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Abt Associates Inc.

THE DEVELOPMENT OF HOUSING FINANCE IN SRI LANKA

PREPARATION OF A WORKING AGENDA FOR THE HOUSING FINANCE STEERING COMMITTEE

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1.0 OVERVIEW AND SUMMARY OF RECOMMENDATIONS

1.1 Introduction

The Government of Sri Lanka (GSL) is currently undertaking fundamental changes to its economy. State-dominated ownership and control are giving way to deregulation and an increased role for the private sector. The financial sector is one of the key targets for liberalization. Directed credit policies and barriers to market-determined interest rates are being reduced; numerous proposals for further restructuring and privatization are under consideration; and private sector financial institutions are playing an increasingly important role.

Within this context, fundamental changes are being sought in the delivery of housing finance. With the support of USAID and the Asian Development Bank, the GSL is implementing policy changes with regard to the roles of existing institutions in providing housing finance and seeking the transformation of the sector's activities in accordance with market-based principles. Major goals include restructuring the activities of the State Mortgage Investment Bank (SMIB) and the Housing Development Finance Corporation (HDFC), with the intent of eventual privatization; enhancing the role of the private sector in delivering housing finance; and continuing efforts to increase the availability of long-term funds. Given the current dominance of public sector institutions and the distortions endemic to systems based on directed credit and controlled rates, these reforms, taken together, point to a new phase in public/private coordination.

Nevertheless, major problems of direction and consistency remain to be solved. Problems that particularly impact housing finance include (1) a "non-level playing field", that is, privileged competition from state-owned institutions that inhibits the emergence of the private sector; (2) the "crowding out" by government debt policies of access to long-term funds; and (3) distortions in interest rate policies that undermine determination of market rates.

Interestingly, in some respects, policy reform in the housing finance sub-sector is at least as advanced, if not more so, than for the financial sector overall. Sri Lanka has been an active proponent of innovative housing programs; the quest to provide improved housing to all segments of the population has included attention to developing housing finance. The GSL is now working to ensure that housing finance operates according to market principles and increasingly involves the private sector. Thus, the GSL is working closely with USAID in its efforts to enhance the participation of private commercial banks and cooperatives in housing finance. The Government is also working with the Asian Development Bank to restructure and eventually privatize the SMIB and HDFC.

In order to consolidate policy planning and implementation for housing finance, the GSL has established the Housing Finance Steering Committee (HFSC), which will provide policy coordination and support for the entire sector. As the highest policy advisory body, the HFSC will undertake the following roles and responsibilities:

- overall policy decision making and implementation for housing finance;
- coordination of the housing finance policy reforms efforts of the various GSL Ministries, institutions, and donors;

- coordination with reform efforts in the financial sector which impinge on the evolution of housing finance;

- establishment of a forum for resolution of policy differences; and

- establishment of agendas for training, technical assistance, and performance monitoring for the sector.

In addition to its goals for sector-wide reform, the HFSC will implement USAID's Housing Guarantee IV Program. Establishment of the HFSC is one of the conditions precedent of USAID's Housing Guarantee IV Program, the major goals of which include the following:

- provision of housing finance by private financial institutions, including private commercial banks, finance companies, the Cooperative Rural Banks (CRBs), and the Thrift and Credit Cooperative Societies (TCCS):

- adherence to market-based principles in provision of housing finance, especially through establishment of market rates of interest; and

- increased access of low income households to public and private sources of housing finance, including targeting of funds to the very poor in a manner effectively separating grants and loans.

The HFSC is co-chaired by the Secretaries of the Ministries of Policy Planning and Implementation (MPPI) and Housing and Construction. The Secretary of MPPI is also the Secretary for the Ministry of Finance, which is directing other financial sector reform efforts. The Director, National Planning, is the Secretary to the Committee. The appointed members are:

- Director, Development Finance Department, Central Bank of Sri Lanka

- Chairman, National Housing Development Authority

- Chairman, State Mortgage and Investment Bank

- Director, National Planning, Ministry of Policy Planning and Implementation

- Chairman, Ceylinco Group

- Chairman, John Keells Holdings Ltd.

The Committee's broad representation across public sector institutions involved in housing and housing finance and the inclusion of private sector representatives effectively support its broad mandate for reform. Given its representation at the highest level of the Ministries responsible for housing, planning, and finance, the HFSC is well able to provide the needed policy direction. The numerous duties of its members, however, preclude their day-to-day involvement. Thus, as discussed below, one of the most urgent recommendations is provision of appropriate long-term staff and local and foreign short-term technical assistance. Immediate staffing with an experienced advisor having a background in financial sector issues is crucial to timely implementation of the HFSC's agenda.

The remaining sections of this report seek to provide a context for describing the roles and responsibilities of the HFSC. Chapter 2.0 summarizes the major issues facing Sri Lanka's financial sector. The structure of the current Housing Guarantee Program is also described in this section. Chapter 3.0 provides an analysis of the important policy issues facing the HFSC in reform of the housing finance sector. Finally, Chapter 4.0 sets forth our recommendations for the staffing, agenda, and operations of the Housing Finance Steering Committee.

The remainder of this introductory section summarizes each of these topics.

1.2 Major Policy Issues in the Reform of Housing Finance

There is a large overlap between the policy issues facing the overall financial sector in Sri Lanka and those facing housing finance in specific. The HFSC will be involved in supporting the privatization process, including the encouragement of private sector participation as well as the privatization of SMIB and HDFC. The evolution of housing finance will also be dependent on the development of a market for long-term debt, both for funding its lending and for establishing appropriate interest rates. Thus, the HFSC will need to closely monitor developments elsewhere in the financial sector and coordinate with other GSL Ministries and donor representatives pursuing policy reforms.

There are a number of important policy issues specifically affecting the implementation of the current HG and the continuation of private sector involvement. These include:

- ensuring a "level playing field" with regard to borrowing rates;
- development of a variable rate mortgage for the HG Program and consideration of other alternative mortgage designs;
- monitoring the direct lending and on-lending under the HG and studying the adequacy of the spread;
- study of alternative methods of enhancing recoveries.
- regulation and supervision of housing finance

The technical adviser to the Committee, the technical adviser to AID, and the technical advisor to the ADB should be able to contribute to the development of position papers on these and other topics. Working groups under the auspices of the HFSC would seek consensus solutions to recommend to the Committee.

1.3 The Agenda of the Housing Finance Steering Committee

The broad-based reforms being considered in the overall financial sector, the momentum for reform on multiple fronts in the housing finance sector, and the innovative nature of the current Housing Guaranty Program, together present a very expansive agenda for the Housing Finance Steering Committee. And, as discussed above, there is a need for timely action, since distortions and problems in the financial sector will have a negative impact on the success of efforts to rationalize housing finance.

Figures 1.1 and 1.2 summarize the key issues facing the HFSC and the administrative functions required to help design and implement these policy reforms. Figure 1.1 lists the roles and responsibilities of the HFSC; these functions are designed to make the HFSC highly visible as well as enabling the Committee to carry out its mission. In the short-run, it is important to establish the HFSC's reporting and coordinating efforts; in the longer-run, the HFSC must formulate plans and carry out studies for implementing the policy agenda. The HFSC should assume the following roles and responsibilities:

- serve as a forum for policy decision making
- serve as a forum for coordination of GSL and donor policy reforms in housing finance
- serve as a forum for conflict resolution, particularly as regards the roles of public and private institutions
- provide a venue for establishment of working groups and conduct of special studies
- undertake sector-wide communication and performance monitoring
- provide a forum for design of housing finance training and technical assistance strategies

Figure 1.2 presents an overview of the issues facing the HFSC. The Committee has numerous tasks to address. For convenience, we have separated the agenda into four areas, depending on the time frame (short-term and long-term) and the focus (the Housing Guarantee Program in specific or housing finance/financial sector overall). In summary, the four areas are:

(1) the short-term agenda for the HG -IV Program, which includes finalizing the roles of the sub-apex and direct lenders and the interest rate structure for the program;

(2) long-term guidance and monitoring for HG-IV. Major issues include assessing interest rate and on-lending policies as the project continues, with a long-term focus on incentives for continued involvement of private sector institutions in housing finance after the HG is completed;

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Figure 1.1

HOUSING FINANCE STEERING COMMITTEE
ROLES AND RESPONSIBILITIES

HOUSING FINANCE STEERING COMMITTEE	Policy Decision Making →	• Full Committee Meetings • Working Groups • Forum for resolution of problems in financial reform
	Performance Monitoring and Communication →	• Performance Indicators Data Base • Published Minutes • Media Releases
	Working Groups and Special Studies →	• Analysis of Key Sector Reform Issues • Technical Assistance Plan for Research
	Coordination of Financial Reforms →	• ADB Housing Finance Reforms • GSL Financial Sector Reforms
	Design of Training and Technical Assistance Strategy →	• Training and Technical Assistance for Private Sector Lenders

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Figure 1.2

HOUSING FINANCE STEERING COMMITTEE
POLICY REFORM AND IMPLEMENTATION

Focus / Time Frame	Short-Term Agenda	Long-Term Agenda
HOUSING GUARANTEE PROGRAM IV	• Finalize roles of Sub-Apex lenders (Hatton National Bank, People's Bank, others) • Finalize roles of Primary Lenders TCCS, CRBs and others. • Finalize interest-rate structure and on-lending policies	• Ongoing Institutional Involvements (Private Banks and Finance companies) as direct and/or Sub-Apex lenders • HG Interest Rate Structure • Training and technical assistance to lenders
HOUSING FINANCE SECTOR	• Secure long-term staff and institutionalize working groups • Set a meeting schedule and reporting format, media presentations • Provide liaison to ADB Housing Finance Program • Provide liaison to other GSL Financial Sector Reform efforts • Selection of Performance Indicators and Design of Data Base	• Interrelationships of Financial Sector and Housing Finance Reforms • Institutional Structure in the Housing Finance Sector • Financial Sector Interest Rate Structure • Generation of Long-term funds • Regulation and Supervision

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(3) the short-term steps needed to assist in sector-wide reform, which emphasize creating an institutional structure for the HFSC to enable coordination with overall financial policy. The major tasks include securing long-term staff and establishing formal Working Groups; and

(4) the long-term agenda for policy development, research, and coordination, as both housing finance and the financial sector continue to move toward a market system. As noted above, major issues include interest rates, long-term funds, regulation and supervision, and the roles of the public and private sectors.

1.4 Summary of Recommendations

The policy reform and implementation tasks, summarized above, are discussed at greater length in Chapter 4.0. In addition, our recommendations for the administrative and policy development tasks are discussed in Chapter 4.0. This section summarizes the key recommendations, which are grouped under the following topics:

- institutionalizing the HFSC: selecting a long-term staff member and formalizing three working groups focused on the Housing Guarantee Program, the housing finance sector, and the financial sector reform efforts;
- addressing policy issues in the design of the Housing Guarantee Program and in ongoing sector-wide issues; and
- monitoring the HG Program in order to help ensure the continued involvement of the private sector in housing finance.

1.4.1 Institutionalizing the Housing Finance Steering Committee: Long-term Staff and Working Groups

The HFSC Secretariat. Only a limited amount can be accomplished until the Secretary of the HFSC can draw upon permanent, long-term staff. We suggest that the HFSC Secretariat have the following composition:

- Director: Secretary, National Planning, MPPI
- Long-term Technical Advisor to the HFSC
- Permanent HG Monitoring Staff: MPPI
- Short-term Technical Experts
- Short-term Implementation/Facilitation and Evaluation

The permanent staff member from MPPI will help the HFSC director monitor the HG Program; it is our understanding that this staff member has already been assigned to the HFSC.

The long-term technical advisor will assist the Director in design and implementation of policy reforms, preparation of technical working papers, and scheduling and convening the meetings of the full Committee and the Working Groups. The advisor should have a degree in finance or economics and solid experience in financial operations and policies. Securing this individual is an urgent priority. Note that the HFSC technical advisor is not the same as long-term advisor sought by USAID to assist in HG implementation and other housing sector tasks. There are two positions to be filled: one long-term advisor directly attached to the HFSC and another housed at USAID. The USAID advisor will serve as a resource to the HFSC, as will local and foreign short-term technical experts brought in to assist in technical studies, monitoring and evaluation, and training.

Working Groups. We recommend that three Working Groups be formed: (1) the Housing Guarantee Program Working Group; (2) the Housing Finance Institutions Working Group, and (3) the Financial Sector Reform Coordination Group. Each of these has a distinct membership and agenda (see Chapter 4.0 for a list of recommended participants). In summary:

- the Housing Guarantee Working Group has the most urgent agenda, because important design issues are still outstanding. It is crucial that all participants in the HG program meet on a regular basis without the necessity of convening the full HFSC;

- the Housing Finance Sector Group includes all the key institutional participants in housing finance; its membership most closely mirrors that of the HFSC, but it also includes, for example, the National Savings Bank (NSB), and key participants in the HG, such as the Hatton Bank and FTCCS. The major goal of this group is coordinated development of the reform policies noted above in Section 1.2 (and further elaborated in Chapter 3.0);

- the Financial Sector Group is composed of the key GSL and donor groups active in policy development, including the Ministry of Finance, the GSL Banking Commission, USAID, the ADB, and the World Bank. The key purpose of this group is liaison, that is, coordinated evolution of financial sector policies.

The Working Groups are expected to take pressure off the full committee, whose members are very senior and do not have the time to address all the issues we think are important. The groups will also have agendas focused on very specific topics. The Director of the HFSC is the chairman of all the Working Groups, but the HFSC technical advisor serves as the Secretary, and is expected to undertake the major share of the administrative and technical efforts. Similarly, Working Group members should appoint a staff person to serve on a day-to-day basis as their designate. We are seeking the development of strong staff-to-staff ties so that the research and communication necessary to policy development can go forward at an acceptable pace. The HFSC technical advisor should prepare schedules and agendas as soon as possible. The Housing Guarantee Working Group, in particular, should immediately begin its efforts.

1.4.2 Policy Design and Implementation Issues for the Housing Guarantee Program

As noted, the agenda for the Housing Guarantee Working Group is urgent and important. The issues include the following:

Separation of Grants and Loans: Simplifying the HG Structure. We recommend that the HG Program consider doing away with the bridging loan program as it is now structured. The grant and loan programs would be made entirely separate: grants would be administered by NHDA and all loans would be offered by banks and cooperatives participating as direct lenders under the HG.

Only very poor households would receive grants, as it is now structured under the program. However, only some of these households would receive a loan. Thus, some households (for example, up to the 25th percentile), could get both grant and a loan. Only households who meet the underwriting criteria of the lender would receive loans; those who do not meet the underwriting criteria are not guaranteed to also receive a loan. Especially in situations where there is not collateral, there are two important aspects to consider in lending: income and other non-income criteria. Thus, underwriting becomes of utmost importance, and lenders consider factors such as personnel knowledge of the borrowers; membership in the cooperative society; savings record; and prior repayment records. While level of income is clearly important, the source of income and the expected level of income variability should also be considered.

Thus, this recommendation seeks to accomplish the following:

- the program structure is simplified. Grants and loans would be entirely separated. All lending would be done by the financial institutions and cooperatives acting as direct lenders;

- loans are offered only to households deemed to be qualified by a lender; loans are not automatically a function of income as defined by those eligible for grants.

Insurance Scheme. We do not currently recommend the institution of a formal insurance scheme. The participating private commercial banks, at this point, seem to consider the spread adequate to cover risk. Implementing an insurance scheme is complicated; more importantly, it does not imbue the program with the credit climate that is desirable, that is, the continued involvement of private banks on a commercially viable basis. The one percent charge that is now levied by the Central Bank can serve as a contingency fund is desired, but need not be formalized as an insurance scheme.

Sub-Apex Lenders and Direct Lenders. For simplicity in beginning the program, it may be desirable to start with only one or two sub-apex lenders. In the medium-term, however, it is important to get as many private sector sub-apex/direct lenders involved as possible. This allows the non-sub-apex direct lenders to have a choice of sub-apex institution; allows the ultimate borrower to have a choice of lending institutions; and most importantly, increases the involvement of private sector banks and/or non-bank financial institutions in housing finance.

Variable Interest Rate Lending. There are two aspects to the issue of variable rate lending. First, under the HG, the onlending rate will be reviewed every 6 months and the HFSC could recommend changes in the rate structure it warranted by new circumstances. Second, in addition, the HFSC may wish to address the issue of VRMs -- variable interest rate mortgages -- in the HG Program. HDFC has introduced VRMs; it is our understanding that SMIB will also do so. This issue should be addressed once VRMs are established in the market; use of VRMs would be beneficial if inflation stays relatively high.

1.4.3 Monitoring the Housing Guarantee Program to Promote Long-term Financial Sector Development

As has been noted, sector-wide reform for housing finance must deal with major issues of institutional structure, sources of funding, and interest rate policies. These issues will shape the HFSC's long-term agenda, the formulation of working groups, selection of research topics, and so forth. The success of the HG, however, is also very important to the long-term structure of the housing finance sector.

The HG program essentially offers private sector institutions access to long-term funds at below market rates. While these institutions are assuming the risk (as the program is currently being structured), the "spread" appears to be adequate to allow them to "get their feet wet".

The obvious question is whether these private sector participants will continue to lend for housing finance, using their own resources, after the HG is completed. If the spread proves inadequate (for example, debt recovery is difficult or too time consuming, or administrative costs are in excess of plans), HG participants will re-examine their strategies. If, on the other hand, the structure proves to be commercially viable, private banks, other financial institutions, and cooperatives will be more likely to continue housing finance lending to lower income households and also to extend their lending into the rest of the income distribution.

The HFSC can impact this outcome in perhaps two ways: (1) very careful monitoring of HG market rate lending activity, to anticipate and deal with problems before they become severe; and (2) design of training and technical assistance packages in conjunction with the private sector participants so that their needs are addressed as fully as possible. Thus, the HG and the "overall" sector aspects of the HFSC's agenda are very closely linked.

Several factors requiring monitoring are noted here in addition to the design issues discussed above:

Spread. There seems to be a great difference of opinion as to whether the spread currently built into the program is at the appropriate level, or is too high or too low. There is really no way to determine a priori whether eight percent is, in fact, "correct". This is a function not only of the costs associated with administration, recovery, and non-payment, but the decision of each lender as to what constitutes an acceptable return. Thus, in conjunction with the program participants, the spread must be carefully reviewed during the program.

Costs of Low Income Loans. Obviously, one of the key determining factors regarding the adequacy of the spread, is the cost of lending to low income households under the HG. Costs should be carefully monitored; this impacts not only the discussion of spread, but also the design of the lending and grant schemes. If costs are deemed "excessive", then the grant scheme might be extended up the income scale. It may not make sense to extend very small loans if the administrative charges equal a substantial share of the value of the loan. If this is the case, it may be preferable to simply switch to grants for this portion of the income distribution.

Institutional "level playing field". The Housing Finance Institutions Working Group should include all active participants in housing finance, public and private. As discussed in Chapter 3.0, the "minimum lending rate" under the HG, which was established in consultation with SMIB, HDFC, and the ADB consultant for these institutions, is the principal tool the HFSC has to create a "fair" lending situation between public and private institutions. This rate is extremely important, as it can help provide the incentive for participation in the sector by private institutions. At the present time, the minimum rate should not be undercut by public lenders.

Median Income. It has been noted that new data measuring income indicate that median income, at least in urban areas, exceeds the current estimate of the median. This evidence should be reviewed as quickly as possible. Private sector banks can lend as high into the income distribution as permitted under the terms of the HG. In this regard, the program is likely to be more successful, and thus, ultimately benefit housing finance lending for all income groups if the ceiling reflects the true median. This estimate should also be reviewed periodically throughout the program.

Training. It is our understanding that a training agenda will be developed by the HFSC with the assistance of USAID. The training agenda should be designed with the private sector participants strongly in mind. Access to this type of benefit through which both staff and management can become more experienced in housing finance, is a valuable input to the likelihood that these institutions will continue lending when the HG has ended.

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2.0 THE ECONOMIC AND FINANCIAL CONTEXT FOR HOUSING FINANCE REFORM AND IMPLEMENTATION OF THE HOUSING GUARANTEE PROGRAM: PHASE IV

This study builds upon a number of earlier studies of housing and housing finance in Sri Lanka. Following a study of the long-term need for housing, a subsequent report introduced macroeconomic and financial sector development issues through a review of procedures for increasing the market orientation of housing finance.[1] Subsequently, an overview evaluation of issues facing development of an effective housing finance system was undertaken; this report suggested that a Housing Finance Working Group be formed, with goals, structure, and membership reflecting the current Housing Finance Steering Committee.[2] At the same time, another report addressed approaches to separation of grant and loan components in Housing Guarantee Programs; similarly, major steps have now been taken to implement this separation.[3]

This chapter very briefly describes the economic and financial context within which Phase IV of the HG will be made operational and the HFSC seeks to design and implement policy reform. In summary, the economy overall has achieved very respectable targets with regard to growth and stability. International and bi-lateral donors continue to provide funds and assistance for policy reform and liberalization of the economy. Notable progress has been in transition to a market-oriented system in many sectors of the economy, including the financial sector. Phase IV of the Housing Guarantee Program, with its emphasis on private sector participation and market rate lending, is an salient example of program design within this context. Nevertheless, numerous problems remain to be solved; for the financial sector, the ultimate nature of the dual public/private sector and the future of monetary and fiscal policy are among the most pressing issues.

2.1 Economic Progress and Donor Reform Programs

The Sri Lankan Aid Group, which includes all the major multi-lateral and bi-lateral lenders met in Paris on February 7 of this year. Sri Lanka was commended for its recent progress, and donor funds of $825 million were awarded, which is apparently $25 million more than the amount sought.

The GSL has set forth four principles which underlie its stabilization and adjustment program: (1) tight macro-economic management, especially fiscal management; (2) continued rationalization of the public sector; (3) continued rationalization of the poverty program; and (4) provision of an enabling framework for the public sector. The International Monetary Fund and the World Bank noted that the improvement in the economic situation has been remarkable considering the serious difficulties faced by the economy, including the slowing international economy and a precipitous decline in tea prices. Real growth in 1990 was about 6 percent and

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[1] See Roger Tufts, 1988.

[2] See Merrill, Tufts, and Garnett, 1989.

[3] See Griffin, Jeter, and Richardson, 1989.

is estimated to near the target of 5 percent for 1991. Of particular importance for the financial sector, deficit reduction and monetary management helped reduce inflation from over 20 percent in 1990 to about 9 percent at the end of 1991.[4]

USAID, the World Bank, and the Asian Development Bank are all involved in various aspects of the reforms program, including those for the financial sector, private sector, and capital market. For USAID, a "sound investment climate" is one of four main program objectives of overall Mission strategy. Within this objective are assisting the privatization program, strengthening the capital market, and, through the housing finance subsector, implementing financial market reform. The Asian Development Bank has focused on a number of institutions in the financial sector, including the public commercial banks (People's Bank, PB, and The Bank of Ceylon, BOC), the National Development Bank, and the National Savings Bank (NSB). The goals include restructuring and commercialization, improved management practices, and recapitalization. In addition, as mentioned above, the ADB is working toward restructuring the SMIB and HDFC, with an eventual of privatization.

Finally, the World Bank has examined nearly every aspect of Sri Lanka's financial sector; the three volume evaluation includes a 15 page summary of recommended actions extending from the state-owned banks to monetary and debt policy. Some of the major policy actions include major restructuring of both the PB and BOC; privatization of the BOC; major restructuring of the NSB, including possibly its closure; creation of a secondary market for long-term government bonds; and improved supervision of the banking system.

Taken together, these reforms would bring about a major overhaul of the system, reducing the inefficiencies and distortions noted by the donors, and likely transform the role of the already private institutions as well as that of the public institutions elected for privatization. Competitiveness in deposit mobilization, wholesale funds mobilization, and access to long-term funds would be among the major factors influencing the evolution of housing finance. The extent to which these suggested reforms have been agreed to is not clear, however, nor is the time table established. Thus, by virtue of its establisned policies regarding market rate lending, and the eventual involvement of several private sector institutions, the current Housing Guarantee Program is one of the sector's most promising reform efforts.

2.2 The Housing Guarantee Program: Phase IV

The design of HG-IV is still evolving. The brief description offered here is based on the October 1991 draft of the Program Delivery Plan and discussions with the Mission Housing Officer, the HFSC, and potential program participants during our consultation in Sri Lanka in February 1992.

The HG-IV will assist the GSL's One Point Five Million Houses Program, which follows the Million Houses Program. Several characteristics of Phase IV make it unique, However:

- it seeks to greatly broaden the role of the private sector;

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[4] See the **Sunday Observer**, " Donors give $825 Million in Aid", February 9, 1992, Colombo.

- the program has separate components for loans and grants; Subsidies for housing loans will take the form of direct grants, not indirect subsidies through subsidized interest rates;

- the Housing Finance Steering Committee is established as the highest policy reform body for housing finance, as a condition precedent of the loan;

- all lending will take place at the Minimum Market Rate, an interest rate determined by the HFSC and reviewed throughout the program;

- the Minimum Market Rate has been established in consultation with the SMIB, HDFC and ADB; thus, policy has been set with regard to public/private cooperation for a crucial rate.

The ADB has estimated that the deficit in Housing Finance for new construction, for the period 1990 to 1994, is Rs. 26,500 million. Table 2.1 indicates total lending during 1988 and 1989. Since the ADB figure excludes upgrading, expansion, and overcrowding, the shortfall is even greater than indicated. Thus, it is expected that demand for housing finance, at market rates for all recipients receiving loans, is ample.

Table 2.1
HOUSING FINANCE LENDING
1988 and 1989
(Millions of Rupees)

	1988	1989
State Mortgage Investment Bank (SMIB)	562	334
National Savings Bank (NSB)	48	52
Housing Development Finance Corporation (HDFC)	30	11
National Development Bank	346	0
NHDA	311	472
Insurance Corporations	10	76
People's Bank	306	406
Cooperative Rural Banks	84	137
TCCS	80	170
TOTAL	1,777	1,658

The structure of the loan component of the HG is illustrated in Figure 2.1. The Central Bank (CBSL) will serve as the Apex lender, and will on-lend funds to so-called sub-apex lenders, that

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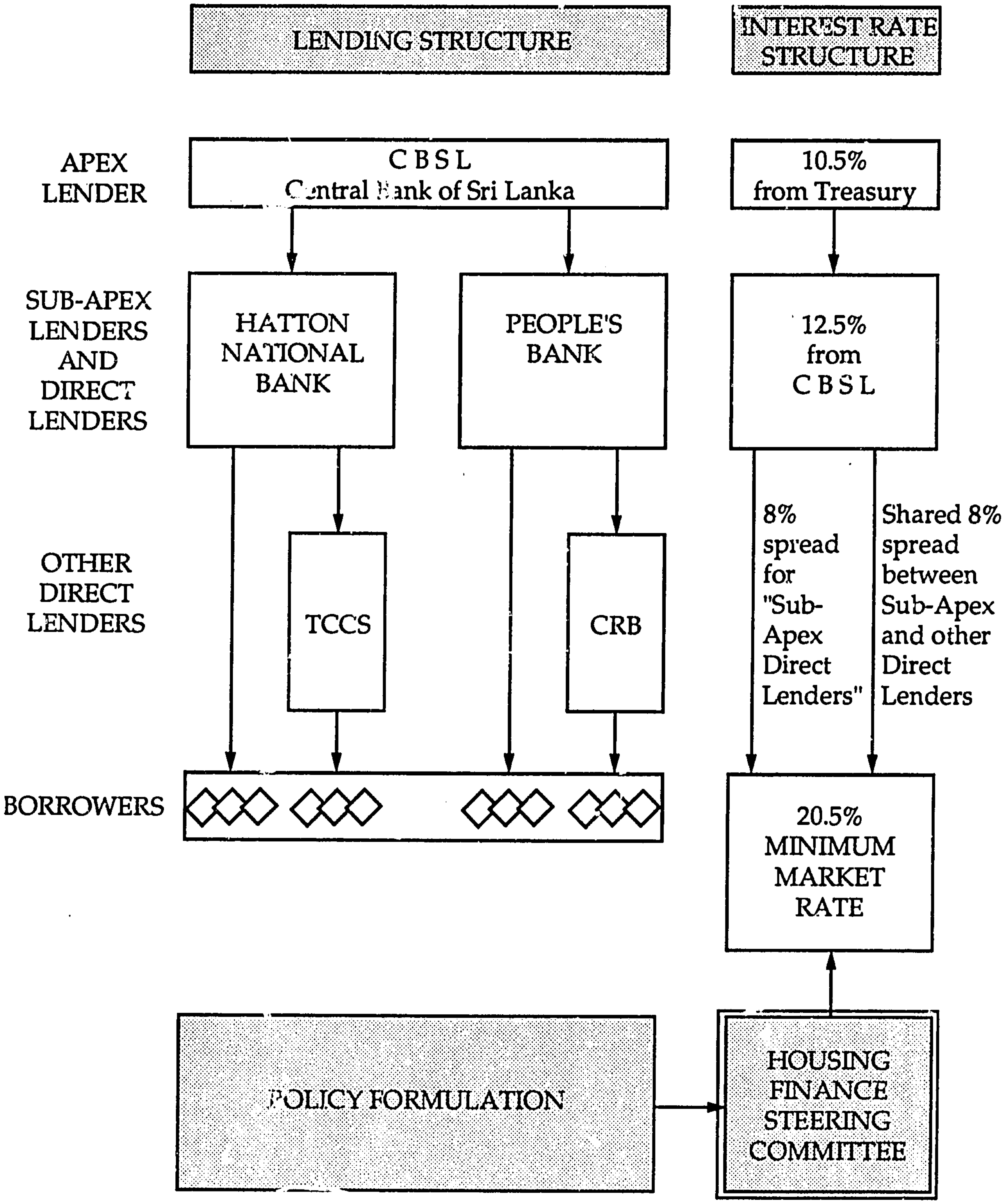
Figure 2.1
HOUSING GUARANTEE LOAN COMPONENT LENDING AND INTEREST RATE STRUCTURE



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is, institutions which are eligible to borrow from the CBSL. These institutions, in turn, may choose to on-lend to direct lenders as well as to lend directly themselves. The originally proposed structure for the HG was similar in its framework but involved many more sub-apex and direct lenders. At the present time, it is planned that the HG will go forward with those institutions shown in the figure. However, there is interest from other private commercial banks, such as the Seylan Bank, and from a private finance company, Ceylinco; once the program is operating successfully, it is in the best interests of the sector to involve as many private institutions as feasible.

There are a number of other important design and implementation issues for the HG that are still outstanding. These include:

- the existence of a formalized insurance scheme;

- the design of the so-called bridging grant, whereby some grant recipients (for example the 15th to 25th percentiles of the income distribution) would also receive loans;

- the share of the spread between sub-apex lenders and the institutions to which they lend as direct lenders.

These issues must be decided as soon as possible by the HFSC, participating institutions, and USAID. In addition, as further discussed in Chapters 3.0 and 4.0, there are important design and monitoring issues for the ongoing program. The most important of these is probably the Minimum Interest Rate. This rate is determined by the AWDR (Average Weighted Deposit Rate) and allowances for overhead, risk, and profit. On the other hand, serious consideration must be given to the spread for direct lenders, which could get squeezed if rates fell. These issues regarding HG design and implementation, as well as coordinating reform policies for the sector overall, provide a challenging agenda for the HFSC.

3.0 POLICY ISSUES IN THE DEVELOPMENT OF THE HOUSING FINANCE SECTOR

The Housing Guaranty will have an immediate impact on the availability of long-term, market-rate financing to households with less than median incomes. But, the policy effects of the HG-004 are intended to extend beyond the target group to the development of the whole housing finance sector as private and market-driven. The vehicle for these policy initiatives is the HFSC.

To fully achieve this goal, the HFSC would need to set an ambitious agenda covering every aspect of the financial intermediation process for housing. These include:

1) Interest Rate Determination
2) Raising Funds
3) Mortgage Design
4) Recoveries
5) Matching Terms
6) Liquidity
7) Regulation and Supervision
8) Privatization

This is a comprehensive list of policy areas for the HFSC and it cuts across all four areas of the Committee's agenda as described in Table 1.2. It is probably beyond the capacity of the Committee to pursue them all, at least simultaneously. However, in order to provide guidance to the Committee, we shall briefly discuss the issues that we see in each of the areas and then note which issues are key to the near-term success of the Committee's efforts to implement the HG and reform the housing finance sector.

Interest Rate Determination

The financial sector in Sri Lanka has been taking its first steps towards creation of a true financial market, where interest rates balance supply and demand for funds, differentiated by both term and risks. It is still too early in the process to be able to rely on market forces to indicate what the lowest cost sources of funds are and what is the appropriate market rate.

Because of this, it is expected that the HFSC will review the level of interest rates under the HG-004 on a regular basis and administratively set a minimum lending rate to charge the ultimate beneficiaries. Working back from this minimum lending rate, the Committee will also set a spread for sub-apex lenders over the CBSL's refinance rate and thus what the refinance rate will be.

This minimum lending rate is the principal tool that the Committee has to create a "level playing field" in a market which includes both public and private institutions, as well as hybrid institutions such as the Cooperative Rural Banks and the TCCSs. It has already been agreed that this minimum rate will be coordinated for lending under the ADB and HG programs. The benefit from this system is that the rate can be set high enough to encourage participation by all types of institutions, particularly private, profit-motivated ones. Specifically, it could prevent government-controlled institutions or those with too little experience to properly gauge costs and risks, from undercutting private (either currently or potentially) profit-motivated institutions from establishing a long-term viable role in the sector.

The costs of such a system are equally clear. It limits the potential for competition to pass on to the borrowers the benefits of one or more lenders having truly a lower cost of intermediation. If the minimum rate is enforced, such suppressed competitive advantages probably will manifest themselves through non-price competition. In other words, those lenders with lower costs, including government entities with subsidized sources of funds, may attempt to compete through better service or offering more attractive terms along dimensions other than the interest rate. The Committee may have to intervene to determine whether such primary lenders are following acceptable lending policies as described in the PDP.

The most immediate challenge to the HFSC will be the extension of this minimum lending rate to non-participating lenders. To the extent such lenders are totally private, the basis for intervention is weak. But the more significant threats to the development of a market-driven system come from governmental entities such as NSB or NHDA, which clearly benefit in direct and indirect ways from their government ownership.

As far as we can ascertain, there is no explicit basis under either the PDP or the ADB agreements for the HFSC to constrain the interest rates on loans made by non-participating institutions. However, both documents indicate a commitment on the part of the GSL to develop housing finance on a private-market basis. This commitment should be translated into an agreement by major government lenders not participating in either the ADB or HG programs to observe the rate guidelines set under those programs.

A related near-term task of the Committee will be to properly coordinate the setting of rates under the ADB and HG programs. The PDP provides that the rate will be established through the same formula for both programs. Taken literally, such a policy may soon prove to be untenable. Loans made under the ADB loan have interest rates which will decline if short-term rates decline. However, loans made under the HG will have fixed rates, mirroring the fixity of the terms of the refinance by the CBSL. If short-term rates trend downward, borrowers from SMIB and HDFC will benefit, while borrowers under the HG may complain and, potentially, seek to refinance their loans through the ADB lenders.

This scenario illustrates a basic issue, that rates on Variable-Rate Mortgages (VRMs) are usually different (usually lower) than on Fixed-Rate Mortgages (FRMs), especially FRMs with the potential for early prepayment. Resolution of this issue raises a more complex problem, that of the term structure of interest rates in Sri Lanka. Conceptually, there should be two different minimum rates set by the HFSC, each based on market rates in the relevant part of their term structure. The permitted mark-up over the cost of funds should also vary across the types of loans.

The Committee could examine this issue and determine what might be a good indication of what a longer-term market rate might be (if there were a market in longer-term debt). It could also determine what, if any, premium should be added to the spread for the risk borne by the lender that the loan will be prepaid in a lower-interest rate environment. This topic is examined in a later section.

Raising Funds

There is a wide range of alternative paths down which raising funds can proceed. Which path(s) are followed depends heavily on the development of the overall financial system. There is already a strong tradition of households maintaining small deposit savings accounts, especially with the NSB. This system needs to be put more on a market basis, with deposit rates tied to rates on short-term government debt, either by fiat or through competition across deposit-taking institutions, and the tax-exemption of NSB deposits needs to be removed. If the government still continues to be the dominant deposit-taker through the NSB, perhaps because of implicit or explicit subsidy of operational expenses or because of the implicit guarantee of the deposits, then NSB should wholesale those funds to private sector lenders through the purchase of long-term variable rate notes, as is done in the U.K.

ADB is planning to build up the deposit base of HDFC and SMIB, especially through savings schemes linked to eventual loans. The success of this effort is important for the evolution of housing finance through depository institutions. The Committee should keep appraised of the situation and offer policymaking assistance if changes are needed to permit fair competition for deposits.

The major alternative sources of long-term funds for housing are the provident funds and insurance companies. These are the natural holders of the longer-term debentures needed to back fixed-rate mortgage lending. There are two major issues blocking development of these funding sources, (1) the high government deficits and (2) a proper market pricing mechanism for longer-term debt.

Efforts are underway under the auspices of USAID, the ADB, and the World Bank to develop markets in longer-term government debt. Even debt of 3 to 5 years could serve as a benchmark for setting rates on mortgage-related debt of 7 to 9 years (which could support self-amortizing loans of up to 15 years). Alternatively, 15 or 20 year loans with rates fixed for 5 years at a time could be financed with 5 year debentures, as in Germany.

The Committee could sponsor a study of funding sources, including the funding needs of provident funds and insurance companies, as well as liaise with other donor projects in the area. One of the key issues is whether these long-term institutional investors need fixed-rate, variable-rate, or inflation-adjusted assets to meet their obligations.

Mortgage Design

The design of the mortgage instrument should be closely related to the funding sources. Until recently, all housing finance was at rates fixed for the term of the loan. This has caused problems for some lenders, because the loans were funded by short-term deposits or medium-term debentures, on which rates have risen. Some lenders, such as the TCCS, have lent only on a long-term refinance basis and thus avoided this problem. Other potential lenders, such as commercial banks and finance companies, have simply avoided housing finance because of their short-term funding base.

It is in this context that SMIB and HDFC are adopting a variable rate design for their future mortgages (VRMs). Variable-rate mortgages can come in a variety of types. The major distinction is between the reviewable-rate mortgage (RRM) where the lender is legally free to change the rate whenever and however much it wishes, and the adjustable rate mortgage (ARM), where the rate is reset periodically at a fixed spread over some specified measure of the cost of funds. It appears that SMIB and HDFC will use a blend of these. The loan documentation will permit reviewable rates, but the expectation is that the loans will be treated as ARMs, where the rate will be reviewed only every 6 months and changed to follow a fixed spread over the average weighted deposit rate for all financial institutions (with some consideration of the cost of funds to those particular institutions).

Currently, SMIB is resolving some legal difficulties facing its use of variable rate mortgages, but soon both HDFC and SMIB should be offering such loans. However, loans funded through the long-term, fixed-rate refinance offered under HG-004 presumably would continue to be at a fixed rate. This situation presents some challenges for the Committee, which will be discussed below.

Once VRMs are well-established in the market, the Committee may want to consider the introduction of loans in which 1) some or all of inflation is factored back into the principal or 2) a portion of the variation in rates under a VRM is factored back into the principal. The former type of loans is known as an inflation-indexed mortgage. Launching such a loan requires the creation of deposits or debentures which also offer a rate of return indexed for inflation, as well as, of course, a reliable measure of inflation as it is relevant to the depositor or investor and to the borrower. Such a loan may be worth introducing if inflation stays over 10 percent, since it can bring down the first-year interest rate to levels under 10 percent.

An alternative type of VRM can be used either to bring down the first-year interest rate (if a portion of the current market rate is added back into the principal) or to soften the effects of possible jumps in interest rates in the future. In the former case, the loan is very much like an indexed loan, with the payment going up every six months or year as the principal rises. In the latter case, if interest rates rise, the impact on the payment can be deferred towards higher payments later, or the term of the loan can be extended.

In the case of any of these more complex loans, consideration must be given to maintaining the liquidity of the lender despite the deferral of interest payments and also to the ability of the borrower to understand the nature of the terms. Such innovations cannot be adopted without significant study, but they may be needed if interest rates remain high or move higher.

Recoveries

The rate of recoveries for housing loans has improved from the very low levels experienced after the impact of the partial forgiveness of loans by the government in 1988. Moreover, the expedited foreclosure process once available only to certain government institutions has now been extended to private banks (but not to finance companies). Despite these favorable developments, the potential for defaults and losses remains significant.[5] This is a good reason for the generous spread offered institutions participating under either the HG or ADB programs. Since most of the institutions operating under these programs are private, or plan to privatize, they will undertake serious and effective recovery efforts, which will be indicative of what the potential is for managing credit risk in the sector.

There have been proposals to set-up a formal insurance scheme to indemnify lenders against part or all of their losses on housing loans. Such mortgage insurance is available from the private sector in the United States and the United Kingdom, but in few other countries. Apparently, default is an insurable risk in those countries because the foreclosure laws and the fluid housing markets make loan losses primarily a function of the course of house prices, i.e., the collateral value is the primary basis of recovery. Trends in house values and the variation around that trend are relatively predictable and a price can be placed on the risk borne by the insurance company. Upon occurrence of a default, the collateral is quickly secured and usually resold, with any amount remaining after repayment of the loan and expenses being returned to the borrower.

Such mortgage insurance is not available in other countries, even those in Western Europe, where legal or social considerations militate against rapid and predictable disposition of the collateral. Lenders in those countries instead go to greater lengths to assess the credit worthiness of the borrower and often charge a premium for relatively more risky loans. Upon default, they expend greater efforts to work with the borrower to resolve the default, often through rescheduling the loan.

Sri Lanka is clearly among the latter types of countries; foreclosure and disposition is not a simple proposition. The techniques of loan recovery are still being developed and there seems to be good potential for incurring relatively minimal losses ultimately on housing loans.[6]

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[5] Hopefully, the study underway by Ernst & Young will develop verifiable data on delinquencies and actual losses experienced in the past, differentiated by type of lender and borrower.

[6] It seems to be premature and probably counterproductive to interject a formal guarantee or insurance system at this point. It is conceivable that some housing loan insurance scheme could be good public policy, even if not commercially viable, particularly if it were oriented primarily towards protecting against major, systematic losses that could bankrupt institutions but left institutions with strong incentives to use their best efforts in evaluating and recovering home loans.

Matching Terms

As noted above, the determination of interest rates on long-term lending needs to be consistent with the determination of the cost of funding. In the case of deposit-based lending, this concern implies the use of variable rate mortgages, where changes in the rates closely match the changes over time in the costs of deposits.

In the case of fixed-rate lending, as under the HG program or through debentures, it is just as important that the term of the debenture or refinance facility match the effective term of the loans. For example, if a five-year debenture is issued today at 17 percent to back a loan at 20.5 percent, the lender will experience a loss if the loan is paid off in less than five years, and the funds can no longer be re-lent at 20.5 percent or if the loan is not paid off for 15 years and the debenture needs to be reissued at 25 percent.

There are a number of ways of handling the matching of terms. The simplest approach is to utilize only VRMs funded by short-term deposits. This leaves some risk to the lender, in case the lender's cost of deposits changes over time in a way different from the average cost of funds used to set the interest rate. The more serious problem with sole reliance on this approach is that the borrower is fully exposed to increases (but also decreases) in rates. Some of an increase in interest rates can be translated into an extension of the term of the loan, but this is only viable if the increase is temporary.

In the case of the HG funding, it may seem unlikely that early repayments could be a problem, since borrowers do not have the resources to accelerate repayment and generally would not have an option of going to another lender to get another loan at a lower rate to repay the HG-funded loan. This perspective overlooks the enormous pressures to accommodate the refinancing of loans recently made at 20.5 percent if funds are now available at 16 percent. However, it appears that there is nothing to prevent the sub-apex or primary lenders from repaying their refinancing loans early. In this case, it is really the Central Bank that is taking the risk that interest rates will come down and stay down, and it is in a relatively good position to do so.

If fixed rate loans are funded by debentures, the problem becomes more acute. In this case, the easiest solution for Sri Lanka is probably for the debentures to have the option to be redeemed after, say, 5 years of a 10 year debenture. This limits the exposure of the financial intermediary, but does not eliminate it.

Although the Committee has no immediate agenda item in this area, it should be mindful of these hazards as it makes other recommendations.

Liquidity

To the extent that the housing finance system develops along the lines foreseen by the ADB, i.e., with significant depository funding, there may be a need for a liquidity window at the Central Bank. Since the Central Bank already performs this function, even for private finance companies in distress, there do not seem to be any issues in this area.

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Regulation and Supervision

The broad development of regulation and supervision of the financial sector is well outside the scope of the Committee. However, the Committee may wish to assure that the risks and requirements of the specialist housing finance institutions and the housing finance activities of the generalists lenders are understood by the Central Bank, the Banking Commission and any other authorities affecting the governance of the system. The Committee may also want to make it clear that housing finance must be operated on strictly commercial grounds if it is to remain sustainable and thus that social policy goals in the area of housing should be implemented through grants through institutions such as NHDA.

Privatization

The Committee will play a central role in the privatization of housing finance in Sri Lanka. Privatization consists of developing the participation of institutions which are already private, as well as of the conversion of government-controlled institutions into private entities. Essentially, the HG program is a temporary supply of long-term funds at below-market rates. If the private sector is to continue operating in this area, it must find that home lending pays enough and is safe enough to compensate depositors or investors for their funds and yield a profit.

There are at least two key elements to the success of such a strategy. The first is the creation of a "level playing field," particularly in the area of interest rates. In the near term, this will be accomplished through extension of the "minimum interest rate to borrowers" to non-participating governmental lenders as well. The Committee may also want to work towards the exclusion of government-controlled entities from the lending market. It has been found in other countries that such institutions are inevitably subject to political pressures to operate in a non-commercial manner, as well as subject to poor repayment attitudes on the part of borrowers.

The Committee can also support the privatization of the housing finance system through its evaluation and recommendations in all of the areas discussed above. Under the HG and ADB programs, the search has begun for a viable and stable basis for offering housing finance to low and moderate income households. Success in the endeavor will require a consistent policy framework, based on sound financial logic.

A Near-Term Policy Agenda

While the Secretariat of the Committee will need to monitor developments across the full range of issues described above, the Committee itself needs to focus on only a few areas in the near term. These areas include:

1) Observance of the Minimum Interest Rate
2) A Minimum Rate for VRMs and FRMs
3) Development of Longer-Term Funding

The first of these topics is already the subject of extensive discussions among SMIB, HDFC, and the Ministry of Finance. The Committee may choose to participate in a variety of ways.

Whatever manner it chooses should be in the context of acting as the body designated by the GSL to coordinate the development of housing finance.

This coordination also involves coordinating the interest rates set for the VRMs issued by ADB-assisted lenders and the FRMs issued under the HG program. The Committee should probably solicit expert advice as well as the perspective of its lenders on how it should set the interest rates on new FRMs or perhaps whether the refinance rate by the Central Bank should be made variable, thus permitting the HG lenders to also offer VRMs.

The last immediate task of the Committee is to interface with the governmental, donor, and private sector entities involved in the strengthening of the long-term financial market. For example, the World Bank's and ADB's financial sector reforms package seek development of a market in a longer-term government debt and reorientation of the provident funds and insurance companies towards holding long-term assets. USAID is also providing technical assistance to the development of a medium-term debt market. Not only is housing a natural focus of long-term finance, but the long-term refinance facilities provided under the HG and ADB programs will need to be replaced by just such local funds relatively soon.

Chapter 4 develops a plan for the Committee to meet these responsibilities for policy development and liaison, as well as other roles in the implementation.

4.0 POLICY DESIGN AND IMPLEMENTATION: THE ROLE OF THE HOUSING FINANCE STEERING COMMITTEE

This chapter discusses the policy agenda of the HFSC and the means by which the Committee might carry out the agenda. Section 4.1 begins by suggesting a staffing structure for the Committee, and notes again the urgency of supporting the Secretary and the membership with the full-time assistance of an advisor trained and experienced in finance. Section 4.2 then notes the need for policy coordination within the GSL and suggests a Working Group structure for addressing the extensive agenda of the HFSC. A Working Group approach would limit the need for frequent meetings of the full Committee and also establishes direct staff-to-staff links with the HFSC technical advisor and senior staff from other institutions and/or Ministries. Section 4.3 comments on the agenda for the HFSC, including issues germane to the HG Program as well as to sector reform. Finally, performance monitoring for both the HG and the sector overall and the need for a housing finance sector data base are discussed in Section 4.4.

4.1 Membership and Staffing for the Housing Finance Steering Committee

The membership of the HFSC represents the key institutions and decision makers for policy design and implementation in housing and housing finance. The Co-Chairman are:

- Secretary, Ministry of Policy Planning and Implementation: Mr. R. Paskaralingam;

- Secretary, Ministry of Housing and Construction: Mr. W.D. Ailapperuma;

The appointed members are:

- Director, Development Finance Department, Central Bank of Sri Lanka: Mr. Y.A. Piyatissa;

- Chairman, National Housing Development Authority: Mr. Susil Sirivardana;

- Chairman, State Mortgage and Investment Bank: Mr. Robin Talwatte;

- Director, National Planning, Ministry of Policy Planning and Implementation: Mr. K. A. L. Premaratne;

- Chairman, Ceylinco Group: Mr. Lalith Kotalawala;

- Chairman, John Keells Holdings Ltd.: Mr. Ken Balendra.

The Director, National Planning, Mr. Premaratne, serves as Secretary to the Committee.

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The first and foremost need of the HFSC is staffing for the Committee itself. Only a limited amount can be accomplished until the Secretary can draw upon permanent and long-term staff. Thus, obtaining long-term staff for the HFSC should be considered the highest priority for USAID and the HFSC Secretary. Staff should consist of (1) permanent staff available to the Secretary from MPPI; (2) a long-term, highly experienced technical advisor in finance, either local or foreign; and (3) part-time technical consultants, both local and foreign, available to assist the HFSC carry out its technical studies. The structure below represents an initial recommendation for staffing and assignments.

HOUSING FINANCE STEERING COMMITTEE

SECRETARIAT

SECRETARIAT STAFF

Director of the HFSC: Secretary, National Planning, MPPI

- Overall direction of HFSC functions including policy formulation and prioritization of technical studies and coordination efforts

Long-term Technical Advisor to the HFSC

- Assistance in Policy Formulation and Implementation
- Assistance in Preparation of Technical Studies
- Assistance in Coordination of GSL and Donor Reform Efforts
- Assistance in Convening and Assisting Working Groups

Permanent Staff: MPPI

- Monitoring the HG IV Program
- Performance Monitoring and Data Base Preparation for the Sector
- Scheduling, Reporting, and Administrative Assistance

Technical Experts: Part-time Local and Foreign Consultants

- Assist the HFSC and USAID conduct Technical Studies in furtherance of the Policy Agenda
- Advise the HFSC regarding training programs for HG participants

Implementation/Evaluation Experts: Part-time Foreign Consultants

- Assist the HFSC and USAID implement policy reform through facilitation workshops and conflict resolution techniques

- Evaluate the progress of policy reform under the HG and assist in revising the HFSC agenda

OTHER PART-TIME RESOURCE ASSISTANCE

USAID Long-term Technical Advisor for Housing

- Assist USAID Housing Officer and HFSC in Implementation and Monitoring of HG IV
- Assist HFSC Secretary and Secretariat Staff in Policy Implementation

The Long-term Technical Advisor(s). The first step is to secure a long-term technical advisor to the HFSC. It is our recommendation that this person be Sri Lankan. This would help assure continuity for the Committee's work and provide important on-the-job training in housing finance for a local financial expert. The candidate should have at least a B.A., or preferably an advanced degree in finance, economics, or business administration with an emphasis in finance. He or she should definitely have some years of experience in a financial institution in Sri Lanka or abroad (preferably both). Since private sector housing finance in Sri Lanka has been limited, experience in banking or finance companies will be more common.

There is a case, however, for employing a foreign national as the long-term technical advisor to the HFSC. One issue is direct experience in housing finance in either the United States, Great Britain, or Europe. Another issue is the intricacies of dealing with public and private government bodies or institutions which have conflicting agendas with regard to the future of the financial and housing sectors. To the extent that diverse agendas need to be coordinated, an outside advisor may assist this process without alienating a potential future client or employer.

In weighing the advantages of long-term advisors with different backgrounds, the best solution may be to provide the HFSC with **two** advisors: a long-term Sri Lankan financial expert and short-term foreign housing finance advisor. Rather than assuming long-term residency for the foreign advisor, an attractive option is for the housing finance advisor is to make a series of short-term trips at regular intervals over the life of the HG.

Short-term Experts in Technical Assistance and Implementation. It is also recommended that two types of short-term technical experts be made available to assist the HFSC.

First, technical experts in various aspects of housing finance will be utilized by the Committee to address topics such as liquidity and matching terms, regulation of housing finance institutions, asset/liability management, alternative mortgage instruments, and management information systems.

Second, specialists in policy implementation, evaluation, and training agendas and workshops can assist the HFSC in numerous ways, including monitoring, conflict resolution, and selection of training agendas appropriate for the HG participants. The importance of monitoring the HG is discussed below; performance monitoring is especially important since the design of this Housing Guarantee Program ties it so closely to sector-wide development. Similarly, periodic evaluation is important to assist in re-establishing or revising targets and schedules. It may also be the case that conflict resolution skills will become very important. Because the future roles in housing finance of public and private agencies and institutions must be clarified as the sector develops, differences may be voiced over issues of the "level playing field" and the future public/private partnership. Also, it is recommended that only financial institutions ultimately engage in lending. It is our experience that it is best to get these issues clearly and openly expressed and to utilize an experienced "facilitator" to assist in their discussion, perhaps in a workshop setting.

4.2 Coordination of Housing Finance Reforms and Establishment of Working Groups

The membership of the HFSC, at the highest levels of representation for both public and private groups, assures access to persons who will decide the future structure of policies for both housing and housing finance. Since Mr. Paskaralingum is also Secretary of the Ministry of Finance, the reform process for the overall financial sector is also represented on the HFSC.

For three reasons, however, it is desirable to formally institute separate Working Groups to help design and implement the policies of the HFSC: (1) the members' available time for Committee duties is likely to be very limited; (2) not all agenda items are equally applicable to each member, and similarly some items pertain to groups not represented on the HFSC; and (3) it is desirable to shift the day-to-day efforts to senior staff designates within the pertinent institutions.

As discussed in the introduction and summarized on Table 1.2, the HFSC has several major categories of responsibility: (1) implementation, monitoring. and guidance of the HG Program; (2) policy formulation for housing finance; and (3) coordination of housing finance policy across donor efforts and with other financial sector reforms. Numerous topics are germane to the deliberations of the HFSC. Similarly coordination of policy reform efforts across GSL Ministries, the Banking Commission, USAID, the World Bank, and the Asian Development Bank is important. Now is the time to solidify and formalize links among these efforts. This process will be considerably aided by the fact that HFSC members are also members of other committees.

Three working groups have been proposed: for the Housing Guarantee Program, for the housing finance sector, and for policy liaison with reform efforts in banking, the capital market, government debt policies, and so forth. The recommended membership is presented in Table 4.1.

Institutions which are already members of the HFSC are noted with an asterisk. Also note again that senior staff designates of the member institutions are proposed to carry out the bulk of the implementation work. The HFSC must develop specific agendas, meeting schedules, and reporting formats so that the GSL and the HFSC can keep abreast of Working Group findings and recommendations.

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Table 4.1
HOUSING FINANCE STEERING COMMITTEE
PROPOSED WORKING GROUPS

I. HOUSING GUARANTEE PROGRAM POLICY WORKING GROUP

CURRENT PARTICIPANTS IN HG-IV

- Secretary, HFSC: Working Group Advisor*
  Technical Advisor, HFSC: Working Group Secretary
- Hatton National Bank: GM and Senior Staff Designate
- People's Bank: Chairman and Senior Staff Designate
- FTCCS: President and Senior Staff Designate
- Dept. of Cooperatives/ CRB Designate
- NHDA: Chairman and Senior Staff Designate

POTENTIAL FUTURE PARTICIPANTS IN HG-IV

- Seylon Bank: GM and Senior Staff Designate
- Commercial Bank: GM and Senior Staff Designate
- Ceylinco: Chairman* and Senior Staff Designate
- Other Private and Public Participants in HG-IV

II. HOUSING FINANCE SECTOR INSTITUTIONS WORKING GROUP

- Secretary, HFSC: Working Group Advisor*
  Technical Advisor, HFSC: Working Group Secretary
- SMIB: Chairman* and Senior Staff Designate
- HDFC: Chairman and Senior Staff Designate
- NHDA: Chairman* and Senior Staff Designate
- NSB: Chairman and Senior Staff Designate
- Hatton National Bank: GM and Senior staff Designate
- FTCCS: President and Senior Staff Designate
- Ceylinco: Chairman* and Senior Staff Designate
- Asian Development Bank: Mr. Kenneth Wren, Technical Consultant

III. FINANCIAL SECTOR REFORM COORDINATION WORKING GROUP

- Secretary, HFSC: Working Group Advisor*
  Technical Advisor, HFSC: Working Group Secretary
- Ministry of Finance: Secretary* and Senior Staff Designate
- Banking Commission: Dr. Ranee Jayamaha
- Central Bank of Sri Lanka: Dept. of Bank Supervision
- USAID: Housing Officer
- Asian Development Bank: Mr. Kenneth Wren, Technical Consultant
- World Bank: Resident Representative

The proposed membership of the Housing Guarantee Working Group includes participants involved in the start-up of HG-IV. The membership will expand as additional institutions become involved. The membership of the Housing Finance Institutions Working Group includes the major lenders in housing finance and several potential new lenders, such as Hatton National Bank and Ceylinco. It is this group of institutions which must work out the "level playing field" and public/private issues noted above. Finally, the Financial Sector Reform Group has the key GSL and donor members.

The short- and long-term policies issues to be discussed by the HFSC and the Working Groups are discussed in the following section. Finally, the important task of performance monitoring, some aspects of which should be assigned to the Housing Guarantee Program Working Group and some to the Housing Finance Institutions Working Group, is discussed in Section 4.4.

4.3 Housing Finance Steering Committee Policy Agenda

As has been discussed, the policy agenda with regard to success of the HG is particularly important, given the close links between the current phase of the HG and development of a market-oriented system. Thus, although we have (arbitrarily) divided the HFSC agenda into four areas (short- and long-term and HG and sectoral issues), all current efforts have an eye to the future development of HG programs and on-going participation of the private sector. Again, one of the key questions is whether private sector institutions will participate without infusion of HG funds. Similarly, the eventual privatization of SMIB and HDFC could be greatly encouraged by a successful HG Program. Some of the key short- and long-term policy questions include the following:

Issues in the Implementation of HG IV

- To what extent is it desirable to include additional private sector institutions in the HG and how might this be determined as early as possible?
- Will sudden changes in the interest rates, particularly a drop, threaten viability of the Program through impact on the spread?
- What are the early warning signs of problems such as recovery, which threaten the implicit decisions concerning risk structure? What steps could be taken?
- How can the loan and grant portions of the program be most effectively separated? To what extent should loans be granted **only** by financial institutions?

Policy Development under the Housing Guarantee Program

- Is there a role for the private sector commercial banks in housing finance after the HG IV Program?

- Will the HG provide a model for commercially viable low income lending?

- What might be an optimum distribution of housing finance lending by income group?

- What is the role for other private sector institutions in housing finance, such as the CRB and TCCS, after the HG Program?

- Will the HG serve to strengthen their housing finance lending?

- What might be the income profile of their housing finance portfolio after the HG?

- Is the sub-apex/direct lender role between the commercial banks and the TCCS and CRBs a mutually beneficial structure for continuation of housing finance lending?

- Might commercial banks consider establishment of subsidiary institutions specializing in housing finance?

- What types of training might be offered to the participants in HG IV to assist their current housing finance program and help assure its viability in the future?

Policy Research Issues for the Housing Finance Sector

- How can institutions currently participating in housing finance adopt an effective public/private partnership and a level playing field with regard to incentives for the growth of housing finance?

- What is an appropriate mix of fixed and variable rate instruments in the market and how might all institutions be assisted in developing instruments of their choice?

- How should the specialized requirements of regulation and supervision of housing finance be handled for private and public sector financial institutions engaging in housing finance and how does this relate to current reforms in CBSL supervision?

- How can construction finance best be introduced into the emerging housing finance sector?

- What are the requirements for the regulation and supervision of the non-financial institutions engaged in housing finance, such as the TCCS and CRBs? How can the design of this regulation be coordinated with that for banks and non-bank financial institutions, with specific regard to the housing finance portions of their portfolios?

In order to address these questions, and others, we have suggested the four part program of implementation noted above. The implementation steps were summarized in Figure 1.2 and are listed in more detail below:

Housing Guarantee IV Program

Short-Term Agenda

- finalize the roles of the current sub-apex lenders (Hatton National Bank, People's Bank);
- finalize the roles of the primary lenders (including Hatton, the TCCS through the FTCCS, the CRBs, others);
- finalize the initial interest rate structure and on-lending policies, including determination of the designated market rate;
- examine the assumptions regarding distribution of risk taking among sub-apex and direct lenders; the viability of the current HG is extremely important with regard to continued involvement of the private sector;

Long-Term Agenda

- establish ongoing institutional involvement of private sector institutions as direct and/or sub-apex lenders, including other private commercial banks and finance companies (Seylon Bank, Commercial Bank, Ceylinco);
- review and update the interest rate structure as internal economic conditions change and/or the policies of other housing finance institutions, such as SMIB, HDFC and NSB;
- plan for training and technical assistance to HG participants, designed in particular to enhance their expertise in housing finance and encourage their future participation in the sector;

Housing Finance Sector and the Overall Financial Sector

Short-Term Agenda

- finalize a meeting schedule and reporting format for the full Committee and the Working Groups;
- coordinate with the Asian Development Bank's efforts to restructure SMIB and HDFC and to establish a market rate;
- coordinate with other GSL financial sector reform efforts including the Ministry of Finance/World Bank agenda and the Banking Commission;
- select performance measures for housing finance and create a sectoral data base to monitor progress;

Long-Term Agenda

- examine the institutional structure of the housing finance sector , specifically addressing the issues of public/private roles and the "level playing field";
- address the long-term interrelationships of housing finance and other financial institutions including the NSB, the state commercial banks, provident funds, finance companies, and cooperatives;
- examine interactions between housing finance and overall financial sector policies regarding the short- and long-term interest rate structure, the use of variable rate instruments, regulation and supervision, and the generation of long-term funds.

4.4 Performance Monitoring and Data Base Development

The crucial importance of performance monitoring was discussed in Chapter 1.0. The success of the HG is very important to the long-term structure of the sector, especially with regard to the participation of the private sector banks, the TCCS, and other private financial institutions Private financial institutions will be able to raise funds on the market only if the HG proves to be commercially viable. Also, while their non-HG lending can and should be extended to all segments of the income distribution in the future, it is important to try and maintain lending to low and moderate income groups. Success of the HG will also provice incentive for privatization of SMIB and HDFC.

At the same time, it is desirable to monitor progress in the development of housing finance sector. Table 4.2 summarizes possible performance indicators for both the housing finance sector and the HG. In addition, both quantitative and qualitative indicators are important to this effort.

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Table 4.2
HOUSING FINANCE PERFORMANCE MONITORING
QUANTITATIVE AND QUALITATIVE INDICATORS

Housing Finance Sector: Quantitative Indicators	**Housing Guarantee Program: Quantitative Indicators**	**Housing Guarantee Program: Qualitative Indicators**
• ratio of total housing finance loans to total outstanding loans	• HG loans and loan size by income group	• "adequacy" of spread for sub-apex and direct lenders
• interest rate structure and terms of hosuing finance loans and other loans (FRMs, VRMs)	• ratio of total HG loans to total loans	• adequacy/implementation of minimum market interest rate
• default rate by time period	• planned-versus-actual HG disbursements	• institutionalization of the public/private level playing field
• income distribution of housing finance portfolio	• number and type of sub-apex and direct lenders	• "unmet demand" for housing finance
• ratio of private sector housing finance loans to total housing finance loans	• ratio of NHDA grants to loans under HG	• maturity and interest rate structure of government debt and debentures
• number and type of banks, financial institutions and non-financial institutions offering housing loans	• administrative costs of HG loans for direct and sub-apex lenders	• change in deposit mobilization and wholesale funds by type of institution
• interest rate structure for borrowing and lending for the financial sector by maturity	• fee realized on HG loans for direct and sub-apex lenders	• utilization of housing finance training by private sector institutions

Indicators such as the ratio of housing finance lending to the total volume of lending, and the ratio private sector housing finance to the total represent the type of qualtitative information on the sector overall which should be maintained in a computerized data base on an ongoing basis. (These sectoral indicators are already under discussion by USAID in Sri Lanka; the list was based on a memo from RHUDO Bangkok to the Mission.) We have added, in particular, monitoring the interest rate structure in housing finance and for the sector, to help assess the cost of funds by source, by term, and so forth. These data will be utilized regularly, along with the CBSL's AWDR, by the HFSC in its review of the Minimum Lending Rate.

Key indicators for monitoring the Housing Guarantee Program include both quantitative and qualitative measures. Measures which will help guage the "health" of private sector HG lending include the "adequacy" of spread to provide an acceptable return; the viability of agreements between sub-apex and direct lenders; and administrative/default costs for different income groups. It is never easy to collect, in a timely manner, adequate data for the analyses one wishes to carry out. For evaluating the HG, timely determination of whether or not problems exist is crucial. We need to know, for example, whether underwriting procedures are proving to be appropriate and whether collections meet the initial assumptions used in evaluating the spread. This will have to be done with "qualitative" evaluations at the same time as more complete data collection is in progress.

Finally, note the utilization of training by HG participants is listed as one of the qualitative indicators. Training, workshops, seminars, assistance with MIS, and so forth, are among the very tangible benefits that the HG can offer the private sector direct lenders. This training should be designed to provide a group of professionals and mid and senior management with the experience required to continue housing finance in the absence of HG funds.

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