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1.0 Executive Summary

The Government of Pakistan is in the process of establishing a market oriented housing finance system. A key to this system is the development of Housing Finance Companies (HFC's) which can accept deposits from the public and lend money on the security of property.

To assure the effective operation of such financial institutions, the Government must establish a system for licensing, regulating, supervising and closing these private companies. Such a system must adequately provide for the management of control, liquidity, credit and interest rate risks.

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LICENSING, REGULATION, SUPERVISION AND CLOSURE OF HOUSING FINANCE COMPANIES IN PAKISTAN

August 1990

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Washington, DC

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1.0 Executive Summary

The Government of Pakistan is in the process of establishing a market oriented housing finance system. A key to this system is the development of Housing Finance Companies (HFC's) which can accept deposits from the public and lend money on the security of property.

To assure the effective operation of such financial institutions, the Government must establish a system for licensing, regulating, supervising and closing these private companies. Such a system must adequately provide for the management of control, liquidity, credit and interest rate risks.

Legal Framework

In order to expedite the process of establishing private Housing Finance Companies and avoid a lengthy legislative process, the Government has invoked a provision under current laws which allows its Controller of Capital Issues (CCI) to license companies according to any set of conditions it deems fit. This conditioning provision allows the Government to establish entry requirements (licensing) for owners and managers of Housing Finance Companies. It also allows for the establishment of conditions (regulations) under which these companies can function, and it provides for revoking licenses (closure). The Government has modified its current banking ordinance to extend certain commercial banking oversight (supervision) powers of the State Bank of Pakistan (SBP) to cover HFC's.

This arrangement accomplishes the objective of rapidly implementing a regulatory framework. However, it splits the licensing, regulatory, supervisory, and closure responsibilities between two agencies. While this arrangement is adequate, and perhaps even preferable during the experimental period of establishing and first regulating these institutions, efforts should continue to develop legislation which consolidates all four functions in the SBP.

Additionally, the SBP should be given several intermediate powers to sanction and establish control of institutions being operated in an unsafe and unsound manner. These powers should include removal of directors and establishment of conservatorships. The need for such powers will increase as the efficiency with which HFC's gather funds increases.

Proposed Regulations

The Controller of Capital Issues has issued a draft set of regulations to govern HFC's. These regulations address the issues of entry and capital on an adequate basis. They also address credit risks, but they could be greatly improved in this area. They are largely silent on liquidity and interest rate risks and need additional strength in these areas.

The Government should consider starting its regulatory scheme on an innovative footing which is made possible by the fact that Pakistan's private housing finance industry will be building from the ground up. For one thing, it should consider the use of variable capital requirements tied to the riskiness of the investments made by these institutions, an approach that has only recently been adopted in more developed countries. In addition, it should consider requiring that these institutions, which are exposed to substantial interest rate risk, submit market value based financial reports. It should also explicitly authorize supervisory authorities to take actions against institutions based on these market value reports, regardless of what traditional accounting reports state.

Supervisory Arrangement

The responsibility for supervision of HFC's has been placed squarely on the shoulders of SBP. This arrangement is appropriate due to the current powers of the State Bank and the fact that SBP is already serving this function for commercial banks. Broad powers have been grated to the State Bank, and some added powers, mentioned previously, would strengthen its supervisory position.

However, before the State Bank can be an effective supervisor of HFC's, two conditions must exit. First, SBP must be free to recruit, retain, and compensate people on a par with the private sector. If current restrictions imposed by wage scales and trade unions cannot be overcome, the Government should consider establishing a separate supervisory entity outside the SBP and funded with assessments on the regulated institutions.

Second, these supervisory personnel will need a significant amount of training to assure that they understand the behavior of mortgage portfolios. HFC's should be restricted in their activities until training and policy and procedure development can be completed.

Closure Issues

While the legal framework exists for closing companies that are in an unsafe or unsound condition, the Government of Pakistan needs to develop means whereby its agents can quickly attain control over institutions which are threats to depositors' funds. To the extent that problem institutions become efficient in gathering funds and can grow rapidly, the need to achieve rapid control will become more critical.

2.0 Licensing, Regulation, Supervision and Closure of Housing Finance Companies in Pakistan

Introduction

One of the functions of government in modern societies is to control the risks associated with the gathering of savings deposits from the public and lending those funds to borrowers. Another function of government is to assure that the equity investors in institutions which act in this role of financial intermediary are protected in their investments through adequate disclosure regarding the financial condition and health of these institutions.

In Pakistan this latter function has been assigned to the Corporate Law Authority (CLA), which performs this same duty for all corporations in the country. However, the management of the risks associated with deposit gathering and lending for commercial banks has been assigned primarily to the State Bank of Pakistan (SBP). Since the development of Housing Finance Companies (HFC's) creates new financial institutions, the unique risks associated with them must be identified and assigned to appropriate parties.

The risks associated with these institutions are as follows:

- Control Risks: these are the risks associated with allowing individuals who run financial institutions o gather large sums of money from the general public and manage those funds in a fashion which is in the best interest of the depositors, foregoing the opportunities to use those funds for personal benefit of managers and owners.

- Liquidity Risks: since financial institutions promise to give depositors' funds back with limited prior notice and since these same institutions allow borrowers to keep loaned funds for extended periods specified in loan documents, there is a risk that at any point in time depositors will request that more funds be returned than an institutions has on hand or in liquid form.

- Credit Risks: this is the risk that borrowers will be unwilling or unable to repay their loans and that the lending institutions will suffer losses, even after obtaining title to loan collateral and liquidating it.

- Interest Rate Risk: since HFC's borrow from depositors using savings instruments with relatively short maturities and lend to borrowers using mortgages with maturities of 15 to 20 years, there is a risk of loss associated with short term rates on liabilities (deposits) rising to levels as high or higher than long term rates on assets (loans), creating interest spread losses.

These risks are controlled in most countries by a combination of procedures for the licensing (controlled entry), regulation (establishing rules for conduct of business), supervision (monitoring to determine if the rules are being followed and direction to take corrective actions if they are not), and closure (removing institutions from the business which endangers depositors' funds). In order to accomplish these four functions, a country must establish a legal framework which empowers certain government entities to perform these functions. Regulations must be promulgated, and supervisory policies and procedures need to be established. Closure and winding up functions are also necessary.

Subsequent sections of this report deal with the current legal framework for licensing and oversight of HFC's, the proposed regulation and regulatory structure, the supervisory function, and the closure mechanism now under consideration for HFC's in Pakistan. The current or proposed conditions are described, certain conclusions are discussed, and recommendations are presented.

2.1 Legal Framework for Oversight of Housing Finance Companies

There appears to be general agreement on the part of the government officials that the most logical approach to provide for licensing, regulation, supervision and closure of Housing Finance Companies would be to modify The Banking Companies Ordinance, 1962, to provide for direct oversight of HFC's by the State Bank of Pakistan. There is a similar high level of agreement that such a specific legislative modification would require a minimum of two years to achieve passage by the Pakistani parliament.

In order to avoid the requirement for extended legislative action, Ministry of Finance (MOF) officials have determined that they can establish, license and regulate Housing Finance Companies under authority granted by The Companies Ordinance, 1984. This ordinance generally specifies the rules and requirements associated with formations of companies and sale of stock. However Section 499 of the Ordinance provides that the Authority (Corporate Law Authority) or registrar (any agent authorized to register companies under the Ordinance) may grant companies approvals to commence business "subject to such condition, limitations or restrictions as the Authority or registrar may think fit to impose . . ." This authority to condition approvals for the licensing of companies forms the basis of the Government's ability to control entry into and establish regulations for a housing finance industry.

Part XI of the same Ordinance grants authority under which companies can be "wound up." Such proceedings can be entered voluntarily by a company or can be undertaken by court order. Section 305 of Part XI contains an extensive list of conditions under which the courts can order such actions, and the list is sufficiently broad to incorporate most conceivable circumstances under which Housing Finance Companies might need to be closed. However, the slow pace of the Pakistani court system (which is covered in a separate report by David Madway) necessitates that alternative means be found for the winding up and closure of HFC's if depositors' interest are to be adequately protected.

Thus the legal basis for issues of licensing, regulation and closure of HFC's can be addressed under The Companies Ordinance, 1984. The supervision functions are to be delegated to the State Bank of Pakistan and require legislative action.

Recently, an ordinance called the Banking Companies (Third Amendment) Ordinance, 1989, was implemented by a special provision of the Constitution of the Islamic Republic of Pakistan whereby the President of the country can promulgate a law when the National Assembly is not in session. The effect of this amendment is to extend application of certain provisions of The Banking Companies Ordinance, 1962, through Section 3A, to non-banking financial institutions or other institutions "as the Federal Government may from time to time, by notification in the official Gazette, specify in this behalf." Thus it appears that these powers can be extended to HFC's through a simple notification process.

The impact of this Third Amendment is to grant the State Bank useful supervisory powers applicable to the oversight of HFC's. Those powers are summarized in Table 1 (where "institutions" may be read as HFC's).

Extend of Powers Granted Under the Legal Framework

The licensing powers granted to government registrars under The Companies Ordinance, 1984, are very broad. The abilities of registrars to condition licensing in any way they see fit should provide sufficient latitude for the Federal Government to control entry into the housing finance business. These broad powers should allow the registrars to require that persons organizing HFC's submit background information which documents that individuals controlling such institutions and having responsibility for depositors' funds will be persons of integrity, will have a track record of successful business management, and will be persons of substance.

These powers should allow registrars to specify minimum capitalization for HFC's and limit the types of business such institutions may undertake.

These same powers to condition licensing can be used to regulate the way in which HFC's do business. That is, a wide-ranging set of rules can be promulgated for the operation of Housing Finance Companies under the umbrella of "licensing conditions." Thus there appears to be little restriction on the authority of the Federal Government to control the operation of these companies.

Theoretically, the supervision of HFC's can be done adequately by the SBP under the recent Third Amendment of The Banking Companies Ordinance, 1962. The critical sections of that Ordinance which allow the State Bank to properly supervise these institutions are the following:

Section	Powers
32	Power of SBP to receive periodic reports and to demand special reports as it sees fit.
40	Powers of examination and questioning under oath. Also may recommend to Government the revocation of licenses for institutions and application to the High Court to wind up institutions.

Section	Powers
41	Broad powers to issue specific directives to a set of institutions or individual institutions.
42	Powers to prohibit specific transactions, assist in merging institutions, call on boards of directors to take action, and to require removal of management.

While these powers are extensive and impressive, other powers are needed. The underlying need for added powers rests on the fact that supervisory authorities need additional intermediate sanctions -- between persuasion/directives and closure. For instance, the State Bank should have the power to remove directors (as it does for banking institutions in Section 41A of The Banking Companies Ordinance, 1962). It should also have the power to install conservators to act in the stead of directors and management of HFC's which are being operated in an unsafe and unsound manner (as it does for banking institutions in Section 41B of The Banking Companies Ordinance, 1962).

It would also be useful for supervisory authorities to enter into supervisory or letter agreements with institutions whereby the supervisory agent agrees to forebear in taking more drastic action if the institution agrees to correct past problems and meet specific milestones laid out in a correction action plan. One additional enforcement tool which might be useful to the supervisors is the power to issue cease and desist orders. A findings at subsequent examinations that the conditions of the cease and desist order have been violated should then lead to expedited removals of officers or directors, establishment of conservatorships, or winding up.

The closure of HFC's is possible under the legal framework now in place in Pakistan. The State Bank may apply to the Federal Government, based on examination results, to have an institution prohibited from taking new deposits. The Government may direct the State Bank to apply to the High Court for winding up the institution (see Section 40 of The Banking Companies Ordinance, 1962). This process allows an opportunity for the institution to respond to criticism and to present the Federal Government with its point of view.

However, it is possible that a great deal of mischief can be done if a financial institution is being run in an unsafe and unsound manner -- especially by parties who believe that a government takeover is imminent. Thus it is important that representatives of the SBP and the Federal Government work closely and in harmony so that management of institutions cannot play them off against one another. This is also why supervisory authorities must have clear power to install a conservator in an institution pending the resolution of disagreements concerning its condition or operation on the part of the Federal Government or the High Court. Actions requiring High Court disposition could, of course, require an extended period of time.

The three elements: 1) potentially slow High Court response, 2) no conservatorship powers for supervisors or regulatory and 3) the ability of desperate or unqualified HFC management to carry on the business of managing millions of rupees in assets, could be a potentially explosive combination. To the extend that HFC's become efficient in gathering deposits in short periods of time, the potential for damage through unwise investment of deposits becomes even greater. Giving conservator powers to supervisory agents appears to be the most expedient solution to this problem and assure that supervisory officials can achieve speedy control over institutions engaged in activities detrimental to the interests of depositors.

Conclusions Concerning the Legal Framework

Given the constraints of time and politics involved with passing legislation to create an entirely new regulatory framework, the approach taken by the Government of Pakistan to incorporate a licensing, regulatory, supervisory and closure scheme within its existing legal structure is innovative and will provide an adequate structure. Some improvements are necessary, however, to refine the supervisory powers of the State Bank and allow it to take actions which are more measured than may now be possible. Also, there is a need to assure that institutions in the initial stages of serious problems and which may be headed toward winding up activities can be put under responsible control until disputes are resolved by the Federal Government authorities or the High Court. Finally, efforts, should continue to draw legislation which provides a long-term, unified legal framework for licensing, regulation, supervision and closure of HFC's and achieves the preferred approach of putting all four of these functions under the State Bank of Pakistan.

2.2 Regulatory Structure

The proposed regulatory structure for HFC's is constrained by the need to proceed with the establishment of these institutions, where at all possible, within the current legal framework without substantial changes requiring extended legislative debate. The result is a proposed system with somewhat fragmented responsibilities for oversight of the functions performed by HFC's. The Corporate Law Authority will have responsibility to oversee the equity securities activities of these institutions. The Controller of Capital Issues will have responsibility for the licensing, regulation and closure functions. And the State Bank of Pakistan will have the supervisory responsibilities. In addition to performing examinations and reporting its activity to the CCI, the SBP will also have certain powers to issue directives to institutions, to recommend regulatory changes to the CCI, and to recommend to the CCI that closure actions be initiated.

This system of divided responsibilities has certain advantages. It provides some check and balance between various oversight functions and helps to protect institutions from having one overzealous agency regulate them.

The major disadvantage of this system of divided responsibilities is that the process of making regulatory changes or taking strong supervisory actions (such as revoking licenses or applying for an expedited winding up) can be slowed when it is necessary to involve multiple offices in semi-independent or totally independent agencies. In situations where oversight responsibilities are shared, there is the added problem of determining just which group is accountable for the overall performance of the regulated institutions. Also, attempts by officials to establish responsibilities and clarify different organizations' roles can lead to accusations of bureaucratic empire building.

The conclusions concerning the Regulatory Framework are similar to those cited with regard to the Legal Framework, which established and assigned the various regulatory responsibilities. Namely, successful operation of the regulatory apparatus will require a great deal of cooperation between the individuals and organizations with oversight responsibilities for HFC's. In addition, legislative initiatives should be pursued to consolidate the oversight powers under a single agency. A new agency is not necessarily needed since the SBP is the logical home for these powers, once the experimental period of oversight for HFC's has passed and the Ministry of Finance is comfortable with the nature and operation of the private housing finance industry. However, certain operational issues associated with SBP as a supervisor must be resolved. These are covered in subsequent sections.

Proposed Regulations

Several drafts of regulations governing the licensing and operations were circulating during July, 1990, in the form of a Statutory Notification, or S.R.O. These proposed regulations deal with a number of the risks which HFC's pose. Subsequent paragraphs address the way in which these regulations approach control risks, liquidity risks, credit risks, and interest rate risks defined in the Introduction of this report.

The major focus of the S.R.O. is on the licensing questions, and the provisions of the S.R.O. are aimed primarily at addressing control risks. For instance, HFC activities may commence only after a company received affirmative approval from the government, applications must be in a form and contain information required by the government, and the information needed can be changed at any time by a notification order. Only organizations of financial substance can become HFC's (those with an initial capitalization of Rs 100 million or more). Persons with unsavory backgrounds are barred from being officers or directors, and HFC's must obtain insurance coverage to guard against employee theft or fraud. An HFC cannot make loans to affiliated parties (employees, officers, directors, or shareholders) who have a significant ownership in the company (more than 10% of paid up capital) and cannot employ these people as brokers, directly or indirectly. Controlling interest in an HFC cannot be transferred without government approval.

These provisions, together with the broad powers of the SBP to issue directives to resolve unsafe and unsound activities at HFC's provide an adequate initial coverage for regulations which address control risks. Later modifications may be necessary if experience demonstrates it is appropriate to identify and regulate certain types of control risks more explicitly.

However, the proposed S.R.O. does not clarify how liquidity risks will be handled. While it lists the approved means of raising funds, neither it nor he ordinances which authorize HFC's appear to mention the authority under which an HFC can borrow from the SBP or similar entity. However, SBP personnel apparently recognize this and agree that some sort of credit facility must be made available through the State Bank. This facility must be identified and the rules under which funds are advanced and repaid must be established prior to opening any HFC's.

The S.R.O. deals with credit risks in a somewhat patchy way. First, the minimum initial capitalization of Rs 100 million provides a cushion against loss of depositors' funds. Also, requirements (contained in some S.R.O. drafts) hold that subsequent to opening its doors an HFC must maintain a capital ratio in excess of approximately 14.3% for the first two years of operation and later exceed a 10.0% ratio of capital and reserves to deposits. These are conservative ratios by standards in western economies. But they are not based on actuarial data or experience in the Pakistani economy since private HFC's are new institutions. Therefore, initial underwriting standards used by HFC's should be conservative, and capital levels and asset quality should be monitored closely to assure that an adequate cushion is maintained at all times to protect depositors' funds.

There seem to be some inconsistencies in the provision of the most recent drafts of the S.R.O. HFC's are authorized to make loans and advances to individuals, projects and housing companies. Loans can also be made on the security of nonresidential property. However, the maximum loan size is initially restricted to Rs 300,000 which is an amount that would not likely be of interest of housing companies or individuals constructing nonresidential properties. The impact of this loan limit will be to restrict the activities of HFC's to residential lending to individuals, a result which may be intended. It is certainly prudent during the initial experimental stages of HFC operation.

The S.R.O. lays out a few (very few) underwriting guidelines--noting that advances should be made for periods "up to 15-20 years..." (one figure should be chosen) and debt service for the loan should consume no more than 33.3% of monthly income. There are many other factors which should be considered in underwriting decisions. Also, underwriting issues and standards should be considered for nonresidential and home improvement loans. That fact that some drafts of the S.R.O. specify different loan-to-cost limits for residential, nonresidential, and improvement loans indicates the drafters recognize that these different types of loans carry different levels of risks.

Due to these different levels of risk, the credit risk profile of different HFC's could differ significantly from one another, depending on the mix of residential, nonresidential and home improvement lending pursued by the institutions. Thus it might be more appropriate for regulations to require institutions' boards of directors assure that underwriting guidelines appropriate to the type of lending done by an institution be in place and that internal auditors review actual lending practices relative to the guidelines and report their findings to the board. The boards should be relieved of approving each loan by at least a two-thirds vote. Boards should be left to establish and monitor general policies and should not serve as underwriting committees, except for very large or unusual loans. Examiners from the State Bank must be trained so that in their inspections examiners are capable of effectively evaluating boards' underwriting guidelines and performing file reviews to determine the extent of compliance to those guidelines.

The S.R.O. specifies that an HFC's "financing and investment policy shall be clearly and concisely stated in its Memorandum and Articles of Association and the prospectus published for the offer of its securities." A useful extension of this requirement would be to ask that, during its first five years of operation, each HFC submit an annual business plan to the SBP, outlining its intended lines and volumes of business, expected markup and margins, its projected loss experience, and its forecasted profits. Such plans would help the examination personnel determine which institutions are planning to pursue risky business ventures and therefore need closer monitoring. Also, the business plan would help instill a planning discipline in the managements of these companies and would give examiners a standard against which they could audit for results.

Since different lending strategies and portfolios mixes produce different levels of risk, the Government should consider variable capital requirements based on the riskiness of the institutions' investment portfolios. Capital requirements based on international standards currently being discussed should be examined.

Further credit risk issues are addressed in the proposed S.R.O. They include the requirement that properties securing loans be covered by adequate (not defined at this time) fire and casualty insurance. Loans are to be made at "prevailing rate" (again not well defined). Also, loan fees are specified. The application fee is set at Rs 300, but it would seem more appropriate to leave such a fee to market forces or to specify the fee as some percentage of the amount to be borrowed. Or better yet, it could be indexed to some base so there is no need for continual revisions and subsequent S.R.O. issues just to modify an outdated fee.

The serving/administrative fee is specified as .25% of the balance outstanding on a loan. This figure is low by standards in other countries where large automated loan servicing operations are standard. Raising the limit on this fee should be considered. Also, the direct cost of serving a loan tends not to go down as the balance goes down. But the .25% servicing fee drops with the loan balance and could encourage institutions to abandon servicing of low-balance loans once they become uneconomical to handle. Since the HFC industry is being established from the ground up, it would be wise for the regulatory bodies to consider establishing fees that closely reflect the economic costs associated with actions required by the HFC's.

Losses associated with the acceptance of credit risk, according to the draft S.R.O., are supposed to be absorbed by a reserve fund. This fund is established by an HFC's setting aside "at least 25% of its net profits." HFC's will have to withhold the payment of dividends until such time as the reserve is built up to a level specified by "the Central Government." This appears to be a prudent initial policy, given the uncertainties of HFC operation as a new institutional type in a country where significant losses are being incurred at that country's single largest residential lender, the House Building Finance Corporation (HBFC).

The proposed S.R.O. does not address the issue of interest rate risk. This risk is likely to be rather pronounced at HFC's due to the fact that they anticipate taking deposits with minimum maturities of 30 days and lending for up to 20 years. The expected life of a mortgage in Pakistan is likely to be longer than the seven to eight years seen in the United States. In Pakistan, the housing turnover is significantly slower due to lower population mobility and traditions which involve passing housing ownership on through families.

Significant increases in interest rates could expose HFC's to serious earnings problems as the yield required to fund operations on a short term basis rise and the return on long term loans remains constant. The reaction of institutions caught in this type of earning squeeze is likely to be an attempt to "grow out of the problem" by dramatically increasing originations of mortgages at the new, higher rates. This is an effort to make the old portion of the portfolio, with negative returns, a smaller percentage of the overall portfolio and thus less damaging to earnings. The problem with this growth strategy is that institutions are tempted to lower their underwriting standards to achieve their growth targets.

Since the consequences of interest rate fluctuations can be so serious for HFC's, it is imperative that steps be taken to both measure the extent of, and to mitigate the impact of this risk. It is important that the supervisory agents of HFC's have the explicit power to obtain reports which measure the extent to which these institutions are exposed to interest rate risk. This power appears to exist implicitly under the provision that the SBP can require reports in any form it deems fit. HFC's need to be authorized to take steps to protect themselves against these risks, just as they are authorized and encourage to protect themselves against currency exchange fluctuations through hedging activities. It is important that institutions be able to demonstrate they have the sophistication and the experience personnel to undertake such hedging and maturity matching activities prudently.

Once the supervisory agents have reports which show the level of interest rate risk exposure for an HFC, they can take appropriate action to request the reduction of excessive levels of risk.

The economic value of interest-rate-sensitive assets and liabilities differs from the accounting value of the same items when interest rates have undergone significant changes since the accounting values were recorded on the HFC's books. The supervisory agents should be able to examine the books of HFC's on the basis of market values for assets and liabilities and then take action against HFC's in cases where their true economic values are so low as to endanger the depositors--regardless of what the traditional accounting reports state. This power is implicit in Sections 40 and 41 of The Banking Companies (Third Amendment) Ordinance, 1962; however, it should be stated explicitly to highlight the importance of managing interest rate risk to the health of HFC's.

2.3 Supervisory Arrangements

The proposed arrangements for supervision of HFC's puts the responsibilities for monitoring and reporting on these institutions squarely on the shoulders of the State Bank of Pakistan. This is a logical place to house those responsibilities. SBP already has experience in examining, or inspecting, commercial banks on a periodic basis, and it already has similar supervisory responsibilities for the banking companies. Thus the State Bank should be the focus of the examination and supervisory talent which presently exists in the country.

However, there are two serious concerns which must be addressed if SBP is to be an effective supervisors of HFC's. The first is the requirement that the State Bank have the ability to recruit and retain qualified people. Pay scales comparable to those paid for people with comparable skills in the private sector should be available to inspection and supervisory personnel. If they are not, the State Bank will experience constant employee turnover as the best personnel are trained to be effective and then hired away by the HFC's or professions which advise HFC's. The newly hired replacements will find themselves trying to supervise the activities of institutions staffed with and advised by people who are more experienced and better trained than the supervisors. It is equally important that the State Bank have the ability to promote and assign personnel solely on the basis of merit without giving consideration to external influences from trade associations or trade unions.

The problems of low wages and union influence have been discussed in other reports dealing with SBP (see Pakistan Financial Sector Review, Volume II, pp. 196-202). The recommendations contained in these reports are appropriate. If better pay scales and freedom from union restrictions on recruitment and placement of SBP officers cannot be achieved within SBP, the Government should consider setting up an independent organization without the current salary and hiring restrictions. Such an organization could be funded by assessments on the institutions being inspected and supervised.

The second major concern which must be addressed if SBP is to be effective involves training. Even highly qualified and well compensated people, if they can be recruited and retained, will need training in the issues surrounding mortgage finance. Long term mortgage instruments behave differently than short term commercial loans. Underwriting issues are significantly different since business loans depend on the cash flows and profitability of a business or a project for repayment. Mortgages depend on both the ability and willingness of the borrower to repay the loan, which are necessarily not associated with business income-generating activity.

Both examiners/inspectors and supervisory agents will need intimate knowledge of mortgage loan financing arrangement and appropriate documentation standards. Skills in assessing borrower credit worthiness are critical. SBP inspectors should be capable of classifying assets according to procedures being discussed and developed in the international banking community.

Comprehensive inspection and supervisor policies and procedures will need to be developed. Some of these can be lifted from the material used in SBP's oversight of commercial banks. However, significant start-up efforts will be required, and this argues for restricting the initial activities of HFC's to relatively simple single family residential lending while training of supervisory personnel can be completed and a full set of supervisory policies and procedures can be developed to cover the range of legislatively authorized HFC activity.

Lending on the security of collateral is difficult in Pakistan and this complicates underwriters' jobs. The value which institutions, underwriters and the Government's inspectors place on collateral is complicated by two factors. The first is that Pakistan's real estate appraisal system is not well developed. Attempts to refine it are frustrated by the fact that there is an incentive in the Pakistani economy for recording property at less than their acquisition costs in order to minimize wealth taxes. Even more importantly, the value of collateral backing up a mortgage may only be illusory if foreclosure proceedings cannot be expedited, premises vacated, and properties sold within reasonable time frames. This means that underwriting standards will need to be based much more on issues of income and integrity of the borrower than on collateral value as is the case in many countries' economies.

Thus a corps of well qualified, well paid, and well trained supervisory agents will be required to supervise the activities of the new HFC's. The potentially vast sums that can be loaned in the form of mortgages, the complex behavior of interest sensitive financial instruments, and the exposure to both new credit and interest rate risks on rather large scales mean that relatively small amounts spent in the recruitment, compensation and training of supervisory personnel will be well worth the investment.

2.4 Closure Issues

The legal framework exists for closing HFC's which are in an unsafe or unsound condition and which cannot be rehabilitated. Prior sections of this report have mentioned the need for intermediate penalties and sanctions short of revoking licenses or application to the High Court for a winding up order.

If intermediate or closure actions are to be effective, speed in implementing those actions is critical. Supervisory agents should have the powers to install conservators at HFC's just as they can in commercial banks under Section 41B of The Banking Companies Ordinance, 1962. In addition, if the winding up process cannot be accelerated, the current authority to renew conservatorships for only two years should be modified.

As HFC's become efficient in their ability to attract deposits, they will be in a position to grow more rapidly than they can initially. Those which may be operating in an unsafe and unsound manner will then be able to compound their problems more quickly. During the United States' experience with failing housing finance companies, regulators found that some institutions grew rapidly by offering high deposit rates and then investing these new funds in potentially high return schemes--with the attendant high risks. Many of these thrifts lost substantial sums of money when the risky investments went sour. To the extent that HFC's accomplish the same deposit-raising efficiency, the SBP and ICC personnel involved in oversight of problem institutions must be willing to be aggressive in exercising their options to revoke licenses and/or deny accepting of new deposits.

3.0 Overall Conclusions and Recommendations

The overall legal framework for the licensing, regulation, supervision and closure of Housing Finance Companies in Pakistan is adequate. However, it could be strengthened by giving the supervisory agents power to establish conservatorships and remove directors. Legislation to allow the entire oversight function to be consolidated under the State Bank of Pakistan should be pursued.

The proposed regulatory structure is potentially adequate. However, it will require close cooperation to assure that the licensing, regulatory, and closure functions performed by the Controller of Capital Issues is well coordinated with the broad supervisory powers of the State Bank. After an initial experimental period in which the problems associated with oversight of HFC's are worked out and legislation can wend its way through the National Assembly, the consolidation of these functions under the State Bank would be appropriate.

The proposed regulations in the draft S.R.O. address a number of important licensing and regulatory issues. However, they are silent on many other matters which should be addressed. For instance, they could be improved by requiring that institutions submit business plans showing the volume and mix of lending they intend to pursue and thereby indicating to supervisory personnel which institutions require closest monitoring. The regulations should address liquidity and interest rate risks, which they largely ignore in their current state. Supervisory personnel should be explicitly authorized to take action against institutions whose economic value, rather than accounting value, reaches a point which endangers depositors.

Finally, regulatory and supervisory issues associated with HFC's will be substantially different from those associated with commercial banking institutions with which banking officials are currently familiar. It is critical that regulatory and supervisory agencies be allowed to recruit and retain highly qualified, well trained, and appropriately compensated personnel to staff the oversight functions.