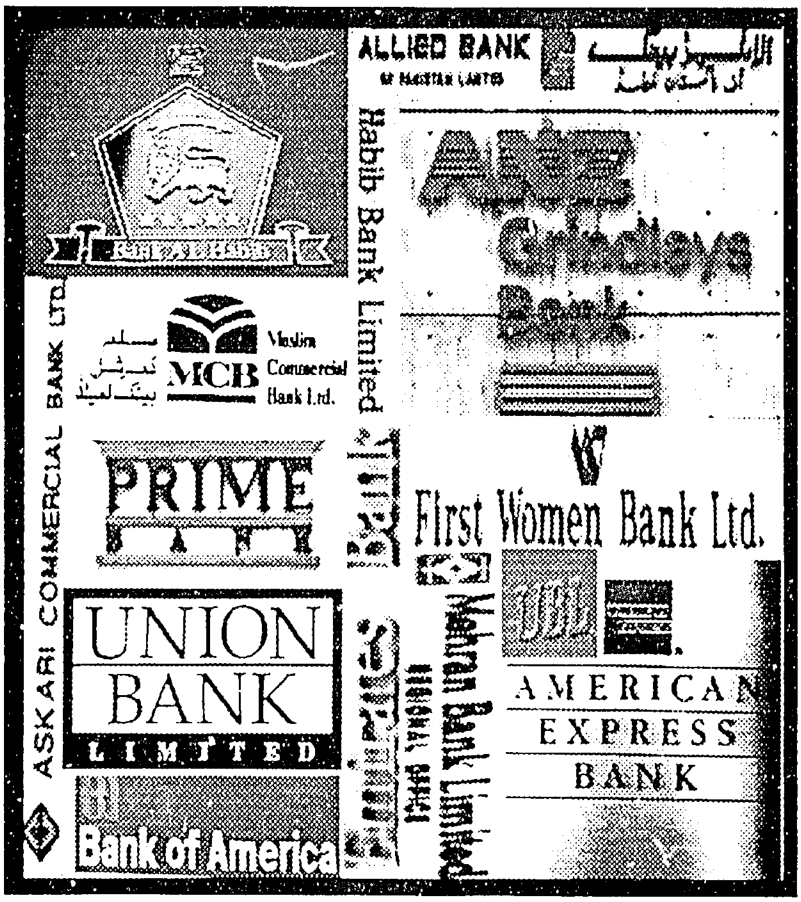
"No Credit"

The Role of Commercial Banks in Pakistan's Housing Industry



by the
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January, 1994

Note: At the time this report was written, 30 Pakistani rupees (Rs. 30) were equivalent to one US dollar (US $1).

Contents

Executive Summary

The purpose of the Shelter Resource Mobilization Program is to assist Pakistan to establish a private, market-based housing finance system. To date, seven applicants have been issued letters of intent by the Ministry of Finance authorizing them to establish Housing Finance Companies (HFCs). Of these, only two have completed the licensing process and commenced operations. One of the primary problems HFCs face is resource mobilization. At a recent SRMP sponsored national seminar on the subject, several recommendations were formulated that will require action on the part of the Government of Pakistan to integrate the new HFCs into the financial sector and allow them to compete for funds on a level playing field with other financial institutions.

In addition to Housing Finance Companies and savings and loan associations, commercial banks are a source of mortgage loans in most countries, and sometimes form the largest component of housing sector lending. However, in Pakistan, despite the advantages of access to the majority of liquidity available in the financial system, branches that reach into most communities, a rapidly expanding deposit base, and special rates for registration and stamp duty tax on mortgaged property transactions, commercial banks have made very little contribution to housing finance. The purpose of this report is to identify the factors which have inhibited commercial bank participation in housing finance, to demonstrate why commercial banks should invest in housing, and to identify the actions or incentives required by the Government to encourage banks to become more involved in the housing sector.

The first section of the report discusses the role of public policy in promoting and stimulating the housing finance sector. Drawing extensively on World Bank research, this section also describes the "Do's" and "Don'ts" of effective housing policy. The next section discusses the micro and macro-economic benefits of commercial bank involvement in housing finance, and the factors currently limiting bank participation in the housing sector. Subsequent sections of the report describe Pakistan's banking institutions and patterns of lending and investment, the impact of recent reforms on Pakistan's banking operations and financial performance, the impact that the growing budget deficit and domestic debt are having on the economy, and issues and recommendations specific to integrating housing finance into the commercial banking sector.

The last section of the report summarizes the conclusions and recommendations from an SRMP sponsored national seminar held in Karachi on August 12, 1993, on the potential for increasing the role of commercial banks in housing finance. Approximately 100 representatives of commercial banks, government, housing finance companies, and developers attended the seminar, which was chaired by Mr. Ashraf Janjua, Deputy Governor of the State Bank of Pakistan. A draft of this report was distributed to participants in preparation for the seminar.

Over the past several years, Pakistan has made significant strides towards liberalizing and deregulating the finance sector, but banks still experience difficulty in expanding their range of activities, especially in housing. These constraints, which were a focus of discussion at the seminar, include lack of liquidity due to government borrowing, maintenance of a low and rigid ceiling on bank credit for housing, and lack of a supportive policy and procedural environment for the housing sector. During the course of the seminar, several recommendations were formulated and are summarized as follows:

Reduce the budget deficit: *Seminar participants unanimously agreed that measures to bring down the government's budget deficit, now approximately 8% of GDP, are urgently needed. By soaking up the liquidity in the financial system, Government is raising the level of interest rates in the economy, capturing the majority of scheduled bank deposits at artificial interest rates,* *crowding out the private sector, and thwarting the development of the financial sector.*

Abolition of housing sector credit ceiling: *Commercial banks are constrained from housing lending by a 1% ceiling on such loans, which inhibits them from developing a portfolio of loans and the actuarial base through which they can diversify their portfolios. Commercial banks should be allowed to develop mortgage lending on a market level as part of their overall business plan.*

Further expansion and de-regulation of the financial sector: *Existing commercial banks are highly regulated, and should be allowed to play a more independent role in expanding their resource base. Furthermore, new commercial banks should be given permission to establish operations in the private sector as demand warrants.*

Development of bridge financing: *Bridge financing is a traditional investment for commercial banks in many countries. In addition, bridge financing can attract many new customers. Developers direct clients seeking mortgage loans for individual units to bridge lenders. The lender makes money both on the shorter term bridge financing and on the longer term mortgage loan.*

USAID Assistance: *Seminar participants proposed soliciting additional help for the housing finance industry through USAID and the SRMP. However, efforts in this regard are already underway to provide a US $15 million Housing Guaranty (HG) loan to establish a refinance window at the State Bank of Pakistan. USAID has also offered related technical assistance to structure the operations of the window and develop adequate loan underwriting standards and documentation.*

Apex bank: *Over time, with growth of the housing sector, a national mortgage bank could expand and continue resource mobilization through meeting short and long term requirements of funds from both public and private sectors at home and abroad. It could issue various capital market instruments like house bonds, commercial paper, and mortgage backed securities, and design home linked savings deposit schemes, including passbook savings and foreign exchange deposits.*

Fiscal Incentives: *Several seminar participants recommended tax concessions for investment in housing, which is a common practice in several countries in the region. In Sri Lanka, for example, 75% of the income of a company engaged in lending for low cost housing is exempt from corporate income tax. In India, HFCs can transfer up to 40% of their gross earnings to general reserves prior to computation of their tax liability.*

Expand housing sector investment: *Investment banks, leasing companies, modarabas, life insurance companies, and pension and provident funds are restricted from housing sector investments. Seminar participants recommended that such housing investment restrictions be removed, thus enabling the housing sector to compete with other sectors for credit*

Cross-subsidizing mark-up fees: *Several seminar participants expressed concern that lower income segments of the population can not afford home loans, and recommended that different rates of mark-up be established for various categories of houses within the framework of the overall structure of loan operations. In this manner, lower mark-up rates for lower income groups would be offset by higher mark-up rates for middle and upper income groups.*

Hire-purchase facility for low income employees: *In order to boost the housing industry and provide a mechanism for lower income families to be homeowners, several seminar participants felt that large companies, with financing from HFCs, should be encouraged to construct housing for employees, especially low income employees, on a hire-purchase basis.*

Foreword

Over the past five years, Pakistan has been moving toward a more liberal, less-regulated finance system, one that relies far more on market forces to allocate credit and establish rates of mark-up. This movement has created a number of opportunities for new types of financial firms to establish themselves. As directed credit is reduced and subsidies become more constricted, there is an increasing need to develop financial intermediaries to channel market-rate funds into a number of sectors that urgently need to be integrated into the financial system.

No sector offers greater potential in terms of economic scope than does housing finance. Housing has long been neglected, and reliance solely on subsidized housing loans through House Building Finance Corporation has never begun to meet demand for loans. Enormous potential exists for banks and specialized housing finance companies to enter the market for funding of new construction, home improvement, and mass housing development.

Over the past five years, the U.S. Agency for International Development, through its Shelter Resource Mobilization Program (SRMP), has assisted the Government to begin establishing a market-based housing finance system dominated by private housing lenders. Experience in the region and world-wide shows that housing finance is typically pioneered by specialized lenders, but that once success is demonstrated, commercial banks enter the field, often quickly rising to dominant positions in the mortgage market.

Banks in Pakistan have a number of potential advantages over specialized lenders, including extensive branch networks and access to lower-cost deposits and other sources of capital. Construction financing is one opportunity for banks, but they can also benefit from lending for housing, which offers an excellent opportunity to develop stable, longer-term assets to diversify their loan portfolios, which typically consist largely of short-term loans that often are volatile.

We are pleased to offer this study of the potential role for banks in Pakistan's housing industry and hope that it will assist in the development of sound policies and mechanisms that enable commercial banks to explore housing lending.

Jon Wegge
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January, 1994

Government and the Housing Sector

Pakistan is in the process of establishing a private, market-based housing finance system. The economic and financial potential for success is enormous. A strong housing finance sector will enhance housing and infrastructure investments, stimulate the construction industry, and contribute significantly to national economic growth. The role of government should be as manager of the housing sector's economic performance. Its top housing priority should be to integrate the new HFCs into the finance sector and create conditions that stimulate market-based housing sector lending by commercial banks.

For the past twenty years, Pakistan's finance system has been characterized by public sector banks and development finance institutions, central control, and directed credit. Private sector institutions have played a limited role in the economy.

The State Bank of Pakistan and the Ministry of Finance have been responsible for the distribution of credit among provincial governments, public enterprises, and the private sector. Historically, credit to the housing sector has been severely rationed, and its economic performance has been dismal. Over the past several years, however, as government has loosened its reins on the finance sector, the prospects for invigorating the housing industry have improved notably.

During the era of government control, virtually all formal sector credit for housing was subsidized, flowing through House Building Finance Corporation (HBFC) and to a lesser degree through the nationalized commercial banks. This system has been and remains unable to generate adequate resources for the housing sector: formal sector sources have been able to supply less than 15% of the potential demand for long term credit and housing. Housing investment contributes only 2.7% to GNP, well below the average for low income countries, and this percentage is declining. Housing production as a proportion of gross capital formation is only 9%, less than half the figure in comparable developing countries.

World-wide, experience shows that government sponsored housing programs have rarely benefited more that a handful of people in the context of meeting real demand, and that such programs diminish both the economic

Benefits of a strong market-oriented housing finance system...

- ***a broader and deeper financial sector***
- ***more and better housing***
- ***a stronger construction industry***
- ***improved savings rate and greater investment in fixed capital***
- ***credit flowing at market rates and according to demand***

Many programs to "solve the housing problem" have proved ineffective or worse when governments have tried to provide credit or produce housing directly.

vitality of the housing sector and the physical quality of people's housing. The practice of subsidizing interest rates for housing loans is sustainable only if a country has sufficient government resources to meet all of its housing needs, or alternatively, private firms give loans at less than market interest rates (Lee, 1992). Neither of these conditions exists in Pakistan, or for that matter, anywhere: government cannot meet a fraction of housing needs, and private firms cannot operate for long at below-market rates.

Government actions, although well-intended, often have adverse results in the financial sector. One only has to look at the performance record of House Building Finance Corporation and government housing banks in several other countries in the region. These banks, established with the intent to serve the poor and underprivileged, have often resulted in relaxed financial discipline. The operating policies of these institutions are often characterized by subsidized interest rates, lax underwriting criteria, and poor attention to loan servicing (Lee, 1992). In short, most public sector programs to "solve the housing problem" have proved ineffective or worse when governments have tried to provide credit or produce housing directly.

Since 1990, the Government of Pakistan has been implementing reforms designed to liberalize the economy. Plans include broadening and deepening financial markets and expanding private investment and savings. In the developing housing sector, reforms are intended to create an enabling environment in which a market-based, private sector finance system will mobilize resources for mortgage and construction credit.

Housing finance is central to the development of the economy and the overall financial system. When financial institutions diversify their asset portfolios into housing, this adds to financial deepening and promotes a more efficient allocation of savings in the economy. In the U.S., for instance, one third of personal savings are held with savings and loan associations which specialize in making housing loans.

Experience has shown that when the housing sector functions well, households invest a significant portion of income in housing, usually up to 30% or even more. Generally, housing forms an asset that represents from 20% to 50% of reproducible wealth, and is a major motivation for savings that may otherwise be held unproductively in gold and jewelry rather than bank deposits.

The purpose of the Shelter Resource Mobilization Program (SRMP) is to assist Pakistan in the establishment of a private market-based housing finance system. Seven applicants have received letters of intent from the Ministry of Finance authorizing them to establish private Housing Finance Companies (HFCs). To date, only two companies, Citibank and International Housing Finance Ltd., have completed the licensing process and commenced operations.

One of the primary problems new HFCs face is resource mobilization. At a recent SRMP sponsored national seminar on capital markets and resource mobilization for housing finance, several major recommendations were formulated to assist new HFCs gain access to capital resources. These are briefly summarized as follows:

Refinance Window: A refinance window at the State Bank of Pakistan is a first step toward eventual development of a secondary market in housing finance and could lead to the development of mortgage-backed securities. USAID, through the SRMP, has offered to provide a US $15 million Housing Guaranty (HG) loan and technical assistance to start the window. Over time, with growth of the housing finance industry, it may be prudent to establish a specialized financial institution or apex bank to take over the role of housing loan refinance and facilitate financial flows in the housing finance industry.

Toward a "level playing field": Participants strongly urged the lowering of stamp duty on mortgage registration for HFCs to 1%, which is the prevailing rate for commercial banks. In addition, licensed HFCs should be allowed to offer passbook savings accounts and a broader range of term deposit schemes than presently authorized, permission to mobilize foreign currency deposits on the same terms and conditions as commercial and investment banks, and allowed access to inter-bank borrowing.

Development of Secondary Markets: Government should take the initiative to start a mortgage-backed securities program and frame the necessary rules and regulations for securitization of such a program.

Pension, Provident, and Insurance Funds: Pension and provident funds should be allowed to flow into low risk capital market ventures for the housing sector. As an example, provident funds could be invested in a government guaranteed refinance window. In addition, investment of insurance funds in the securitization of mortgages, development of insurance company housing finance subsidiaries, and deposit insurance and mortgage related life insurance packages would facilitate development of secondary mortgage markets.

Deposit Insurance: It would be prudent to set up deposit insurance schemes to instill confidence in the safety of deposits with HFCs and with the increasing number of newly emerging financial institutions.

Fiscal Incentives: One way to reduce the high cost (currently about 20%) of taking out a home mortgage loan would be to allow home buyers to deduct interest payments from taxable income. In order to enhance the capital base of HFCs, several participants proposed a tax holiday for HFCs for a specified period of time. Others suggested that HFCs be allowed to transfer up to 40% of gross earnings to general reserves prior to computation of their tax liability.

Commercial Banks: A ceiling on housing loans by commercial banks constrains the growth of housing finance, inhibits the diversification of commercial bank portfolios into an essentially low risk area of investment, and should be abolished.

Under existing circumstances it will be difficult for the housing industry to expand and meet the growing demand for housing. It is important to note that the government has made a commitment to the establishment of a private-based housing finance industry. However, the role of government in the private housing sector does not stop with the licensing of new HFCs. In a sense, this is where goverment's most important role begins. As manager of the economy, government needs to create a nurturing legal, institutional, and economic framework to ensure a healthy housing sector.

Clearly, to enable housing finance to develop and contribute to economic and financial sector growth, a number of policy aspects of the housing sector must be supportive, so that the quantity, quality, and range of housing produced matches demand. In addition to regulatory supervision, it is government's responsibility to ensure the neutrality of interest rates and the fiscal environment, in effect, to ensure a "level playing field" for entrants to the housing sector. Furthermore, as caretaker for the social well-being of the country, government must be prepared to address supply-side constraints and ensure that mortgage and construction credit is available, and that adequate infrastructure is available to meet the growing need for decent and affordable housing.

Demand fuels housing growth, but is greatly constrained in Pakistan by inadequacies in land use planning, tenure, building regulation, construction, infrastructure, and housing policy. In order for resources to be applied efficiently to the "housing delivery system," the performance of the entire housing sector must be greatly enhanced. Without enhanced performance of the housing sector, the economic, social and financial benefits to be gained from developing mortgage finance will be realized slowly, if at all.

The table that follows, adapted from the World Bank policy paper titled "Enabling Housing Markets to Work," presents a series of policy strategies that should be adopted and practiced by the Government of Pakistan to allow the housing sector to perform adequately and meet the housing needs of the country.

As manager of the economy, government needs to create a nurturing legal, institutional, and economic framework to ensure a healthy housing sector.

Enabling Pakistan's

The DO's and DON'Ts

Policy Area: Mortgage Finance

DO:

- *Allow the private sector to lend.*
- *Encourage competition in mortgage lending.*
- *Ensure lending is at positive/market rates.*
- *Enforce foreclosure laws and debt recovery mechanisms.*
- *Ensure prudential regulation.*
- *Introduce appropriate and standardized loan instruments.*

DON'T:

- *Allow interest-rate subsidies.*
- *Neglect or disadvantage resource mobilization.*
- *Allow high default rates.*
- *Discriminate against rental housing investment.*

Policy Area: Property Rights

DO:

- *Regularize land tenure.*
- *Expand land registration.*
- *Privatize public housing stock.*
- *Establish effective property taxation.*

DON'T:

- *Make land titling expensive.*
- *Discourage land transactions.*
- *Engage in mass eviction.*
- *Nationalize land.*

Policy Area: Subsidies

DO:

- *Make subsidies transparent.*
- *Target subsidies to the poor.*
- *Subsidize people, not houses.*
- *Regularly review subsidies.*

DON'T:

- *Build subsidized houses.*
- *Allow hidden subsidies.*
- *Let subsidies distort prices.*
- *Use rent control as a subsidy.*

Housing Market to Work

of Housing Policy

Policy Area: Infrastructure

DO:

- *Coordinate land development.*
- *Emphasize cost recovery.*
- *Base provision on demand.*
- *Improve slum infrastructure.*

DON'T:

- *Neglect infrastructure investment.*
- *Use environmental concerns as a reason to clear slums.*

Policy Area: Land and Building Regulation

DO:

- *Reduce regulatory complexity.*
- *Assess the cost of regulation.*
- *Remove price distortions.*
- *Remove artificial shortages.*

DON'T:

- *Impose unaffordable standards.*
- *Maintain unenforceable rules.*
- *Design projects without links to regulatory and institutional reform.*

Policy Area: Building Industry

DO:

- *Eliminate Monopoly practices.*
- *Encourage small-firm entry.*
- *Reduce import controls.*
- *Support building research.*

DON'T:

- *Allow long permit delays.*
- *Inhibit competition.*
- *Create or maintain public monopolies.*
- *Delay provision of infrastructure.*

Policy Area: Housing Policy and Institutions

DO:

- *Balance public and private roles.*
- *Create a forum for managing the housing sector as a whole.*
- *Develop enabling strategies.*
- *Monitor sector performance.*

DON'T:

- *Engage in direct public housing delivery.*
- *Neglect a role for local government*
- *Retain financially unsustainable institutions.*

Introduction and Issues

Most banks in Pakistan have no experience in the area of housing finance as a product line and a profit center. There is a perception at large that it entails higher risk and lower profitability than commercial lines of business.

Commercial banks are not only a source of mortgage loans in most countries, but are sometimes the largest component of the housing sector. In real terms, commercial banks in Pakistan have made very little contribution to housing finance, particularly when compared with banks in other developing countries like India, Thailand, and Malaysia.

Commonly, banks in Pakistan provide housing loans only for employees and valued clients. This leaves a great majority of the country's population with no formal sorrce of mortgage credit. Investment in the housing sector can be a very profitable undertaking for commercial banks. Housing finance is a stable profit center, and when managed properly, offers the opportunity to diversify portfolios into an essentially low risk area of investment.

Collateral for mortgage is property, and property offers high security. Manufacturing loans, which are currently the preferred choice of commercial banks, actually provide lenders less security than mortgage loans. An inherent risk in commercial lending is the failure of the business, whereby the sale of primary assets of equipment and machinery typically do not go a long way in covering debts. On the other hand, a loan secured by land and housing improvements have traditionally appreciated in value over time, and as a result provide much greater equity and collateral security to the lender. In addition, people who have mortgage loans on the home in which they live will go to great lengths to repay rather than lose their basic shelter. All of these factors make mortgage lending a stable and profitable business throughout the world.

Private sector commercial banks currently enjoy the advantages of low cost funds, a lion's share of the liquidity available in the financial system, and high levels of return with very little effort. Commercial banking is highly developed in Pakistan; unlike the new housing finance companies, branch banks are established in most communities.

Commercial banks also enjoy incentives which are not available to the new housing finance companies. A primary example is the low registration fee (1%) and low stamp duty tax (1%) charged commercial banks. In the Punjab Province, HFC's must pay as much as 2.5% registration fee and 10% stamp duty tax. Commercial banks also have a rapidly expanding deposit base. With their low cost of funds (between 3% and 6%), commercial banks have three times the profit margin than will be the case for new HFC's.

However, there are also constraints that prevent commercial banks from pursuing housing finance as a source of business. A State Bank credit ceiling in the housing sector is a primary constraint, and reserve requirements, which were recently reduced from 45% to 35%, are still relatively high. This significantly reduces market liquidity. There is also a limited secondary market for short term liquidity, currently restricted to

Housing is a stable profit center, and when managed properly, offers the opportunity to diversify portfolios into an essentially low-risk area of investment.

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Federal Investment Bonds (FIBs) and Treasury Bills (TBs).

Why has housing finance been able to thrive in India— with essentially the same legal environment, court system, and debt recovery laws as Pakistan?

The answer is simply that the housing finance industry in India does not depend on the legal system. It relies on good management and sound credit appraisal procedures

—there is no substitute for a well-run company.

Commercial banks are not only a source of mortgage loans in many countries, but are sometimes the largest component of the housing sector.

Due to government deficit spending (over 100 billion rupees in 1992-93), liquidity available for private sector lending is in short supply. However, at the same time, government deficit spending has made bankers much too comfortable investing in low risk government securities and using their remaining liquidity for prime customers.

Foreclosure is a long and time consuming process, and debt recovery on defaulted loans is difficult to accomplish. The court system in Pakistan has adequate laws for foreclosure but they are poorly implemented by the responsible authorities. Following an SRMP seminar held in May 1993, recommendations were drafted for improvements to the current legal environment for debt recovery. These improvements are necessary to the long-term growth of the housing sector. At the same time, however, it must be noted that housing finance is a success in India, a country with essentially the same legal environment, court system, and debt recovery laws as Pakistan.

To a large extent, the housing finance industry in India does not depend on the legal system. It relies on good management, sound credit appraisal procedures, and computerized recovery systems. Even under an ideal legal framework, the quality of management determines the success or failure of a business. There is no substitute for a well run, efficient company.

In India, the creation of Housing Development Finance Corporation (HDFC) was an entrepreneurial response to the failure of existing public and non-specialist institutions to meet sectoral needs for housing lending. HDFC has developed an enviable capability for good administration. They have mastered credit risk analysis, avoid risky borrowers, and quickly follow up on late payments.

In 14 years of operations, HDFC has initiated foreclosure proceedings only 15 times. Last year, HDFC made thousands of new loans, maintained a recovery rate in excess of 98%, and declared a dividend of 24%. The Government of India has recently authorized HDFC to set up its own commercial banking operation, which will greatly broaden its activities and scope.

When financial institutions diversify their asset portfolios into housing, this adds to financial deepening and promotes a more efficient allocation of savings in the economy.

In Pakistan, House Building Finance Corporation (HBFC) has given the general impression that housing finance is an unprofitable business. But poor management, bad loans, irregularities, and lack of recovery systems have made HBFC a failed institution; its failure cannot be blamed on the housing industry or used to discount the value of mortgage finance as a profit making activity.

Commercial banks have been experiencing a rapidly expanding deposit base; last year the banking system experienced the highest profits in Pakistan's history. If the deposit base continues to expand, the commercial banking system will need new lines of business. Banks that look to the future and start to build a solid mortgage lending capability will be ready to take advantage of the huge demand for housing credit as their deposit base and liquidity increase. Aggressive, forward thinking commercial banks should not continue to be content with placing the majority of their funds in government securities, but should start now to build a housing finance capability.

Home mortgage lending can provide a substantial profit center and stimulate overall economic growth in the country. Allowing and encouraging private sector banks to complement and compete on a level playing field with HFCs in housing finance will expand the number of households with access to housing loans, improve individual welfare, and enhance overall economic development and prosperity.

Banks that look to the future and start to build a solid mortgage lending capability will be ready to take advantage of the huge demand for housing credit as their deposit base and liquidity increase.

Commercial banks in Pakistan should take note.....

- ***In the United States, one third of personal savings are held with institutions that specialize in making housing loans.***
- ***In Malaysia, the housing sector is a major factor in the booming economy—with 16% of commercial bank assets and 20% of finance company assets invested in housing loans.***
- ***Citibank, the most profitable bank in Pakistan, reports that its branches in most Asian countries have 20-25% of their assets invested in housing loans. Citibank is the only commercial bank in Pakistan actively engaged in housing finance.***
- ***HDFC, a private sector company, is the largest home loan institution in India. HDFC declared a dividend of 24% last year. In recognition of this success, the Government of India has granted HDFC a license to commence operations as a commercial bank.***

.....housing finance is good business.

The Banking Sector

Commercial Banks in Pakistan are very conservative organizations. Prior to nationalization in 1972, most of them generally followed prudent lending policies. Following nationalization, the loss of both autonomy and an overall risk-incentive-reward framework intensified the overall inward looking behavior of banks. Profit maximization was replaced by risk aversion.

Following partition in 1947, basic financial institutions were established to aid economic development in Pakistan. Twelve commercial banks were established in the private sector, while one commercial bank and several Development Finance Institutions (DFIs) began operating in the public sector. In the 1970's, largely in response to grievances regarding the concentration of industrial and financial power with a small corporate elite, financial institutions were nationalized. The 13 banks were merged into five nationalized banks and during this process, a proliferation of public sector development finance institutions emerged.

Though nationalization may have broken the hold of private entrepreneurs and families on the financial system, it brought many of the problems common to public sector institutions, including inefficient government subsidized programs, forced lending by commercial banks to subsidize government debt, political loans, and administered interest rates. Due to the absence of incentives for better performance, extensive government intervention resulted in a general lack of innovation in the financial market. Toward the mid to late eighties, it was evident that the financial system was in need of substantial reform.

Since 1990, the Government of Pakistan has been pursuing an economic policy of liberalization, deregulation, and privatization. This program is critically dependent on reducing the hold of the public sector and encouraging greater competition through the active involvement of the private sector. Some of the important changes reshaping the financial landscape include:

- improvement of the competitive environment in which banks operate through privatization and greater reliance on market forces;
- liberalization of exchange controls;
- deregulation of the structure of interest rates and a gradual dismantling of the system of directed credit;
- opening up the capital markets to foreign investment and equity ownership;
- auctioning of government securities;
- improved bank supervision;

Banking Institutions

As the financial sector in Pakistan has evolved, the government has created a framework for specialized institutions, each designed to meet

Recently, the government has been pursuing an economic policy of liberalization, deregulation, and privatization. This program is critically dependent on reducing the hold of the public sector and encouraging greater competition through the active involvement of the private sector.

the needs of a specific financial service. The increasingly complex nature of finance has increased the variety of institutions. These include commercial banks, investment finance companies, development finance institutions, leasing companies, modarabas, stock brokers, and housing finance companies.

The Financial Sector:

- ***4 Nationalized Commercial Banks***
- ***2 Provincial Government Banks***
- ***2 Privatized Commercial Banks***
- ***9 New Private Commercial Banks***
- ***21 Foreign Banks***
- ***15 Leasing Companies***
- ***39 Modarabas***
- ***9 Private Investment Banks***
- ***11 Development Finance Institutions***

Seven Housing Finance Companies have been issued letters of intent; two of these have been licensed and commenced operations.

The State Bank has extensive powers of credit control.

State Bank of Pakistan

The State Bank of Pakistan (SBP) is the Central Bank of Pakistan. It was established on July 1, 1948 and is the regulator of the banking and monetary system of the country. The State Bank's primary functions are control of the money supply and foreign exchange reserves, as well as protecting the interest of depositors in financial institutions. The State Bank issues currency, acts as banker for the federal government, advises the government on economic, financial, and banking issues, is the banker for the various banking institutions, controls credit policy, and regulates foreign exchange transactions.

The SBP has extensive powers of credit control, and may vary the reserve and liquidity requirements of scheduled banks and fix margins for secured advances by commercial banks. Historically, the SBP has used selective credit controls more frequently than any other instrument. Changes in bank rate and reserve operations, generally considered to be the most effective instrument of monetary policy, have rarely been used—the bank rate has remained at approximately 10% for a number of years.

Scheduled Banks

Commercial banks in Pakistan are classified into scheduled and non-scheduled. Scheduled banks are those that have capital of at least Rs. 500,000 and are listed on the schedule of the State Bank of Pakistan. Scheduled banks are the main source of short-term credit to trade, commerce, and industry, as well as the main instrument for domestic savings mobilization for economic development. Over the last few years, there has been a rapid increase in scheduled bank deposits, credit facilities, and investments.

Commercial banks play an especially important role in mobilizing deposits from the public. In addition, they are involved in helping companies meet their working capital requirements, providing a conduit for overseas Pakistanis to remit foreign currency home, and for financing foreign trade.

Nationalized Commercial Banks

The three major nationalized commercial banks in Pakistan—Habib Bank Limited, United Bank Limited, and National Bank of Pakistan—have a very large branch network that facilitates deposit mobilization. While these institutions play an important role in financing short-term credit requirements, their success in raising deposits ensures that they have a significant surplus of funds that can be on lent or invested in government securities. Two NCBs have been privatized since 1990.

The NCBs and the two previously nationalized banks have traditionally controlled in excess of

80% of banking sector activities. However, their market share has been declining over the last five years. This decline is expected to accelerate with the induction of new private banks.

New Private Sector Banks

As one of the measures to induce competition in the financial sector, the government recently allowed several financially sound groups to set up new commercial banks. Nine of these institutions have been established.

Foreign Banks

The foreign banks in Pakistan are branch operations; they are not separate legal entities. They are primarily niche players and have been successful because of their management skills and access to international financial markets. Almost 80% of foreign currency deposits are with foreign banks.

Banking Sector Regulation

Banking regulation by the State Bank is performed under the Banking Companies Ordinance of 1962 (BCO). Under the BCO, the State Bank determines policy regarding credit ceiling requirements, credit targets for various purposes, sectors and regions, margins to be maintained in respect of advances, rates of interest, charges or mark-up applied on advances, and minimum and maximum profit-sharing ratios.

Capital Adequacy and Prudential Regulations are prescribed by the State Bank, and regulate the following (Kabraji, 1992):

- limits on exposure to a single person; limits on exposure against contingent liabilities; and limit on exposure against unsecured advances,
- linkage between a borrower's equity and total borrowing from banks,
- maintenance of debt-equity ratio;
- financing facilities against shares as collateral;
- business dealings with directors, major shareholders, and bank employees;
- classification and provision for loss and assets;
- restrictions on appointment of shareholders to management;
- bank charges;
- procedures for opening accounts;
- prevention of criminal use of banks for money-laundering and other unlawful trades;
- prohibition of service charges on profit and loss sharing (PLS) accounts;
- payment of dividends;
- prohibition of cash payments outside an authorized place of business;
- procedures restricting window dressing of accounts;
- no assumption of obligations for other financial institutions.

Islamization of Banking

In the early 1980's, the government adopted a policy of Islamization of the economy and the domestic banking sector. Since January 1, 1985, domestic lending operations on the basis of interest have been prohibited. Instead, finance is made available on the basis of sale and repurchase, at a mark-up, of goods or other property.

In early 1993, the Federal Shariat Court declared that bank interest of any form, including mark-up, was un-Islamic and would cease to be legal with the new fiscal year. The government has appealed to the Supreme Court and obtained a stay order pending adjudication. Government has requested that a commission assigned to examine the issue be allowed to complete its task, and maintains that bank interest is different from usury, which is forbidden in Islam. The Supreme Court has yet to hear the government's case.

Commercial banks play an especially important role in mobilizing deposits.

Lending Patterns

Short Term Lending

Traditionally, commercial banks have focused their attention for short term lending in the field of financing working capital requirements and commerce and trade activities that generate ancillary business. The spread that they normally achieve is between seven to eight percentage points—borrowing at approximately 10% and lending at 17% to 19% with minimum risk and quick maturity. Approximately 90% of commercial banks activities are concentrated in the manufacturing, agriculture, and commerce sectors.

Approximately 90 percent of commercial bank activities are concentrated in the manufacturing, agriculture, and commerce sectors.

Banks finance the import of goods both for commercial and industrial importers by advancing Letters of Credit. Similarly, they finance purchases of raw materials, manufactured goods, and other inputs for value-added exports.

Most commercial and industrial companies utilize working capital from banks to finance their businesses. Foreign firms are subject to restrictions on the amount they can borrow for working capital.

Long Term Lending

Both the banks and DFIs provide medium and long-term credit for industrial projects. Infrastructure development in the private sector includes power generation and port

New Commercial Banks in the Private Sector (Rs. millions)

Name	Authorized Capital	Paid-up Capital	Deposits	Advances	Profit	Investment	Total Assets
Mehran	600	300	1,583.9	2,413.1	20.3	87.1	5,937.2
Prime	600	300	1,164.3	988.6	40.6	602.7	2,513.9
Union	600	300	2,174.8	1,072.3	81.1	1,078.8	8,832.7
Bolan	600	300	396.1	58.9	15.6	325.8	1,070.5
Askari	500	300	2,935.5	850.6	15	2,268	4,645.7
Soneri	600	300	1,687.5	932.4	77.2	1,067.2	3,631.4
Al-Habib	600	155	1,678.5	597.6	51.2	1,068.9	2,727
Indus	500	300	474.2	324.1	7.5	406.1	1,448.6
Metropolitan	600	300	1,026.7	481.6	11.7	704.1	2,120.3

Source: The News Special Business Report 3, June 27, 1993. Figures as of December 31, 1992.

development projects where DFIs, multilateral lending agencies, foreign government, and export finance agencies are more prominent lenders. These projects are capital-intensive with high foreign currency costs.

Consumer credit is a relatively new area of finance, and reflects the demand for products and durables by the middle class in urban areas. Currently, however, most consumer credit is limited to financing new and used vehicles.

The bulk of long-term foreign currency borrowing is used to finance industrial or infrastructural projects. These may take several forms: commercial bank loans guaranteed by export credit agencies of the country where the machinery supplier is located, credit by suppliers against the security of a local bank guarantee, and letters of credit or loans provided by foreign government owned and multilateral financial institutions against security on the project assets. This type of credit is extended to leasing companies, capital market development, and more recently the housing sector to a very limited degree. Currently, interest is allowed on foreign currency operations.

Short-term borrowing in foreign currency is mainly done by multinational firms to finance working capital requirements. Forward exchange cover is available, and the borrower is entitled to obtain a matching local currency line to the extent of the foreign currency loan.

Purchase and discounting of bills is another form of financing provided to reliable customers. Bills of exchange and checks are purchased and discounted as a means of providing the customer with credit.

Term Finance Certificates (TFCs) and Participation Term Certificates (PTCs) are certificates of fixed nominal value representing

Consumer credit is a relatively new area of finance in Pakistan.

Outstanding Commercial Bank Advances (Rs. millions)

Year	1988	1989	1990	1991
Foreign	101.6	160.6	77.4	179.4
Government	11,455.3	12,635.6	23,990	18,674.3
Public Sector Business	18,200	15,371.7	15,980.5	16,246.6
Private Business	118,126.1	133,536.3	155,794.2	172,522.1
Trust Funds, non-profit org.	160.5	197.1	441.1	231.7
Personal	14,860.6	16,430.9	20,545	14,636.3
Other Activities	146.9	138.9	161.6	168.3
Total	163,051	178,471	216,989.9	222,658.7

Far Eastern Economic Review September 1992 (Source: State Bank of Pakistan).

Citibank is the only commercial bank in Pakistan that has entered the housing finance field.

the amount of investment in a company made by an investor. They are based on the principle of profit and loss sharing instead of interest and are aimed at providing medium and long-term funds for industrial and other financing. The advantage of this security is that the certificates are a transferable investment and are particularly suited for consortium financing.

The State Bank provides refinance facilities to commercial banks at low rates. In turn, commercial banks provide finance at concessional rates for promoting exports other than primary commodities. Likewise, in order to boost the production of locally manufactured machinery (LMM), attractive financing is available to purchasers of local machinery.

In respect to housing finance, Citibank is the only commercial bank in Pakistan that has entered the housing finance field. With only four branches, Citibank has managed to provide excellent service and a substantial return to its investors.

Two years ago, Citibank lauched its Citi-car program to finance new auto purchases. There were only about 200 loans booked in the programs first year of operation. During this period, staff were trained, markets analyzed, and products fine tuned. Today, Citibank is making 200 loans each month, and expects to be making 500 loans per month by the end of 1994. Citibank is also taking a steady approach to home mortgage lending. It hopes to be making 75 loans per month by the end of 1993, and 150 per month by 1994. The Country Director of Citibank Pakistan indicates that most Citibank operations in Asia invest up to 20-25% of their total assets in home mortgages. Citibank believes housing finance is a very stable and profitable business sector.

In the public sector, First Women's Bank is developing a Rural Housing Credit Program with the assistance of World Bank. The program is similar in theory to the Grameen Bank income generating program in Bangladesh. In the Rural Housing Credit Program, after a borrowing group saves 25% of the total proposed loan amount, a housing loan is given to one individual in the group. Once a member of the group receives a loan, others are ineligible for loans until the first borrower establishes a regular pattern of repayment. Under the program, loans range from Rs. 5,000 to Rs. 25,000.

Scheduled Bank Advances: Private Sector Business (Rs. Millions)

Sector	1988I	%of total	1989	% of total	1990	% of total
Agriculture	31,393	26	37,225	28	39,916	26
Manufacturing	50,572	43	54,115	41	63,978	41
Construction	2,569	2	3,167	2	4,314	3
Commerce	23,903	20	28,431	21	35,376	23
Total	118,126	——	133,536	——	155,794	——

21st Century C & MS (Source: State Bank of Pakistan Annual Report 1990-91).

Reforms and the Commercial Banks

The timing of the government's liberalization program coincided with growth in the overall size of the market. Most of the new banks, which have been steadily growing with the market, concentrate on specific market niches for their business and are competing to offer quality services.

In the emerging economic atmosphere of liberalization and privatization, banks face new competitive challenges.

Successful banks will broaden the scope of their services, and become "problem solvers" for customers, rather than just providers of working capital and trade finance.

Growth in Bank Deposits

Between 1986 and 1991, deposits with scheduled banks increased at around 12.8% per annum. Since June 1991, deposits in the banking system have increased by 32.5% (a growth of 23% on an annualized basis). The total bank deposits as of June 30, 1992 were Rs. 416.7 billion, made up of Rs. 310.3 billion in the form of time deposits while Rs. 106.4 billion comprised demand deposits. The latest available provisional quarterly data showed that the growth rate of scheduled banks' deposits accelerated during July-December, 1992. Foreign banks hold 13% of all deposits.

Local currency deposits are maintained on a profit and loss sharing (PLS) basis, with rates announced every six months by the scheduled banks. The latest available data reflect the weighted average rates of return on PLS deposits was around 8.73% at the end of 1992, compared with 8.5% in 1991 and 7.6% in 1990.

The growth of the financial sector has been influenced by several concurrent events, including a collapse of cooperatives and the property market. This has led to a diversion of funds from other investments or instruments into the formal banking system.

Consequently, it is difficult to segregate or assess the impact of these factors on bank deposits. For instance, a fair proportion of these deposits may well represent money that has been "parked temporarily" in search of more attractive investment opportunities—for instance, in traditional investments like real estate. Factors like the low rate of return on bank deposits compared with the returns on instruments like Treasury Bills (TBs) and Federal Investment Bonds (FIBs), as well as the current rate of inflation (even at the official rate of 10%), seem to support this view.

Nevertheless, savers are at least 250 to 300 basis points better off, partly because of intensified competition between banks for deposits, but also because of the establishment of a host of different types of financial institutions, the introduction of foreign currency deposit schemes, and to a limited extent, the introduction of high yielding TBs and FIBs.

Privatization

Allied Bank of Pakistan, sold to its employees in 1991, has been recording record profits since privatization. According to an article in the August 1, 1993 edition of The News, pre-tax profits increased from Rs. 100 million in 1991

Scheduled Banks Customer Deposits (Rs. Millions)							
Category	1986	1987	1988	1989	1990P	1991P	1992P
Fixed	57,842.3	67,951.3	75,093.9	77,899.1	100,990.2	127,244.9	137,068.6
Current	33,081.0	41,079.1	40,583.5	55,868.9	61,959.7	78,067.5	88,984.2
Savings	77,670.8	88,624.8	94,027.9	107,384.1	124,957.9	157,443.5	173,195.3
Call	3,462.5	2,591.2	2,749.1	2,799.4	3,470.4	4,372.6	4,790.1
Other	5,902.6	5,888.1	6,247.1	8,471.9	8,567.8	10,795.2	12,663.9
Total	177,959.2	206,134.5	218,701.5	252,423.4	299,946.0	377,923.7	416,702.1

ANZ Grindlays Bank (Source: State Bank of Pakistan). P: Provisional figures.

Credit ceilings have adversely affected commercial banks' incentive to utilize scarce private sector liquidity for investment in housing finance.

to Rs. 355 million in 1992. During the same period, deposits increased by 35%, and advances and investment grew by 39%.

Overall, in 16 months of privatization, Allied has seen a growth of 633% in pretax profit, 65% in deposits, 54% in investments and advances, 765% in industrial financing, 132% in imports and exports, and 147% in home remittances.

The chairman of Allied Bank believes that privatization on the basis of employee profit sharing has strengthened the enthusiasm of the bank's workforce of 8,000 and that commitment, devotion, and hardwork have enabled the bank to achieve unprecedented results in growth.

Ceilings

Until mid-1992, in an effort to ensure that the aggregate credit expansion by commercial banks did not exceed overall limits, the State Bank of Pakistan allocated individual ceilings to all commercial banks. These ceilings were calculated on the basis of the bank's share of total deposits in the previous year, the size of the bank's capital fund, foreign currency deposits, and the previous year's utilization.

To promote the flow of credit to priority sectors of agriculture, small scale industry, and small business, mandatory targets were laid down. Ceilings were fixed for preshipment export credit, fixed industrial investment, and housing loans. If mandatory targets were not achieved or ceilings were breached, the State Bank imposed penalties.

One of the basic problems with credit controls is that allocation of commercial bank credit to the private sector is treated as a residual after meeting the credit requirements of the government and public sector enterprises. Credit ceilings adversely affect commercial banks' incentive to mobilize deposits, and inhibits competition among banks.

A number of policy changes were made during 1992-93 to streamline monetary policy instruments and to move towards market-based monetary management. In a major step in this direction, the use of credit ceilings as an instrument of credit control was abolished in August 1992 and replaced by a system which requires the commercial banks to extend credit to the private sector within credit/deposit ratio limits worked out on a quarterly basis.

The key policy tool under indirect monetary control will be the management of money reserves through open market operations, changes in cash reserve requirements, the discount rate, liquidity ratios, and various selective credit control measures.

The liquidity ratio was raised from 35% to 40% in mid-1992, and to 45% in December 1992. In October, 1993, the State Bank of Pakistan lowered the liquidity ratio to 35%, thereby making an additional Rs. 57 billion in credit available to the private sector. Credit/deposit ratios are governed in the following manner:

- Liquidity ratio/reserve requirements: Cash 5%, Other Reserves (Gold, Approved Securities, FIBs); 30%
- Mandatory targets and ceilings: Public sector credit; 30%
- Discretionary: Private sector credit; 35%

Lifting the credit ceilings under the new formula does not change the present position of banks in any significant manner. Mandatory targets to priority sectors continue; however, credit is linked to deposits in a transparent manner.

One of the basic problems with credit controls is that allocation of commercial bank credit to the private sector is treated as a residual after meeting the credit requirements of government and public sector enterprises.

In the unregulated private sector, commercial banks continue to concentrate on short-term financing in a field of trade and commerce in which they have knowledge and expertise. In addition to being of short term nature, the risk element is minimum and such financing generates ancillary business. Banks also meet short term working capital requirements for their best customers.

For running finance purposes, banks currently make funds available to customers at interest rates ranging from 12-20%. For term loans, banks have recently lent funds at interest rates ranging from 13-20%. Short term investment of funds include equities, while longer term use of funds include fixed asset purchases.

High reserve requirements leave little liquidity for discretionary lending in the housing sector.

Banks routinely trade ceilings among themselves to meet State Bank requirements. The market for ceiling funds is strictly a function of supply and demand, and it follows a seasonal trend. For example, in the cotton season, from approximately November to February, the demand for ceiling normally outstrips supply and becomes quite expensive; it has been as high as 35% on occasion.

Inter-bank Call Money Market

In order to meet short term requirements, scheduled banks borrow from each other at call. As the name implies, call loans have no set maturity, and can be called back at any time. These loans may be overnight, one week, or for up to a month depending on demand and supply in the money market.

The call rate fluctuates with the demand and supply of call funds in the market. The object is to obtain high lending rates and low borrowing rates. Rates can be as low as one-half percent or as high as the State Bank repurchase (repo) rate. From 1981 up to the pre-reform period of 1991, rates ranged from 5.5% to 8%.

Since the reforms of 1991, call rates have varied between 1% to 14%. Similarly, the

State Bank discount/repo rate increased from 6.06 % to 14% during this period; it has now been raised to 15%.

To manage short term liquidity requirements, banks can resort to repurchase agreements with other financial institutions, which means selling the security and simultaneously buying it back at a marked-up price on a specified date. The State Bank also provides repo facility at 15%. Alternatively, in the absence of the repo facility, a bank can liquidate securities to raise funds.

Foreign Exchange

The US dollar/rupee rate is managed by the State Bank and is fixed at the start of any given day. Transactions in the local market are performed between various treasury departments of banks as well as authorized foreign exchange brokerage houses. In view of the fluctuations and volatility in the international markets, the State Bank allows a certain margin to cater to the volatility in the exchange rate.

The uniqueness of this market is that the rates are quoted to the customer in the morning and remain fixed throughout the day, irrespective of the movements in international markets.

Prior to May 1991, foreign currency deposits could only be maintained by non-resident Pakistanis. The economic reforms of 1991 now permit resident Pakistanis to hold foreign currency deposits. Foreign currency deposits increased by US $ 1.4 billion between May 1991 and November 1992.

The economic reforms now permit Pakistanis to hold foreign currency deposits.

Privatization Works:

Nationalized Commercial Banks currently dominate the branching and deposit network in Pakistan.

Accelerating the privatization of NCBs will allow them to be more efficient and competitive—and will increase the depth and breadth of the financial system.

Allied Bank is a prime example of the immediate benefits that can be gained through privatization of a nationalized bank.

Government Debt, Securities, and the Commercial Banks

The long term climate for growth and the ability of the government to support development in a stable environment are threatened by large and unsustainable fiscal deficits. High levels of government borrowing, primarily from domestic sources, has resulted in a rapid accumulation of debt servicing obligations. This puts pressure on future borrowing and crowds out private investment.

The fiscal deficit is currently estimated at 107.7 billion rupees.

\ critical issue facing the economy in the ecent past has been the trend of rising fiscal leficits. The consolidated fiscal deficit during he period 1980/81 to 1991/92 averaged around '.2% of gross domestic product (GDP) nnually, growing at a rate of almost 22% per nnum.

n July 1993, the revised estimate of the deficit vas Rs. 96.69 billion, or 7.1% of GDP. In the State Bank of Pakistan's 1992-93 annual eport, the revised estimate currently stands at ts. 107.7 billion, or 7.9% of GDP, for which et internal bank borrowing was Rs. 62.6 illion.

'he broad composition of this debt has icreased the share of the permanent debt omponent to 41.4%, while that of the floating ebt has dropped to 35.8%. Growing interest ayments now represent approximately 40% of urrent expenditures.

ince March 1991 the government has been unctioning two debt instruments, Treasury bills TBs) and Federal Investment Bonds (FIBs). reasury bills, a floating debt instrument, are ero coupon instruments of six months maturity. They are treated as money market instruments and can be discounted with the State Bank. Their liquidity derives from their short term maturity period.

FIBs are fixed income securities, paid half yearly, carrying a rate dependent upon the maturity period; 13% for three years, 14% for four years, and 15% for five years. They are not redeemable before maturity.

For individuals, TBs are subject to a 30% withholding tax, while FIBs are subject to a 10% withholding tax. Corporations and local banks are subject to a 30% withholding tax while foreign banks pay 65%. Six month TBs and three year FIBs are viewed as liquid instruments by financial institutions and are used in inter-bank trading.

As part of the government's reform measures, the State Bank established the Subsidiary General Ledger Account (SGLA), a book-based system for settling secondary market deals. The establishment of a book-based system at the State Bank has improved the security and efficiency of the system, as physical movement and handling of securities is no longer required.

The Auction Market for Government Debt

The government raised Rs. 76 billion through TBs in 1991-92, and Rs. 106.2 billion in 1992-93. The cut-off yield which on average, stood at 11.6% per annum during 1991-92, increased to 12.5% during 1992-93.

In absolute terms, banks investment in TBs was Rs. 99.2 billion during 1992-93, an increase of 33.2% over the preceding year. However, due to increased investment in TBs by the non-banking sector, banks' share in total investment declined from 98.02% in 1991-92 to 93.4% in 1992-93.

Federal Investment Bonds

Rs. 44.9 billion was raised by the government through FIBs during 1991-92, while 53.6 billion was raised during 1992-93. Banks' investment in FIPs was Rs. 40.9 billion during 1992-93, an increase of 24.3% over the preceding year.

Maturity-wise analysis shows that banks currently prefer 3 and 5 year FIBs to 10 year FIBs. This shift in preference from long-term to short and medium term government paper is largely attributable to a squeeze on the banks liquidity position during 1992-93 that emanated in part from the (then) Prime Minister's Self-employment Scheme, and in part from two consecutive increases in statutory liquidity requirements.

Government debt servicing now consumes over 40% of the annual federal budget.

Government of Pakistan: Sources and amounts of financing budget deficit (consolidated) as % of overall deficit (Rs. Millions)

Year	Deficit	% of GDP	Bank	% of total	Non-bank	% of total	External	Net (%)
1986-87	46,710	8.2	10,915	23.4	27,371	58.6	8,424	18.0
1987-88	57,563	8.5	13,941	24.2	30,931	53.7	12,691	22.0
1988-89	56,879	7.4	819	1.4	37,865	66.6	18,195	32.0
1989-90	56,060	6.5	3,534	6.3	29,581	52.8	22,945	40.9
1990-91	89,193	8.7	43,368	48.6	23,724	26.6	22,101	24.8
1991-92	93,639	7.7	72,462	77.4	-627	-0.7	21,804	23.3
1992-93*	96,690	7.1	45,196	46.7	18,489	19.1	33,017	34.1

The News, 31 July, 1993 (Source: Finance Division and State Bank of Pakistan) * Estimated

Implications for the Housing Industry

The burgeoning budget deficit of the government has been placing a huge demand for funds on the financial system, setting a bench mark for the price of credit. In a market starved for funds, banks are not under any pressure to venture into activities other than those they have historically performed.

There is a huge demand for credit against which "better quality" collateral is being offered than would be provided by an individual seeking a housing loan. In addition, Government, in view of its massive deficit, is offering risk-free returns of between 13-15%.

Given high risk free yields on long term government bonds, 18-20% interest rates on most corporate credit, and the relatively small administrative costs of these large value transactions, banks will probably broaden their base of operations into relatively riskier areas only if the profit margins are higher, which would mean an interest rate of at least 20%, excluding the 1% excise duty payable on capital loans.

The State Bank does repurchase agreements at 15%, with the objective of forcing banks to concentrate on cash management. However, the fact that the State Bank is always willing to do repo at a fixed rate, a rate which does not adjust to changing market conditions, is adversely impacting upon the development of a secondary market.

Development of a secondary market for private sector debt and a wide range of financial instruments is necessary so that the market provides the liquidity, rather than the State Bank's repurchase window.

Currently, approximately 80% of government deficit spending is funded by commercial banks. Furthermore, the relative absence of instruments in the market other than TBs and FIBs effectively means that except for designated ceiling funds, the government is holding the funds of banks captive.

At a recent international seminar on commercial banking, the Deputy Governor of the State Bank of Pakistan, M. Ashraf Janjua, stressed that banks should not be forced to carry the entire burden of meeting the credit needs of the economy.

> *"The government has to learn to live within their means and not to pre-empt a large part of the bank's credit while the corporate sector has to contain its reliance on bank credit." (Business Recorder, June 23, 1993)*

Low priority

In general, the government has accorded very little priority to the housing sector. Commercial banks are allocated ceilings for housing finance construction at 1-3% of their total lending operations to private sector business. Approximately 95% of the ceiling is lent to bank employees as a job perk, and

Banks invest a great deal of their discretionary funds in government debt— essentially squeezing the private sector out of the credit market.

therefore can not really be considered as part of the formal housing finance system.

Credit Ceilings and Reserve Requirements

In October of 1993, the State Bank of Pakistan lowered the liquidity ratio of banks from 45% to 35%. With directed credit to priority sectors at 30%, the new credit ceiling structure now leaves 35% of bank funds for private lending purposes. This is a positive development. However, competition is still not exacting enough to compel commercial banks to look for other areas in which to invest, and so a great deal of their discretionary funds are invested in risk-free government debt instruments, essentially squeezing the private sector out of the credit market.

As economies move from low to moderate rates of economic development, residential mortgage lending moves from virtually zero to about 25% of the assets of the financial sector.

Perceived higher risk and lower profitability

There is a myth of high risk and low profitability associated with housing finance. In reality, however, mortgage loans are actually a lower risk investment than commercial loans when one considers that property, which generally appreciates in value, is offered as the collateral for a home loan. Conversely, equipment, which depreciates in value, is offered as collateral for industrial and commercial loans.

Likewise, a homeowner's mortgage loan is often their only significant outstanding debt, whereas commercial businesses often owe significant amounts of debt to a number of creditors.

Mortgage lending, bridge financing, and construction loans would allow banks to diversify their portfolios, which would reduce the risk of concentrated investments. And at various levels, the banking system in Pakistan currently shows a high degree of concentration.

First, there is a limited number of financial intermediaries coupled with the dominance of a few. Three nationalized commercial banks and the two previously nationalized banks have traditionally controlled in excess of 80% of banking sector activities.

Second, and more significant, is the concentration of advances in the banking sector. For example, in 1986, according to a World Bank report on Pakistan's financial sector, 0.3% of loans accounted for more than 50% of loans outstanding. Approximately 8% of loans accounted for 90% of the total loan amounts.

Since one firm generally has multiple accounts, and firms belonging to a group would collectively have a large number of accounts, the actual concentration of loans is likely to be significantly higher. As a result, the banking system is probably heavily exposed to a small number of borrowers.

The third level of concentration relates to sectoral distribution of portfolios. Currently, over 90% of commercial bank activities are in manufacturing, agriculture, and commerce. In 1990, construction accounted for only 3% of scheduled bank advances to private sector business, and maximum lending to the housing sector by commercial banks interviewed for this study was 1-3%.

It is generally believed that as housing finance is a long term investment, short-term resources for financing operations is a risky venture. Although concerns regarding cost of capital, the mix of deposits, equity, and long term financing are well placed, they exaggerate the dilemma of resource mobilization. The role of all financial intermediaries is to raise funds for onward lending, taking into consideration liquidity requirements. How well they cover these risks, barring, of course, unforeseen events, will determine the efficiency with which they manage their operations.

Housing finance is an integral component of the financial sector in both developed and developing countries. In 1989, the level of mortgage debt as a percentage of GDP was 58.3% in the UK, 45.2% in the US, and 25.1% in Japan.

As economies move from low to moderate rates of economic development, residential mortgage lending moves from virtually zero to about 25% of the assets of the financial sector.

In Malaysia, it is estimated that housing loans represent about 16% of the outstanding portfolios of commercial banks. In India, many commercial banks have set up HFCs as their subsidiaries.

Foreclosure

A large problem in developing housing finance in Pakistan is the difficulty of enforcing foreclosure laws in the event of a default. Delays are characterized by procedural defects, overworked and understaffed courts, reluctance by the courts to compel compliance with statutory time limits, ancient and archaic office management methods and systems used by court registries, and liberal granting of appeals. As a result, the judicial system fails to resolve disputes in an efficient, effective, and timely manner.

It is disconcerting to note that from 1987-1991, banks in Pakistan referred 27,590 cases of credit default at a total amount exceeding Rs. 2.73 billion to the Banking Tribunals.

Problems related to foreclosure and debt recovery can be resolved by strengthening institutional capacities and by enforcing relevant legislation, creating an environment which emits a clear signal that the government and the courts mean business and that defaulters will not be able to escape the penalties laid out in the law.

However, even under an ideal legal and institutional framework for debt recovery, the quality of credit management in financial institutions is a fundamental variable that separates solvent and insolvent financial institutions—there is no substitute for good management.

In India, Malaysia, and Sri Lanka, leading financial institutions maintain recovery rates of 90% and often much higher. These institutions have mastered credit risk analysis, avoid risky borrowers, and rapidly follow up on late payments before they become a problem.

A large problem in developing housing finance in Pakistan is the difficulty of enforcing foreclosure laws in the event of a default.

The banking system in Pakistan is highly concentrated...

- ***There are a limited number of financial intermediaries coupled with the dominance of a few. Three nationalized banks and the two recently privatized banks have traditionally controlled in excess of 80% of banking sector activities.***
- ***In 1986, 0.3% of the number of loans accounted for 50% of loans outstanding, and about 8% of loans accounted for 90% of the total loan amounts.***
- ***Over 90% of banking sector activities are in manufacturing, agriculture, and commerce.***

Issues for Action

In Pakistan, it is critical for the government to create an enabling environment for long term development of housing finance. Similarly, commercial banks, which are an integral component of the economy, can and should play a pivotal role in the growth of this new sector. The rest of this section is devoted to specific recommendations which, taken together, can assist in the development and expansion of housing finance in Pakistan.

Throughout the 1990's, infrastructure spending will be a major focus of commercial bank lending in Asia— in Pakistan, commercial banks have a pivotal role in broadening and deepening the financial sector so that some of the growing urban needs can be met.

Expansion of the financial system

There is room for further expansion of the financial system in Pakistan. If more commercial banks were allowed to establish operations, and less restrictions were placed on foreign bank branching, the result would be a much greater mobilization of deposits and increased competition among banks.

Under the prudential regulations, the recent strengthening of the regulatory and supervisory framework can ensure that private bank ownership patterns and portfolio behavior is in line with sound banking practices and socio-economic objectives established by the government. Higher levels of competition will encourage banks to enter new fields such as housing finance.

In Pakistan there have been discriminatory restraints on foreign bank activities, particularly on branch expansion. Considering the government's overall objective of encouraging foreign investment, limiting one or another kind of foreign investment sends contradictory signals. Restraining factors like country exposure limits and competing claims on foreign banks' equity effectively dispel the myth that foreign banks could ultimately dominate domestic banking. Foreign banks not only provide quality service to their customers and a valuable contribution to the local economy—they offer valuable management training skills to their employees as well.

Privatization of Nationalized Banks

The nationalized commercial banks (NCBs) are dominant institutions in the banking system. More often than not, because of their unsatisfactory autonomy, accountability, and system of rewards, the NCBs have been less efficient and competitive than their local private sector and foreign bank counterparts. Since the NCBs dominate the branching and deposit network, it seems clear that increasing the depth and breadth of the financial system cannot be accomplished unless the NCBs become more efficient and competitive.

Allied Bank exemplifies how inefficiency and lack of competitiveness can be turned around when a nationalized bank is privatized in Pakistan. Government should heed the message of Allied Bank's success and accelerate the privatization process for the

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remaining nationalized banks. However, to maximize the return from bank assets, the privatization process needs to be transparent, banks should be sold to the general public through the stock market.

Disintermediation for banks as capital markets grow

A crucial question for banks in Pakistan, in Asia and throughout the world is the extent to which they are likely to be disintermediated from their traditional lending functions by the growth of capital markets, where direct investment continues to grow. This has happened throughout the developed world in the 1980's and will likely continue in the 1990's.

Local governments should have the authority to address infrastructure needs.

If in fact the capital markets in Pakistan continue to expand and strengthen, which they can and must do, direct investment will also increase and could potentially erode the growing commercial bank deposit base. It could also provide prime customers with reason to take their deposits elsewhere as alternative investments in secondary market financial instruments become more widespread and readily available.

Commercial Banks can offset disintermediation and continue to raise deposits through home buyer deposit schemes, which would in turn generate new deposits and a large new business clientele from the growing number of Pakistanis who do not own their own home simply because there is no credit available to them.

Infrastructure financing

There will be other demands on bank resources in the 1990's. The Far Eastern Economic Review (September 24, 1992) suggests that infrastructure spending will be the major focus of 1990's commercial bank lending in Asia. Pakistan will not be able to continue its industrial growth without paying major attention to the sad shape of existing infrastructure in its urban areas. Public sector banks and Government do not have the resources to begin to handle this growing urban problem.

New capital formation and private bank capital will have to play an increasingly important role in Pakistan's infrastructure finance. Already Development Finance Institutions (DFIs) in Pakistan have been experiencing a loss of funding by multinationals, and have been forced to concentrate on attracting more of their capital through domestic deposits.

Commercial banks can play a significant role in broadening and deepening the financial sector so that the capital base is increased and at least some of the growing urban needs can be met. Infrastructure financing can be collaterized by the wealth of the land it serves.

Government urgently needs to stop deficit development spending and create an environment that enables the private sector to do the job it has been unable to do. This would free up capital currently going to government, and would make development more efficient, and very likely better planned and implemented.

Local governments should have the authority to address infrastructure needs. Short and long term financing in the form of a municipal bond market could help solve this problem. To accomplish this there is a need for an independent rating institution, uniform and reliable financial data from the issuing municipalities, and clear and concise regulatory restrictions which enable local authorities to manage debt with minimal central government oversight.

In the United States, the municipal bond market has existed for over two hundred years. In 1992, US local governments issued $235 billion worth of municipal bonds for a variety of items, including water and sewer facilities and highway and toll roads. Commercial and investment banks can serve as intermediaries and develop the capacity to rate municipalities and provide management services for municipal bond issues.

Innovation

Citibank is one of the most innovative commercial banks in Pakistan. They are developing new product lines to attract new customers and expand the capital base. Their latest product is the Share Multiplier Margin Financing Account. This account will provide customers with capital against shares pledged as collateral, thus increasing the capital base. The new product offers a complete financial package to the stock market investor. Cash can be borrowed against shares, and custodial actions, as well as trading and investing in further shares, are handled by the bank. This is the type of innovation that, like housing finance, can keep commercial banks competitive in the market place.

Bridge financing

Most construction in the country is done on an individual and informal basis, where standards of quality are low or nonexistent and development has a tendency to occur without the provision of essential services. One of the primary reasons for this is the lack of bridge financing available to build large multi-unit developments with better infrastructure and economies of scale in terms of material and labor costs.

Bridge financing is a traditional investment for commercial banks. It is generally a two to three year period of financing, which compliments the short term lending role of most commercial banks. In addition, bridge financing can attract many new customers. Developers direct clients seeking mortgage loans on individual units to bridge lenders. The lender makes money both on the shorter term bridge financing and on the longer term mortgage loan.

A survey of builders and developers indicates that they are willing to pay over 20% mark-up for bridge financing. However, bridge financing can be risky and it will require a conscious effort on the part of commercial banks to gain the staff expertise necessary to analyze and control the development process. There are also safeguards available for commercial banks that enter this field. In many countries in the region, banks routinely form syndicates to spread the risk of construction bridge-financing.

In Malaysia, a project development account is legally required for construction of more than five units. Bridge loans for the projects are kept in development accounts and are disbursed by the lending agency based on documentation of expenditures by the developer. Money collected by the developer from client booking units also goes into this account and can only be disbursed based on progress made in the construction of the units.

Required investment in housing finance

The government should seriously consider the potential benefits to the overall economy of greater involvement by commercial banks in the housing finance system. In Malaysia, commercial banks are required to invest 5% of their total assets in the housing sector. This has created a booming housing finance industry with thousands of new jobs and a growing store of wealth in the houses built.

National Savings Centers

The government should stop competing for funds with financial institutions in Pakistan. A recent government savings scheme pays 13.6% interest and is tax and zakat exempt. This drives the cost of funds for banks and particularly for HFCs, even higher.

Interbank funds and passbook savings accounts

Commercial banks have not been anxious to enter the housing finance field. There are new HFC's currently opening their doors for business. The commercial banks should support the efforts of HFC's to gain access to interbank funds on par with commercial banks and be allowed to offer passbook savings accounts to their customers. Government should also support these two modifications.

Incentives:

- ***Allow a percentage of the money advanced for home loans to be tax exempt.***
- ***Allow borrowers to deduct mortgage interest payments from their income taxes.***
- ***Remove the 2% excise levy on housing construction valued over 50,000 rupees.***
- ***Allow a three-year tax holiday to new HFCs.***

since the first will provide a "bank of last resort" for HFC's, and the second will help expand the savings deposit base in the country.

Incentives

There are several ways for commercial banks to become involved in housing finance. This can be direct involvement, whereby the banks set up new departments and start to book home mortgage loans. Alternatively, banks can indirectly participate in housing finance by providing capital for the State Bank to on-lend to Housing Finance Companies. With SRMP assistance, a refinance window for housing will be opened at State Bank. Commercial banks could purchase packages of refinanced mortgages to meet a specified portion of their reserve requirements. Another option for indirect involvement would be for the banks to lend to the refinance window funds at a rate consistent with the rate they receive for Treasury Bills or Federal Investment Bonds. Either way, whether tied to reserve requirements or outside of them, there should be no ceiling limiting the amount of investment in the housing sector.

Local governments need to be able to address their infrastructure needs and manage debt with minimal central government oversight.

A municipal bond market would address short term and long term infrastructure financing requirements.

Government may provide fiscal incentives to commercial banks that take the initiative to enter the home mortgage business directly. It follows that these incentives should also be given to the new HFCs. One suggestion has been that a percentage of the money advanced for home mortgages be tax exempt. This of course would be a benefit for the commercial banks.

Another incentive would be to give borrowers a tax break by allowing them to deduct mortgage interest payments from their income tax. In the United States, this is a primary tax incentive for individuals as they can deduct the interest paid on a house in which they live from their taxable income.

A third incentive would be to remove the 2% excise currently levied on housing construction valued over 50,000 rupees.

A fourth incentive would be aimed at HFC's as part of the newly declared "construction industry." A three year tax holiday would allow the new companies to lower their cost of funds by 20% and give them a chance to gain some financial depth before being subject to tax burden. The tax exemption could be structured to require the HFC to retain any corporate earning from the tax holiday to increase its capital base.

In India, a public company formed and registered with the main object of carrying on the business of providing long-term finance for construction or purchases of houses for residential purposes can create a special reserve with an amount not exceeding 40% of their total income. Such a reserve is admissible as a deduction in computing income chargeable to income tax under the Profits and Gains of Business or Profession section of the Income Tax Act.

In Sri Lanka, 75% of the income of a company engaged in lending for housing construction is exempt from corporate income tax, provided the income is derived from loans promoting the construction of housing units with less than 2000 square feet of covered area. In this way, the government provides a tax incentive and at the same time directs the incentive towards the middle and lower parts of the housing market by limiting the size of the housing units.

Wealth tax exemptions should also be considered. In Sri Lanka, there are two housing related exemptions from wealth taxes. One house used as a residence by the owner is exempt, and any house having a floor area not exceeding 500 square feet is exempt for six years. In India, deposits up to Rs. 500,000 placed with an HFC are exempt from wealth tax.

It seems clear that if government is serious about supporting the housing finance sector they will have to consider some kind of incentive if they wish to have the commercial banks enter this field. Incentives would be a positive signal to banks that the government is serious about housing finance and wants it to grow and prosper in Pakistan.

Seminar Conclusions and Recommendations

On August 12, 1993, the Shelter Resource Mobilization Program of USAID, in conjunction with 21st Century Consultancy and Management Services, sponsored a national seminar on the role of commercial banks in Pakistan's housing industry. This was the third in a series of seminars being sponsored by the SRMP to explore housing finance issues with leading policy-makers.

This one-day seminar was designed to educate Pakistan's bankers about investment opportunities in housing finance, and identify ways and means to stimulate housing sector lending by banks. Approximately 100 senior executives of commercial banks, housing finance firms, and developers participated in the seminar, which was chaired by Mr. Ashraf Janjua, Deputy Governor of the State Bank of Pakistan.

In his speech, Deputy Governor Janjua described the negative impact on the economy of the government's high level of domestic borrowing to cover its budget deficit, and called for a gradual but marked decline in borrowing. Government borrowing has been absorbing about 80% of all credit, creating intense competition among private firms for resources and pushing interest rates to high levels. Few private firms are now able to raise resources to expand business.

As new players in the finance sector, the specialized housing finance companies have a far harder time mobilizing capital resources than do the established banks. Banks in Pakistan have more than 6,000 branches, enabling them to reach a very broad range of households. Over the past several years, deposits have been rising at a rate of 23% per year as funds have moved into the banking system from speculative investments in urban real estate. Lending, however, remains highly concentrated in the manufacturing, agricultural, and commercial sectors, mostly in short-term assets.

Citibank Housing Finance Company, a subsidiary of Citibank, was the first specialized licensed housing lender to begin operating in Pakistan. In his Keynote Address, Mr. Shaukat Tarin, Country Head of Citibank, focused on the opportunities offered by housing finance.

Mortgage lending is one of the few options available to Pakistani banks to diversify their portfolios with longer-term assets, and developing a mortgage portfolio would enable banks to spread risk over a broader base and reduce vulnerability to business down-turns. Furthermore, as Pakistan's capital markets expand, investors will develop the ability to invest directly, rather than through banks, and the deposit base of banks may begin to erode.

Over the past several years, Pakistan has made significant strides toward liberalizing and

A low and rigid ceiling on credit for housing inhibits banks from developing a portfolio of loans and the actuarial base to diversify their portfolios.

Bridge financing is a traditional investment for commercial banks in many countries.

deregulating the finance sector, but banks still experience difficulty in expanding their range of activities, especially in housing. These constraints, which were a focus of discussion at the seminar, include lack of liquidity due to government borrowing, maintenance of a low and rigid ceiling on bank credit for housing, and lack of a supportive policy and procedural environment for the housing sector.

Seminar participants unanimously agreed that enabling, allowing, and encouraging commercial banks to complement and compete on a level playing field with HFCs in housing finance would expand the number of households with access to housing loans, improve individual welfare, and enhance overall economic development and prosperity. In this regard, the following recommendations were formulated during the course of the seminar:

Reduce the budget deficit: Seminar participants unanimously agreed that measures to bring down the government's budget deficit, now approximately 8% of GDP, are urgently needed. By soaking up the liquidity in the financial system, Government is raising the level of interest rates in the economy, capturing the majority of scheduled bank deposits at artificial interest rates, crowding out the private sector, and thwarting the development of the financial sector.

Abolition of housing sector credit ceiling: Increased involvement in housing finance can be a very profitable undertaking for commercial banks. Housing finance is a stable profit center, and when managed properly, offers the opportunity to diversify portfolios into an essentially low risk area of investment. However, commercial banks are constrained from housing lending by a 1% ceiling on such loans, which inhibits them from developing a portfolio of loans and the actuarial base through which they can diversify their portfolios. Commercial banks should be allowed to develop mortgage lending on a market level as part of their overall business plan. Therefore, all housing sector lending by commercial banks, including residential mortgage loans, home improvement loans, and housing sector construction bridge financing, should be considered as "outside" the credit ceiling system.

Further expansion and de-regulation of the financial sector: Existing commercial banks are highly regulated, and should be allowed to play a more independent role in expanding their resource base. Furthermore, new commercial banks should be given permission to establish operations in the private sector as demand warrants. Combined, these actions would lead to increased deposit mobilization and competition among banks. Increased competition will encourage banks to enter new fields, including housing finance, which will in turn directly contribute to a broader and deeper financial sector.

Development of bridge financing: Bridge financing is a traditional investment for commercial banks in many countries. It is generally a two to three year period of financing, which compliments the short term lending role of most commercial banks. In addition, bridge financing can attract many new customers. Developers direct clients seeking mortgage loans for individual units to bridge lenders. The lender makes money both on the shorter term bridge financing and on the longer term mortgage loan.

Banks that choose to enter the profitable business of bridge financing will have to develop the capability and staff expertise to monitor the development process. Well-developed and standardized procedures for bridge financing can enable banks to maintain a great deal of monetary control and oversight during the development process. In Malaysia, for example, bridge loans are kept in project development accounts, and are disbursed by the *lending company* based on documentation of expenditures by the developer. Money collected by the developer from client booking of units also goes into this account. In many countries in the region, banks routinely form syndicates to spread the risk of construction bridge financing.

USAID Assistance: Seminar participants proposed soliciting additional help for the housing finance industry through USAID and the Shelter Resource Mobilization Program.

Efforts in this regard are already underway, and through the SRMP, USAID has offered to provide a US $15 million Housing Guaranty (HG) loan to start a refinance window at the State Bank of Pakistan. The window will operate at market rates to refinance eligible mortgages and loans made by licensed housing finance companies and private commercial banks. USAID has also offered related technical assistance to structure the operations of the window and develop adequate loan underwriting standards and documentation.

Apex bank: With growth of the housing finance industry over time, it may be prudent to create a specialized financial institution to oversee housing loan refinance, to act as a lender of first resort, and to facilitate financial flows in the housing finance industry. A national mortgage bank could expand and continue resource mobilization through meeting short and long term requirements of funds from both public and private sectors at home and abroad. It could issue various capital market instruments like house bonds, commercial paper, mortgage backed securities, and design home linked savings deposit schemes, including passbook savings and foreign exchange deposits.

Fiscal Incentives: Several seminar participants recommended tax concessions for investment in housing, which is a common practice in several countries in the region. In Sri Lanka, for example, 75% of the income of a company engaged in lending for low cost housing is exempt from corporate income tax. In India, HFCs can transfer up to 40% of their gross earnings to general reserves prior to computation of their tax liability. Any funds removed from reserves are then subject to taxation. This is a positive incentive which would benefit the industry at little cost to Government. The SRMP believes this type of incentive would be more productive than a tax holiday, as it allows the industry to broaden its capital base and helps strengthen overall savings in the economy.

Expand housing sector investment: Investment banks, leasing companies, modarabas, life insurance companies, and pension and provident funds are restricted from housing sector investments. Insurance funds, for example, have played a very important role in the development of housing finance systems in most countries. In addition to investing insurance funds in the securitization of mortgages, insurance companies have found it profitable to set up housing finance subsidiaries. Likewise, insurance companies have played a crucial role in offering deposit insurance and mortgage related life insurance packages, which in turn, facilitates the development of secondary mortgage markets. Therefore, seminar participants recommended that housing investment restrictions be removed, thus enabling the housing sector to compete with other sectors for credit.

Housing credit fund: In view of the paucity of credit for the housing sector, seminar participants recommended that the State Bank consider the development of a Housing Credit Fund to make medium and long term loans available to home loan agencies for meeting capital requirements. This is similar in theory to the existing Export Credit Fund and Industrial Credit Fund. Subsequent follow-up by the SRMP revealed that such a fund, which is apparently relatively unknown and unused to date, has been established at the State Bank for several years.

Cross-subsidizing mark-up fees: Several seminar participants expressed concern that lower income segments of the population can not afford home loans, and recommended that different rates of mark-up be established for various categories of houses within the framework of the overall structure of loan operations. In this manner, lower mark-up rates for lower income groups would be offset by higher mark-up rates for middle and upper income groups.

Hire-purchase facility for low income employees: In order to boost the housing industry and provide a mechanism for lower income families to be homeowners, several seminar participants felt that large companies, with financing from HFCs, should be encouraged to construct housing for employees, especially low income employees, on a hire-purchase basis.

A refinance window at the State Bank of Pakistan is a first step toward development of a secondary market in housing finance and could lead to the development of mortgage backed securities.

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Appendix B: Agenda

Seminar on the Role of Commercial Banks in Pakistan's Housing Industry

August 12, 1993 Karachi

9:30	Participant Registration
10:00	Recitation from Holy Quran
10:05	Welcome address by Mr. Askari Taqvi, Chairman Twenty-First Century Consultancy and Management Services (Pvt) Ltd.
10:10	Address by Mr. William J. Strong, Housing Finance Advisor, Shelter Resource Mobilization Program (SRMP), USAID
10:15	Keynote Address by Mr. Shaukat Tarin, Country Head, Citibank N.A.
11:00	Presidential Address by Mr. Buhammad Ashraf Janjua, Deputy Governor, State Bank of Pakistan
11:15	Break
11:30	Discussion of issues and formulation of recommendations
1:00	Break
2:00	Discussion of issues and formulation of recommendations
4:00	Concluding remarks by Mr. Jon Wegge, Chief Technical Advisor, Shelter Resource Mobilization Program (SRMP), USAID

Appendix C: List of Participants

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AMEMBASSY TEGUCIGALPA
AMEMBASSY TUNIS
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FOR RHUDOS; USAID REPS AND MISSION DIRECTORS; MISSION HOUSING ADVISORS; PRE/H JIM STEIN

E.O. 12356: N/A

SUBJECT: NATIONAL SEMINAR ON THE ROLE OF COMMERCIAL BANKS IN HOUSING FINANCE

PURPOSE. THE PURPOSE OF THIS CABLE IS TO INFORM YOU ABOUT A NATIONAL SEMINAR ON THE ROLE OF COMMERCIAL BANKS IN HOUSING FINANCE, HELD IN KARACHI, PAKISTAN, ON AUGUST 12, 1993, BY THE AID/PAKISTAN SHELTER RESOURCE MOBILIZATION PROGRAM.

BACKGROUND. THE SHELTER RESOURCE MOBILIZATION PROGRAM (SRMP) OF AID/PAKISTAN IS ASSISTING PAKISTAN TO ESTABLISH A MARKET-ORIENTED HOUSING FINANCE SYSTEM. UNDER THE SRMP, SPECIALIZED PRIVATE HOUSING FINANCE FIRMS ARE ESTABLISHING MORTGAGE LENDING OPERATIONS. ALTHOUGH PAKISTAN HAS ANEXTENSIVE COMMERCIAL BANKING NETWORK, BANKS HAVE HAD LITTLE INVOLVEMENT WITH HOUSING LENDING. THE PURPOSE OF THE SEMINAR WAS TO INITIATE CONSIDERATION OF A LARGER ROLE FOR COMMERCIAL BANKS IN DEVELOPING PAKISTAN'S HOUSING SECTOR. PRESENTLY, COMMERCIAL BANKS MAKE VIRTUALLY NO HOUSING LOANS IN PAKISTAN.

THIS WAS THE THIRD SEMINAR IN A SERIES OF FOUR BEING SPONSORED BY THE SRMP TO EXPLORE HOUSING FINANCE ISSUES WITH LEADING POLICYMAKERS. PREVIOUS SEMINARS HAVE EXAMINED FORECLOSURE AND DEBT RECOVERY ISSUES, AND RESOURCE MOBILIZATION FROM THE CAPITAL MARKETS FOR HOUSING FINANCE. THE FOURTH SEMINAR, TO BE HELD IN SEPTEMBER, WILL EXAMINE THE BROAD ARRAY OF CONSTRAINTS ON THE HOUSING SECTOR POSED BY INADEQUATE LAND DEVELOPMENT POLICY AND PRACTICES. THE RECOMMENDATIONS OF THE SEMINARS HAVE BEEN VITAL PARTS OF CONTINUING SRMP POLICY REFORM ACTIVITIES AND HAVE DIRECTLY CONTRIBUTED TO IMPROVING THE ENVIRONMENT FOR HOUSING FINANCE IN PAKISTAN.

THE EVENT. THIS ONE-DAY SEMINAR WAS DESIGNED TO EDUCATE PAKISTAN'S BANKERS ABOUT INVESTMENT OPPORTUNITIES IN HOUSING FINANCE AND IDENTIFY WAYS AND MEANS TO STIMULATE HOUSING SECTOR LENDING BY BANKS. ALMOST 100 SENIOR EXECUTIVES OF COMMERCIAL BANKS, HOUSING FINANCE FIRMS, AND DEVELOPERS PARTICIPATED IN THE SEMINAR, WHICH WAS CHAIRED BY MR. ASHRAF JANJUA, DEPUTY GOVERNOR OF THE STATE BANK OF PAKISTAN. THE KEYNOTE SPEAKER, MR. SHAUKAT TARIN, COUNTRY HEAD OF CITIBANK/PAKISTAN, GAVE A LUCID AND DETAILED DESCRIPTION OF CITIBANK'S RATIONALE FOR OPENING A HOUSING FINANCE COMPANY IN PAKISTAN IN 1992.

CITIBANK HOUSING FINANCE COMPANY, A SUBSIDIARY OF CITIBANK, WAS THE FIRST SPECIALIZED LICENSED HOUSING LENDER TO BEGIN OPERATING IN PAKISTAN. ITS CREATION WAS MADE POSSIBLE BY POLICY CHANGES ACHIEVED IN 1991 AND 1992 BY THE SRMP, WITH THE SUPPORT OF A POLICY-ORIENTED HOUSING GUARANTY LOAN. THESE CHANGES INCLUDED ESTABLISHING A LEGAL FRAMEWORK TO PERMIT PRIVATE SECTOR HOUSING LENDERS TO OPERATE, DEVELOPING A LICENSING PROCESS, AND INITIATING A CAPACITY TO REGULATE THE NEW HOUSING FINANCE FIRMS. A SECOND FIRM, INTERNATIONAL HOUSING FINANCE LTD., WILL BEGIN OPERATING THIS MONTH. THREE ADDITIONAL FIRMS ARE EXPECTED TO BE LICENSED BY THE END OF 1993.

ALTHOUGH PAKISTAN'S COMMERCIAL BANKS CAN MAKE MORTGAGE LOANS, A NUMBER OF CONSTRAINTS EXIST THAT VIRTUALLY PROHIBIT SUCH LENDING. OVER THE PAST SEVERAL YEARS, PAKISTAN HAS MADE SIGNIFICANT STRIDES TOWARD LIBERALIZING AND DEREGULATING THE FINANCE SECTOR, BUT BANKS STILL EXPERIENCE DIFFICULTY IN EXPANDING THEIR RANGE OF ACTIVITIES, ESPECIALLY IN HOUSING. A FOCUS OF DISCUSSION AT THE SEMINAR, THESE CONSTRAINTS INCLUDE LACK OF LIQUIDITY DUE TO GOVERNMENT BORROWING, MAINTENANCE OF A LOW AND RIGID CEILING ON BANK CREDIT FOR HOUSING, AND LACK OF A SUPPORTIVE POLICY AND PROCEDURAL ENVIRONMENT FOR THE HOUSING SECTOR.

DEPUTY GOVERNOR JANJUA'S SPEECH, WHICH WAS WIDELY REPORTED IN THE PRESS, DESCRIBED THE NEGATIVE IMPACT ON THE ECONOMY OF THE GOVERNMENT'S HIGH LEVEL OF DOMESTIC BORROWING TO COVER ITS BUDGET DEFICIT, AND CALLED FOR A GRADUAL BUT MARKED DECLINE IN BORROWING. GOVERNMENT BORROWING HAS BEEN ABSORBING ABOUT 80% OF ALL CREDIT, CREATING INTENSE COMPETITION AMONG PRIVATE FIRMS FOR RESOURCES AND PUSHING INTEREST RATES TO HIGH LEVELS. FEW PRIVATE FIRMS ARE NOW ABLE TO RAISE RESOURCES TO EXPAND BUSINESS. AS NEW PLAYERS IN THE FINANCE SECTOR, THE SPECIALIZED HOUSING FINANCE COMPANIES HAVE A FAR HARDER TIME MOBILIZING CAPITAL RESOURCES THAN DO THE ESTABLISHED BANKS.

BANKS IN PAKISTAN HAVE MORE THAN 6,000 BRANCHES, ENABLING THEM TO REACH A VERY BROAD RANGE OF HOUSEHOLDS. OVER THE PAST SEVERAL YEARS, DEPOSITS HAVE BEEN RISING AT A RATE OF 23% PER YEAR AS FUNDS HAVE MOVED INTO THE BANKING SYSTEM FROM SPECULATIVE INVESTMENTS IN URBAN REAL ESTATE. LENDING, HOWEVER, REMAINS HIGHLY CONCENTRATED IN THE MANUFACTURING, AGRICULTURAL, AND COMMERCIAL

SECTORS, MOSTLY IN SHORT-TERM ASSETS

IN HIS SPEECH, MR. TARIN FOCUSSED ON THE OPPORTUNITIES OFFERED BY HOUSING FINANCE. HE NOTED THAT MORTGAGE LENDING IS ONE OF THE FEW OPTIONS AVAILABLE TO PAKISTANI BANKS TO DIVERSIFY THEIR PORTFOLIOS WITH LONGER-TERM ASSETS; AND THAT DEVELOPING A MORTGAGE PORTFOLIO WOULD ENABLE BANKS TO SPREAD RISK OVER OVER A BROADER BASE AND REDUCE VULNERABILITY TO BUSINESS DOWN-TURNS. HE ALSO OBSERVED THAT AS PAKISTAN'S CAPITAL MARKETS EXPAND, INVESTORS WILL DEVELOP THE ABILITY TO INVEST DIRECTLY, RATHER THAN THROUGH BANKS, AND THAT THE DEPOSIT BASE OF BANKS MAY BEGIN TO ERODE.

THE BANKS, HOWEVER, HAVE LITTLE EXPERIENCE WITH HOUSING LENDING. ALTHOUGH PAKISTAN IS SLOWLY DISMANTLING ITS SYSTEM OF CENTRALLY-DIRECTED CREDIT, A CEILING STILL REMAINS FOR HOUSING AND THE AMOUNT OF RESOURCES ALLOCATED TO HOUSING RARELY EXCEED 1% OF TOTAL CREDIT, FAR TOO LOW TO BECOME A PROFITABLE BUSINESS CENTER FOR A BANK. IN ADDITION, BANKS ARE SKEPTICAL OF THE LEGAL SYSTEM'S ABILITY TO ENFORCE FORECLOSURE LAWS IN THE EVENT OF HOUSING LOAN DEFAULTS AND VIEW CONSTRUCTION BRIDGE FINANCING AS FRAUGHT WITH RISK. GIVEN THE HIGH LEVEL OF GOVERNMENT BORROWING, PAKISTAN'S BANKS HAVE BEEN ABLE TO EARN HIGH PROFITS BY INVESTING ALMOST EXCLUSIVELY IN GOVERNMENT-GUARANTEED SECURITIES.

MR. TARIN ADVISED THE BANKERS TO BEGIN LOOKING AT MORTGAGE LENDING: "TODAY BANKS HAVE TO MAKE A CHOICE," HE SAID, "THEY CAN SIT BACK AND WISH THAT THE ECONOMIC AND POLITICAL AMBIANCE WOULD IMPROVE AND MONEY WOULD START FLOWING, SO THAT THEY MAY INVEST THAT MONEY IN GOVERNMENT SECURITIES AND ENJOY A HANDSOME PROFIT, OR THEY CAN START DIVERSIFYING INTO STABLE AND PROFITABLE LONG TERM PORTFOLIOS. IN MY OPINION, THE LATTER CHOICE, THOUGH IT WOULD INVOLVE GREATER EFFORT, WOULD BE THE BETTER ONE."

RECOMMENDATIONS ADOPTED BY THE SEMINAR PARTICIPANTS INCLUDED THAT THE CEILING ON HOUSING LENDING SHOULD BE ABOLISHED, WITH HOUSING SECTOR LENDING TO BE CONSIDERED AS "OUTSIDE" THE CREDIT CEILING SYSTEM, THAT GOVERNMENT BORROWING NEEDED "TO BE GREATLY REDUCED;" THAT CREDIT RATIONING NEEDED "TO BE FURTHER REDUCED;" THAT MORTGAGE RE-FINANCING NEEDED TO BE DEVELOPED; AND THAT MECHANISMS NEEDED TO BE DEVELOPED TO REDUCE THE RISK INVOLVED IN CONSTRUCTION BRIDGE-FINANCING.

IN PREPARING FOR THE SEMINAR, THE SRMP PRODUCED A REPORT DESCRIBING THE BANKING SECTOR AND EXPLORING THE ROLE OF BANKS IN DEVELOPING THE HOUSING INDUSTRY IN PAKISTAN. THE REPORT, TITLED "NO CREDIT," IS BEING REVISED TO INCLUDE THE SEMINAR FINDINGS AND RECOMMENDATIONS. TO REQUEST A COPY OF THE REPORT OR FOR FURTHER INFORMATION ON THIS TOPIC, PLEASE CONTACT JON WEGGE, CHIEF TECHINICAL ADVISOR, SRMP, O/PEN, AID/PAKISTAN. MONJO##