only one category of loans for which it estimates loss provisions creates an additional problem. Loan loss provisions are educated guesses to begin with, and distinguishing the portion attributable to non-commercial policies makes such guesses even more tenuous. Further, since HA has an interest in making the proportion of its provisions attributable to non-commercial lending as large as possible, a credibility issue is almost sure to arise.

Since it will not be possible to establish definitively the portion of total losses attributable to non-commercial lending, it will be very difficult for the government to hold HA accountable for the efficiency with which HA conducts its commercial operations. Such accountability is another objective of the 1996 legislation.

## Subsidized Lending Monopoly

In addition, under the current HA approach

HA maintains its monopoly over subsidized lending. This is inconsistent with still another objective of the 1996 legislation, which is to create a "level playing field" between government and private entities operating in the same market.

The balance of this paper outlines an alternative approach to resolving the conflict between HA's social and commercial objectives that deals with these problems. It involves three major components:

- Creation of a new housing subsidy program, open to any lender, where the subsidy amounts are budgeted by the government before they are committed.
- Placement of HA's existing portfolio in a "Management and Liquidation" department which would manage the runoff of loans and liabilities.
- Chartering a new HA as a government-owned bank that would be 100% commercial and subject to privatization after a specified period.

These three proposals will be considered in turn.

#### **DEVELOPING A NEW HOUSING SUBSIDY PROGRAM**

The housing subsidy program sketched below is designed to:

- Minimize arrears among households receiving subsidies.
- Make housing subsidy costs to government transparent and controllable.
- Maximize the efficiency of subsidy usage by households.

#### **Developing a Contract Savings for Housing Program**

Depository institutions, including HA with its new banking charter, would be authorized to offer special contract savings programs which will qualify households for housing subsidies. A household which completes a savings program would receive a housing subsidy equal to some multiple of the amount saved.

As an illustration, a household might save \$50 per month every month for three years, accumulating roughly \$2,000. If the subsidy multiple is 2, the government would award the household a subsidy credit of \$4,000. The subsidy could be used in the ways described below to help in the purchase of a home.

There should be a maximum subsidy amount per household and a maximum sale price of home for which the subsidy can be used, with the maximum sale price indexed to the price level. If prices rise by 5%, the maximum sale price should also rise 5%.

Making the completion of a contract savings program a condition for receiving a housing subsidy will reduce arrears because households who complete the program have demonstrated that they have the discipline required to save. The savings requirement is also a sensible way to ration scarce subsidy dollars. In addition, to the degree that it induces some households to save more than they would otherwise, the program would increase national savings.

#### **Administration and Control**

Since the extent of the government's commitment to make subsidy payments would be determined in part by the number of households starting and completing savings programs, the government needs accurate and up-to-date information on the magni-

tude of these accounts. In addition, it should reserve to itself the right to vary both the multiple and the minimum savings period as a way of controlling total subsidy outlays. (Of course, it cannot change these capriciously without undermining the credibility of the program.) HA is the logical entity to design, implement and administer the subsidy program.

#### **Insurance Premiums on Small-deposit Loans**

The subsidy amount should be usable by households to reduce the size of the required deposit, reduce the mortgage payment in the early years, or both. This flexibility would be a unique feature of the program.

In using the subsidies to reduce the required deposit, HA would establish a commercial standard deposit requirement, perhaps 20%. It would also establish a set of insurance premiums for complete loss coverage when deposits are less than 20%, such as the following:<sup>1</sup>

**Table 1.**

<i>Deposit</i>	<i>Premium</i>
15%	1.0%
10%	2.5%
5%	4.5%

As an illustration, assume the maximum sale price on a subsidized transaction is \$30,000, the household saves \$2,000 and earns a \$4,000 subsidy. If the household opted for the 5% deposit, it would cost \$1,283 of the subsidy (4.5% of the loan amount of \$28,500).<sup>2</sup> The remainder of the subsidy would be available to reduce the mortgage payment in the early years.

Under no circumstances should the subsidy be available for the deposit itself, as opposed

to paying for the insurance premium needed to reduce the required deposit. If the borrower could use the entire \$4,000 subsidy for the deposit, immediate resale of the house would put a \$4,000 windfall in the borrower's pocket. This has been a problem with deposit subsidy programs in Latin America.

In the example above, the subsidy payment of \$1,258 pays the insurance premium required to reduce the required deposit to 5%, or to \$1,500. But the \$1,500 must be paid out of the borrower's own funds. The household could use \$1,500 of its accumulated \$2,000 for the deposit, and retain \$500 for other purposes.

**Meeting Early Year Mortgage Payments**

Subsidy recipients may also need help in meeting the mortgage payment in the early years of the loan, and any part of the subsidy that is not used to reduce the deposit should be available to reduce payments. The subsidy can be used more effectively if it is concentrated in the early years of the loan rather than spread out over the entire life.

Consider the household cited above which earns a \$4,000 subsidy to purchase a \$30,000 house and uses \$1,283 to reduce the deposit to 5%. This leaves \$2,717 of the subsidy for reducing the payment. The loan amount of \$28,500 on a conventional mortgage at 11% (the assumed commercial rate) and a 25-year term would require a level payment of \$279. If the subsidy were used to reduce the payment on this loan over its entire life, the new payment would be \$270. This isn't much of a reduction.

If the subsidy were concentrated in the early years of the loan, however, and followed by payment increases that the borrower can afford, the initial payments can be reduced much more sharply. In the example, the \$2,717 subsidy would allow any of the following possibilities:

**Table 2**

Initial Payment	\$203	\$197	\$192	\$186
Annual Pmt. Increase	4%	5%	6%	7.5%
Highest Payment	\$320	\$309	\$303	\$299
Month Reached	145	121	97	85

The first column shows that the initial payment can be reduced to \$203 if it is followed by annual payment increases of 4% for 12 years, reaching a maximum payment of \$320 in month 145. The last column shows that the initial payment can be reduced to \$186 if it is followed by annual payment increases of 7.5% for seven years, reaching a maximum payment of \$299 in month 85.

All of the examples shown above require a subsidy of \$2,717. The subsidy is placed in an escrow account from which monthly withdrawals are made to cover the difference between the payments made by the borrower in the early years and the interest payments on the loan. The withdrawals from the account decline over time as the borrower's payment rises.

In designing the program, the annual percent increase in the payment could be made uniform for all borrowers, or it might be allowed to vary with the preferences and capacities of the borrower.

The numbers in the table above are computer-generated using MARSDP, a mortgage design program developed by GHR Systems, Inc., which makes it available to developing countries free of charge.

**Relevant Experience in Other Countries**

The different components of the housing subsidy program described above have all been used in other countries, but not exactly in the same way, nor tied together in the manner proposed for Fiji.

Contract savings programs for housing are used in many countries as a way to encourage savings and qualify borrowers for housing loans. These programs sometimes are indirectly subsidized by government through tax or similar benefits, as they are in France and Germany. These subsidized programs have similarities to the program proposed for Fiji.

The private mortgage insurance industry in the United States and other countries base insurance premiums on the size of the deposit, with the premium paid by the borrower, exactly as proposed here. The only difference is that under the program proposed for Fiji, the borrower will pay the premium out of the subsidy the borrower has earned by completing the contract saving program.

Mortgages that reduce the initial monthly payment by supplementing that payment through withdrawals from a special account set up at the time the loan is made have been widely used in the U.S. The special accounts are called "buydowns." In the version proposed here, the buydown (subsidy) is the amount required to pay the difference between the payment made by the borrower and interest due the lender in the early years of the loan. We call this an "interest only buydown mortgage." However, in the U.S. the subsidy usually is provided by builders or other home sellers, and sometimes by borrowers themselves, rather than by government.

Perhaps the most novel feature of the subsidy program proposed for Fiji is the way the components are put together. In most other countries, housing subsidies are used to reduce monthly mortgage payments. In a few countries subsidies are used to reduce the deposit. But there are no existing programs of which I am aware under which the household can allocate a fixed subsidy amount for either purpose.

Note that housing subsidies of the types proposed here do not provide subsidy recipients with a windfall that they can realize if they resell the property. Hence, there need be no restrictions on sale of properties purchased with the aid of these subsidies.

#### **Making the Program Available to All Private Lenders**

While the housing subsidy program should be administered by a new subsidy administration unit in HA and would be implemented first by the new loan unit of HA, once all the kinks are out of the program it ought to be available to any lender who wants to participate.

While this means that HA will be obliged to compete with other lenders on an equal basis in both subsidized and non-subsidized lending, it provides HA with political cover and credibility. If HA were the only lender that could offer subsidized loans, it would be much more difficult to induce the government to remove existing restrictions on HA. Further, in the determination of the insurance premiums paid by the government in connection with low-deposit loans, HA would be negotiating with itself. It is important that other lenders have an input into this process.

#### **CREATING A MANAGEMENT AND LIQUIDATION DEPARTMENT WITHIN HA**

I propose that HA create a new "Management and Liquidation" (M&L) department which will manage the existing portfolio until all the loans are paid off and the liabilities retired. This will allow the creation of a "New Loan" entity within HA that will start with a clean slate. It also will facilitate a focused effort to reduce arrears on the old portfolio.

#### **Outsource Loan Servicing to Private Banks**

Government lending entities the world over do a poor job of collecting payments from household borrowers, and HA is no exception. Hence, a first order of business of the new M&L department in HA should be to outsource loan servicing to the private sector. This involves the following steps:

- Developing a "prospectus" setting forth, among other things:
  1. The duties and obligations of the servicer;
  2. The characteristics of the loans in the portfolio that affect the costs of servicing; and
  3. The powers of the servicing agent to impose late charges on borrowers in arrears.
- Assessing the loan servicing efficiency of the private lenders in Fiji to determine which of them should be eligible to bid.
- Setting forth the bidding procedure that will be used to select the winner.

The bidding for loan servicing is in terms of the fee that HA must pay the servicer, expressed as a percent of the loan balance. In the U.S., a customary fee is .25% on an annual basis, or .25/12 on a monthly basis. This payment is retained by the servicer from the interest payment received from the borrower before passing the remainder on to HA. If no payment is received from the borrower, no fee is retained by the servicer.

#### **Consider a Range of Measures to Improve Collections**

Like most housing banks, HA has high levels of arrears that are related to a culture that is excessively accommodating to borrowers,

and to specific operational policies that reflect the culture:

- Interest is not charged for the first two months.
- A borrower in arrears does not hear about it from HA for six months.
- Late fees are capped each year.

The combination of two interest-free months plus the six-month lag in reporting on arrears undermines borrower discipline. Furthermore, the practice of capping the late fee each year means that once the borrower hits the cap, there is no further cost to delaying the payment. All of these policies should be discarded.

Consideration should also be given to shifting borrowers not subject to payroll deduction and who are paid weekly to a weekly payment schedule; and borrowers who are paid every two weeks to a two-week payment schedule. The rationale for this is discussed later in connection with the development of an underwriting function for the newly chartered HA.

#### **Interest-rate Risk on the Old Portfolio**

HA's existing loans are "discretionary adjustable rate mortgages," meaning that HA has the contractual right to change the rate at any time. In practice, however, HA has rarely exercised this right. It has not been under any pressure to do so, because HA's liabilities are long-term. For this reason, M&L will not have any significant interest-rate-risk management problem on the old portfolio. On the new portfolio, however, it will be a different story, as discussed later.

#### **Improving Liquidity Management**

HA has undertaken important initiatives to convert large amounts of illiquid assets into

liquid assets and to reduce the delays involved in being paid by the provident fund. Once HA is in possession of sizable amounts of liquid assets, it should consider retaining a consultant to assist it in developing operating procedures for maximizing the earnings from these assets.

#### **Improving Operating Efficiency**

Important initiatives directed toward this objective have already been undertaken, including the outsourcing of functions that can be executed more economically by the private sector, elimination of redundant positions and the initiation of focused training programs for staff. When the more obvious opportunities for cost savings have been fully exploited, HA should consider retaining a consultant to prepare a detailed audit of possible cost savings from reorganizing the ways in which key functions are executed.

#### **CHARTERING A NEW HOME LENDING ENTITY**

Freed from the constraints imposed by an existing loan portfolio with an unknown amount of embedded losses, HA can create a new lending entity (henceforth "New Loan") that would operate on a strictly commercial basis. New Loan requires a banking charter so that it can offer the contract savings program designed as a part of the proposed new housing subsidy program.

The expectation is that after New Loan builds value, it would be sold to the private sector with the profit realized by the government of Fiji. If New Loan fails to build value it should be terminated.

To be successful in building value, New Loan must shed not only its existing loan portfolio but also much of its existing non-commercial culture. Some of the major requirements of success are discussed below.

#### **Capital and Guarantees**

Since HA now has a capital deficiency which would be carried over to the M&L department, New Loan will begin life with zero capital. Hence, it will require continuation of the guarantee of its liabilities by the government of Fiji. This guarantee would be phased out when and if New Loan is privatized.

An alternative to continuation of the government guarantee is the conversion of debt owed the World Bank (WB) and the Asian Development Bank (ADB) into equity. While WB can't do this, the government of Fiji, as the guarantor of the loan to WB, could become the equity-holder. ADB might be more flexible than WB in converting its loan into equity. In addition, IFC might be interested in providing equity. With sufficient equity, the government guarantee on New Loan liabilities could be avoided.

If existing debt is converted into equity, a portion would have to be allocated to M&L, equal to its estimated capital deficiency. If equity investors objected to that, and any new investor almost certainly would, the government of Fiji would be obliged to assume the deficiency.

#### **Creating a Loan Underwriting Function**

Perhaps the most extreme (and most important) manifestation of HA's non-commercial culture is that it has operated without an underwriting function. Any applicant who can make a 10% deposit and has income three times as large as the mortgage payment can obtain a loan. The willingness of applicants to meet their obligations, as indicated by their past history, is not examined. Only if HA has adverse information about an applicant in its own files does it refuse an application.

The private banks refer to HA those loan applicants they don't wish to serve. HA has

become the dumping ground for "dead-beats"—borrowers with no intention of repaying their loan.<sup>3</sup>

There are actually two functions that are involved in a determination of whether a particular applicant should receive a loan. One is "processing," by which is meant the collection of the complete file of information that bears on the ability and willingness of an applicant to repay the loan. The person responsible for completing the file is a "processor."

Underwriting involves a determination, based on the file of information compiled by the processor, that (a) the loan application should be accepted; (b) the loan application should be denied; (c) the loan should be approved subject to certain conditions; or (d) additional specified information is required. The person responsible for making this decision is the underwriter.

Underwriters are guided by an underwriting manual, which sets out the lender's general philosophy, the criteria that should guide the underwriter and the procedures that are to be followed. It is desirable if the internal systems allow arrears experience to be traced back to the underwriters who approved the loans.

I can't write an underwriting manual here, but let me offer some thoughts about the kinds of things that might go into it:

1. As a general rule, borrowers should be required to demonstrate their willingness to meet their obligations. The burden of proof should be on them, not on New Loan to show the opposite. Since there are no credit-reporting agencies in Fiji, recourse must be had to other sources of information. Possible sources of information are records of payment to landlords, utility companies or others.

2. Another potential source of information is the knowledge that people have about others in their local communities. Fiji is a relatively small place, and many people possess relevant information about others. Westpac Bank uses this source of information by making its branch managers responsible for recommending borrower applicants and providing evidence of the applicant's credit worthiness. If a loan subsequently goes three months into arrears, it goes back to the branch manager for collection. This works because the bank makes it clear to the manager that it expects the manager to document the case for the applicant, and that the manager will be held responsible if the loan doesn't work out.

3. A critical element in underwriting is the amount of other debt that an applicant may have. This is important both as a source of information on how well the applicant has done in paying off debts in the past, but also on the extent to which the applicant's income is already encumbered by the burden of paying off old debts.<sup>4</sup> Underwriting rules typically limit the amount of old debts the applicant must service.

4. Borrowers whose payments are subject to payroll deduction, other things being the same, are less risky than others. However, payroll deduction is little help if the applicant has been in the habit of changing jobs every six months, or if the employer has a poor record of transmitting payments to HA. Length of employment and the record of the employer should both be important inputs in the underwriting decision.

5. Borrowers whose payments are not subject to payroll deduction might be better risks if they were required to pay New Loan on the same schedule as they are paid. If they are paid weekly, for

example, have them pay New Loan weekly.

As shown in Table 3, a comparison of the arrears records of borrowers not subject to payroll deduction, who volunteer to pay more often than monthly, with those who pay monthly, supports this view. While loans not subject to payroll deduction have uniformly higher arrears than those subject to deduction, those not subject to deduction who pay more frequently have lower arrears.

**Table 3.** Arrears as a Percent of Loan Balances, by Frequency of Payment

	<i>Payroll Deduction</i>	<i>No Payroll Deduction</i>
Weekly	3.8%	4.6%
Every Two Weeks	2.0%	5.6%
Monthly	3.6%	6.6%

6. New Loan should monitor the records of individual employers in transmitting payments to determine how much reliance should be placed on payroll deduction by any given employer. Employers with exemplary records could be offered higher fees, or their employees could be given a small rate reduction which the employer could claim as an employee benefit. Such relationships with individual employers could be a useful marketing strategy for New Loan.

7. When lenders write loans on which the interest rate can increase, underwriting should take account of the borrower's capacity to absorb a payment increase in the future. This point is discussed further below.

8. Underwriting decisions need not be simply "yes" or "no." If there is not enough

evidence of the applicant's willingness to meet his obligations, the loan might still be offered but subject to the requirement that the note be co-signed by a third party who does have a good record. Or the loan might be offered with a larger required deposit and higher rate to offset the risk. Making such determinations is what underwriting is all about.<sup>5</sup>

#### **Developing an Interest-rate Risk Management Strategy**

New Loan would not have access to the long-term rate-subsidized funds that HA has enjoyed in the past. It would have to pay market rates, and its liabilities would be much shorter than they have been because long-term money would not be available to it on attractive terms. This is the classic problem of mortgage lenders everywhere.

To illustrate, suppose New Loan borrows money at 5% for one year and lends it out for 25 years at 8%, making a 3-point spread. If the rate on one-year money one year later is 10%, New Loan must raise the loan rate to 13% to maintain its spread; this would increase the mortgage payment by 46%, which could force many borrowers into default.

New Loan must develop an interest-rate risk management strategy that will prevent such situations from arising. It must be able to protect its spread against rate fluctuations, without imposing unreasonably heavy payment increases on its borrowers when interest rates rise.

#### **Types of ARMs**

To protect its spread, HA must be able and willing to increase the rate on old mortgages. Loan contracts that provide this privilege to the lender are called "adjustable rate mortgages" or ARMs. Broadly, there are three types of ARMs: discretionary, indexed and rollover.

**Discretionary ARMs** are offered by HA and the other lenders in Fiji, as well as by lenders in other countries that had been colonized by England. The discretionary ARM allows the lender to change the rate at any time (with notice), by any amount, for any reason. It thus appears to provide the lender with maximum flexibility. But in practice this flexibility has usually turned out to be an illusion.

Lenders who write discretionary ARMs almost always attempt to avoid frequent rate changes in order to avoid annoying borrowers and increasing servicing costs unnecessarily. (HA has been no exception to this rule.) The policy, which is usually implicit although sometimes it is stated, as in India, is to change rates "only when absolutely necessary." But when a situation demanding a rate increase ultimately arises, as it always does, lenders invariably find that they do not have the freedom of action they thought they had.

Adverse borrower reaction can be extremely strong, since the required rate increase, and the impact on borrowers' payments, is very large. The longer the period of rate stability borrowers have enjoyed before the announced increase, the more indignant they will become.<sup>6</sup>

The fact that every borrower is affected at the same time invites collective action, probably through the political process. Since the announced rate change is a policy decision made by the lender's board of directors, it is subject to outside scrutiny and political interference. This is an especially serious problem for lenders having any kind of official status.<sup>7</sup>

Another drawback of discretionary ARMs is that there is no way to vary the amount of interest-rate risk imposed on borrowers based on their ability to bear risk. All borrowers are subject to the same risk of a rate increase.

**Indexed ARMs**, which are the dominant type of ARM in the U.S., base future rates on the movement of an interest-rate index. This makes rate changes completely mechanical rather than discretionary. Furthermore, since the rate adjustment date varies contract by contract, it is never the case that all borrowers are affected at the same time. In addition, the amount of interest-rate risk imposed on borrowers using indexed ARMs can vary widely through the use of rate adjustment periods of different length and caps on rate adjustments. However, indexed ARMs require the availability of a reliable rate index and are also very complicated for borrowers to understand.

**Rollover ARMs** fix the rate for a set period, at the end of which the rate is reset (and the payment recalculated) based on the current rate on rollovers at that time. Common rollover periods are 1, 3, 5, and 7 years. Usually the rate is higher for longer rollover periods. The rollover ARM is the standard loan type in Canada, and they are also used to a small extent in the U.S.

I propose that New Loan adopt the rollover ARM as its standard mortgage for the following reasons:

1. Rollovers are simple to understand. Each borrower knows that the rate is fixed for a set period and will then be reset (and the payment recalculated) based on conditions prevailing at that time.
2. Borrowers can be given a choice regarding the combination of initial rate and rollover period they prefer. New Loan underwriting will require that borrowers who select short rollover periods are better able to assume the risk of rate increases (see below).
3. Using rollover ARMs, New Loan will be forced to keep its rates in line with the market, since loans are always coming

due and the rates at which they can rollover must be formulated.

4. Rollover ARMs lend themselves to a simple yet effective method of managing interest-rate risk called "match-funding."

Elaborating on this last point, assume that New Loan can borrow at 3.8%, 4.3%, 5% and 6% for 1, 3, 5 and 7 years, respectively. It might then offer rollover ARMs at 6.8%, 7.3%, 8% and 9% corresponding to the same rollover periods. The demand of borrowers for different rollover periods would then determine the amounts that New Loan borrowed at the various terms. On the balance sheet the distribution of rollover ARMs by rollover period would approximate the distribution of liabilities by term.

#### Avoiding Severe Payment Shock

A disadvantage of rollover ARMs is that borrowers are vulnerable to severe payment shock on the rollover date if interest rates have increased substantially. Hence, New Loan should adopt policies designed to soften such shocks.

One approach to softening the payment shock resulting from a large rate increase is to lengthen the term, but this works only if the initial term is short. If the initial term is 25 years, lengthening it has little effect on the payment. Hence, the policy should be to make initial terms as short as possible in order to preserve term-lengthening as a payment shock absorber. Furthermore, whenever the rate is reduced on a loan on which the remaining term is 15 years or longer, the payment should remain as it is and the term shortened.

In addition, it would be prudent to underwrite borrowers using the highest rollover rate, regardless of which rollover period they select. This means, e.g., that if rollover rates are 6.8% and 9% on one-year and seven-

year rollovers, respectively, the payment used to determine compliance with the 33% rule would be calculated at 9% even though the borrower has selected the one-year rollover. (The borrower would receive the 6.8% rate but the payment used in the 33% test would be calculated at 9%.) This will assure that the borrower selecting the short rollover has some capacity to increase the mortgage payment if necessary.

#### **Developing a Competitive Marketing Strategy**

If New Loan is going to be successful in competing in the private market, it must develop a marketing strategy that will emphasize its strengths. From a marketing perspective, rollover ARMs have marked advantages over discretionary ARMs. New Loan will be able to quote lower rates than other lenders, and they will be able to offer rate guarantees for set periods. If New Loan charges lower loan fees, they could emphasize that as well.

Another issue is new services that New Loan might offer that would enhance its attractiveness to consumers. HA has taken a significant step forward in developing a program to offer short-term loans as a supplement to housing loans.

In all probability, there are other services that might be added as well, perhaps including real estate brokerage, which appears to be underdeveloped in Fiji. HA already provides this service to its own borrowers, and New Loan might want to consider expanding the service and offering it to anyone.

An idea for a marketing theme arises from the practice of collecting payments from many borrowers on a weekly or biweekly basis. Borrowers who pay one-fourth of their monthly payment every week, or one-half every two weeks, actually make the equiv-

alent of 13 monthly payments per year instead of 12. If they pay religiously, therefore, they amortize their loan on an accelerated schedule. HA now records their principal reductions in excess of the scheduled reductions as negative arrears.

New Loan could allow borrowers with negative arrears to skip payments. While weekly payers who skip four payments a year and biweekly payers who skip two payments simply stay on the same amortization track as borrowers who pay monthly, the privilege of skipping payments could be marketed as a reward for good payment habits.

An alternative to allowing borrowers to skip payments is to offer to pay them some or all of their negative arrears, perhaps at Christmas time. How about "The Loan That Pays You Back at Christmas"?

Still another possibility that opens when New Loan becomes a bank is to transfer the negative arrears into a deposit account. To see the kind of magnitudes that might be involved, consider a loan for \$50,000 at 10% for 20 years and a monthly mortgage payment of \$482.52. If the borrower makes weekly payments of \$120.63, the four extra payments a year at 7% interest would accumulate to \$20,723 over the 20 years. Not bad!

#### **Privatization of New Loan**

Since New Loan must be supported by government guarantees or capital, it should offer the prospect of a significant return to the government. The return would consist of the proceeds from the eventual sale of New Loan to the private sector. Absent this inducement, there is no reason why the government should capitalize New Loan.

HA should develop a business plan that makes the case for New Loan. I view this

section as raw material that HA can mine for use in developing the plan. In addition, the plan should include:

- Spreadsheet projections of revenues and expenses which will support a target date and target price for sale to the private sector.
- Interim net revenue milestones which New Loan must achieve lest government "pull the plug."
- A bonus incentive arrangement for management, payable only if the target price or better is realized by the target date or sooner.

Once the plan is accepted, management should be granted maximum autonomy in realizing the plan, including the provision of full banking powers and the elimination of any existing restrictions on the segments of the market in which New Loan can operate.

#### **NOTES**

<sup>1</sup> These premiums are probably too high. Queensland Insurance charges only .6% of the difference between a 20% deposit and the actual deposit down to 5%. Its coverage is limited to the difference in deposit, however. The insurance premiums actually paid in principle should be the lowest premiums that private lenders would be willing to accept.

<sup>2</sup> The Chief Manager of Westpac Bank indicated to me that he saw no reason why Westpac would not participate in a scheme of this sort.

<sup>3</sup> I am reminded of a favorite aphorism of Peter Maurice, ex-CEO of Canada Trust: "Every market has a fool; and if you don't know who the fool is in your market, it is probably you!"

<sup>4</sup> Some U.S. studies have found that the ratio of existing debt service to income is a more important determinant of future payment performance than the ratio of mortgage payment to income.

<sup>5</sup> In the U.S., some lenders will make a loan to a borrower who has a very bad credit record conditional on a 40% deposit and a rate 2% above the standard rate. However, many lenders will not touch such loans.

<sup>6</sup> In India, lenders kept their rates fixed for so long that for all practical purposes loan contracts that are adjustable rate de jure have become fixed-rate de facto.

<sup>7</sup> Lenders who write discretionary ARMs can avoid this type of problem by adopting a policy of changing the rate periodically—say every six months—even if the required change is very small. Borrowers then become aware of the rate change process and

that rates decline as well as increase. No one rate increase, furthermore, is likely to be all that large. It will continue to be the case, however, that all borrowers will be affected at the same time.