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RECOMMENDATIONS FOR IMPROVEMENT
IN THE FORECLOSURE/MORTGAGE LOAN RECOVERY
LAWS AND RELATED SYSTEMS/MECHANISMS
FOR PROMOTING A VIABLE HOUSING FINANCE
INDUSTRY IN PAKISTAN

DRAFT REPORT NO. 02

IN TERMS OF DELIVERY ORDER NO. 05
IQC 391-0507-I-00-i780

BEST AVAILABLE DOCUMENT

SEPTEMBER, 1992

Draft Report No. 02

1.1 Introduction

A study has already been carried out (in the form of Report No. (01) which has provided an analysis of the current inefficiteness of Pakistan's laws affecting the recovery of loans advanced against mortgage of property. The conclusions from Report 01 are summarized in para 2 of this Report.

1.2 The purpose of this Report (02) is to summarise the findings in Report 01 and to recommend administrative and legislative actions which need to be taken to make foreclosure and loan recovery system effective in Pakistan. Report 03 will follow with draft legislation aimed at providing the necessary legal framework for effective foreclosure and loan recovery.

1.3 In order to promote the establishment of housing finance companies (HFCs) in the private sector, the Ministry of Finance GDP has already issued two SROs dated 31.12.1990 and 18.02.1991, invited applications for licensing from the private sector and granted permission to six firms to incorporate, put their equity in place and then be licensed. Two of the new companies have been incorporated. Citibank, Lahore is scheduled to begin operations as a housing finance company on October 01, 1992. International Housing Finance Ltd intends to do the same in Karachi around the first of November 1992. The other four firms are in various stages of preparation for operational start-up.

1.4 There are many problems that still remain for the new housing finance companies. All are concerned that it will be difficult to recover housing loans made against mortgage of property. The existing foreclosure laws in Pakistan appear to be adequate; but the legal system has not provided the courts, or the authority reeded by the courts, to implement effective foreclosure process. Foreclosure recovery of loan can currently take ten years in Pakistan. Such a time frame is totally unacceptable to the new housing finance companies, commercial banks and other financing institutions.

1.5 To understand the Pakistan situation better, and to see how others in the region are addressing the same problems, a study was conducted of the legal framework currently in place in Pakistan. Thereafter a study was conducted in Malaysia to investigate the very progressive housing finance system in that country. Later a study team spent a week in India where housing finance has made a strong beginning and where the legal framework is the same as in Pakistan. The results of these efforts are summarized in paras 3 and 4 of this

Report, for background purposes, and to prepare the stage for the set of recommended actions that will assist Pakistan in developing a viable housing finance industry.

2. STUDY FINDINGS IN PAKISTAN

2.1 To understand what needs to be improved, it is necessary to first describe the existing legal and administrative framework that impacts housing finance in Pakistan. There are many constraints in the smooth functioning of a housing finance system in Pakistan and they can be grouped roughly into three categories, (1) Land registration, transfer and title, (2) the Legal system, and (3) the Financial system.

2.2 The major constraints identified in the existing land registration, transfer and titling system in Pakistan are as follows:

- (i) the records kept by the Land Revenue Department provide only a rebuttable presumption of valid title to land in favor of the person whose name is mentioned in the Record of Rights;
- (ii) In cases of inheritance, changes in ownership of land are usually not reflected in the revenue record for a long time;
- (iii) Records maintained by Development Authorities are also not conclusive evidence of title. While subsequent sales are compulsorily registerable, the new owners are not obliged under law to get the changes effected in the record of the Authority.
- (iv) The high charges levied by the Development Authorities for registration of transfers and the high registration fee payable under the Registration Act are disincentives for effecting transfer/registration.
- (v) Lack of compulsory system of land registration leads to avenues for fraud. Cases are not rare when the owner sells the same land to more than one person.
- (vi) Oral sales of land are legally permissible in rural areas of Punjab.
- (vii) There are no set rules for valuation of land and employees of lending agencies can and do connive with the borrowers in inflating the value of land.
- (viii) The registration of mortgage is subject to exorbitant stamp duties.

2.2 The major constraints in the Pakistani Legal system are as follows:

- (i) Establishment of Special Banking Courts and Banking Tribunals has not been very helpful so far in expediting disposal of cases. The number of these courts is inadequate and some of them have not even been functional in the past.
- (ii) Number of civil courts is inadequate and there is a huge backlog of cases in these courts resulting in delays.
- (iii) Under the Transfer of Property Act and the Civil Foreclosure Code, it is difficult as well as time consuming to recover loans through sale of mortgaged property.
- (iv) It is a problem to secure a decree from the civil courts and it is still more difficult to have the decree executed by having the house vacated and sold.
- (v) Under the CPC, anyone with an interest in the mortgaged property is required and/or entitled to be joined in the proceedings.
- (vi) Execution of decree passed by the Special Courts and Banking Tribunals is equally difficult and subject to the same delays as in civil courts.
- (vii) Besides the heavy load of work in courts, the delaying tactics of defendant's counsel lead to serious delays in disposal of cases in all types of courts.
- (viii) Delays in service of court process through court bailiffs are frequent due to connivance of the bailiffs with the defendants.
- (ix) Adjournments are given freely without any cost to the party seeking the adjournment.

2.4 The major constraints indentified in the Pakistani Financial system are as follows:

- (i) The State Bank of Pakistan does not accord priority for housing while setting credit ceilings.
- (ii) Lending institutions usually avoid litigation as it is time consuming and sometimes frustrating. Some cases have been pending in courts for more than ten years.
- (iii) Lending institutions obtain personal guarantees, and also irrevocable power of attorney but they try to recover the loans through persuasion/compromise and seldom ever make use of the power of attorney to sell the property.

- (iv) Banks and DFIs have not resorted to make use of Section 69 of the Transfer of Property Act which allows a mortgagee in certain cases to sell the property without the intervention of courts.
- (v) The HBFC can proceed against the defaulters under the Land Revenue Code as well as under Section 30 of its own Act which empowers the corporation to apply to the District Judge to order for the sale of the mortgaged property or for its delivery to the corporation. These powers particularly under Section 30 of the HBFC Act have, in the past been used very sparingly.
- (vi) The IDBP Act provides a summary procedure for recovery of loans (Sections 39 and 40) but the Bank seldom makes use of these powers.

3. STUDY FINDINGS IN MALAYSIA

- 3.1 With the many constraints present in the Pakistan legal structure, it was considered necessary and useful to survey the surrounding countries to see how they are integrating housing finance into their legal framework. Over the last several months study teams have travelled in the subcontinent and Malaysia and found some innovative approaches to problems in housing finance. In Malaysia two of the major factors in its rapidly growing housing finance industry have been (1) an effective land registration, transfer and titling system, and (2) licensing of housing developers and the development of a Housing Project Development Account which reduces risk to developers, home buyers and financial institutions engaged in housing finance.
- 3.2 The housing industry in Malaysia is fairly well organised. Commercial banks are required to invest 5% of their assets in low and medium cost housing. Two large and some small housing finance companies have been established in the private sector and have made significant contribution in providing finance for housing to the developers/builders as well as the individual buyers. Multi-purpose Finance Companies also provide loans for housing. It is estimated that housing loans now represent about 16% and 20% of the outstanding portfolios of commercial banks and finance companies in Malaysia. The average rate of default in repayment of housing loans is very low (3%). This is because of a very detailed and tight appraisalment of loan applications and close monitoring of recovery process and computer aided collection system. To quote an example, the Citibank at Kuala Lumpur employs only 5 officers and 13 staff members to handle as many as 26,500 accounts and the delinquency rate is only 2.6%.

3.3 Malaysia has overhauled its land management system and the result is that title to land is clear and poses no problem in the recovery of loans without having to seek a foreclosure/sale remedy through the courts of law. Their legal system is also not slow and the mortgaged property can be got vacated and sold in about two years with the intervention of courts. The Malaysian law allows service of respondents by the petitioner's attorney which helps in expeditious service of court process and saves the litigant parties from dependence on the court bailiffs.

3.4 In order to safeguard the interest of the HFCs and the house buyers Malaysia has enacted very interesting and useful legislations/regulations. In 1982 regulations were framed for the licensing and control of housing developers. Every developer who wants to build more than four houses has to seek a license as a developer. Evaluation of land and houses can be done only by licensed evaluators. The Purchase and Sale Agreement has been standardised.

3.4 It is mandatory under the Housing Developers (Control and Licensing) Act that the developer should open and maintain an account (known as the Developer's Housing Development Account) with a bank or a housing finance company. This account is operated by the banks/HFCs and not by the developer.

The objective of this requirement is:

- (i) to ensure that the bridge loan, obtained by the licensed developer from a bank/HFC for the housing project, is paid into this Account;
- (ii) to ensure that all monies, collected by the developer from the purchasers of houses as down payment, are paid into this Account; and
- (iii) to ensure that all withdrawals from this Account are in accordance with the Housing Developer's (Control and Licensing) Regulations 1991.

4. SUMMARY OF FINDINGS IN INDIA

4.1 The study in India provided an experience quite different from Malaysia. India has the same basic legal system and laws as Pakistan and is experiencing many of the same problems while making substantial progress towards the establishment of a strong housing finance industry. There has been little reform in land registration, transfer and titling in India. In spite of this deficiency, the Indians have made significant progress in establishing a housing finance system. One of the things that was found in India also, was the lack of a good land registration, transfer and titling system which has reached a crisis point and is now a major impediment to the further growth of the formal private sector housing finance industry in India.

4.2 The Indians have made significant progress in the overall financing system for housing. A National Housing Bank (NHB) was established in 1988 as a subsidiary of the Reserve Bank of India with responsibility for the regulation of the housing finance industry in India. NHB has also been providing significant amounts of refinancing (6.5 billion rupees in 1991), for below medium income mortgage loans at subsidized rates to selected housing finance institutions. This has not only helped the housing industry expand but it has also provided important housing benefits to the low income segments of the population. A second agency the Housing and Urban Development Corporation (HUDCO) has been created by the Indian government to provide low interest loans to State Government State Housing Boards, local public bodies, development authorities, cooperative societies, slum clearance boards, and others for development of housing projects. HUDCO has been in operation since 1970 and has had no serious problem in the timely recovery of its loans since it is a wholesaler to other government bodies. Even though it provides its loans at subsidized rates, HUDCO earned a profit of Rs. 26.00 crores in 1990-91.

4.3 The laws and debt recovery mechanisms in India are the same as in Pakistan e.g. the Transfer of Property Act and the Civil Procedure Code. India has not yet set up the Banking Tribunals or the Special Banking Courts that have been established in Pakistan. Despite this position India has, during the past fifteen years, taken a lead in the establishment of a fairly well knit housing finance system both in the public and private sectors.

4.4 The Housing Development Finance Corporation (HDFC) was established in private sector in 1978, notwithstanding the apprehensions and doubts that existed at that time that, being in the private sector, it would face serious problems in recovery mechanism. HDFC never sought any equity or financial assistance from the government of India and, as a result of sheer efficient management, it has been able to disburse Rs. 2,875.00 crores as housing loans during the last fourteen years. HDFC has been providing 2-3 years' bridge loans to developers/builders @ 19.5% and 15-20 year loans to house purchasers at 10% to 15%. The number of HDFC employees is only 729. The Corporation has not faced any serious problems in recovery of its loans due to the following reasons:

- (i) proper scrutiny and appraisalment of loan application; and
- (ii) computer aided close and effective monitoring of the recovery of loans.

The recovery percentage is over 98% and HDFC instituted only 15 court cases for foreclosure/sale of mortgaged property during the past 14 years. As a result of sound management, HDFC could declare a dividend of 24% for 1991-92.

- 4.5 Commercial banks in India are required to invest 1.5% of their incremental deposits in housing. Many commercial banks have set up HFCs as their subsidiaries. The Life and General Insurance Corporations of India have also set up similar subsidiaries. Equity in some of these HFCs is held by the NHB also. There are about 200 large and small finance companies in the private sector in India providing housing loans. Some of these institutions deal exclusively in housing finance and the NHB has approved 18 of these HFCs for providing them refinance at subsidized rates. Refinance is provided only for low and medium cost houses. Most of these HFCs are functioning quite efficiently. The emphasis by the efficient HFCs in India like Malaysia is on tight appraisal of loan applications and efficient monitoring of recovery. It certainly means selective lending and over-securitisation of loans but the result is that these HFCs do not have to seek the protection and assistance of courts to recover their loans.
- 4.6 One positive legal change in India that could also be applied in Pakistan has to do with bad cheques. In India it is a criminal offense to write a cheque with insufficient funds in the bank to cover it. This has been a strong weapon for HFCs in India to go after defaulters where bad cheques are involved.
- 4.7 The problem of leasehold ownership versus freehold ownership for real property has been examined. In Pakistan as well as in India there are a number of Development Authorities in the larger urban areas. Most of the land under Development Authority control is owned by the government. The land is leased to those interested in developing the land. For commercial development the period of the leasehold is normally 33 years, for industrial use 66 years, and for residential use 99 years. This has created a cumbersome process for transfer of land between parties. In India this has also limited the loans that HDFC and other housing finance companies have been willing to make on such leasehold land. The Indian government is now implementing a process to allow conversion of property from leasehold to freehold with a reasonable fee for the transaction. This is a basic problem in land transfer in both countries and needs to be addressed.
- 4.8 Despite the above analysis, many HFCs in India have to resort to litigation to recover their loans. Courts in India are also overloaded, the defendants' counsel in India also indulge in delaying tactics and the cases drag on for even 10 years or more due to inefficiency and corruption in the recovery process and the legal mechanism. The HFCs are pressing the Indian government to amend the laws to help in expeditious recovery of housing loans.

5. The demonstrable inefficiency and inadequacy of recovery of dues by lenders in case of mortgaged property arises from the inefficient working of the legal system rather than inadequacy in the law. It is a common adage that it is the people who make the system run and the tragedy of the legal system, as with other important institutions in Pakistan, is that, over the last two or three decades, there has been a rapid deterioration of legal institutions. Apart from corruption which is perceived by the public at large as a major factor responsible for deterioration of institutions, a number of other factors have contributed to institutional inefficiencies. For example judges are given no special training in the working of the business world and the relevance of laws thereto. Most judges take banking cases in the same lethargic stride as other civil matters relating to land etc. There is, therefore, need to educate judges on the importance of expeditious disposal of commercial cases in general and banking cases in particular. This is vital not only to the particular issue of recovery suits in case of mortgaged property but more importantly to raise the flagging confidence of businessmen in the legal system as a whole.

6. STUDY RECOMMENDATIONS

An attempt has been made to draw on the findings from the studies and take the positive aspects of the experience of Pakistan's neighbours, to develop recommendations that will help Pakistan get a housing finance system firmly established and provide for its smooth functioning and rapid growth. The recommendations, which follow, are grouped in three categories similar to the constraints identified earlier (1) Land registration, transfer and title, (2) the Legal system, and (3) the Financial system.

6.2 LAND REGISTRATION TRANSFER AND TITLE

Pakistan has a well developed system of record keeping for the purposes of collection of land revenue which was developed during the Mughal period. All title documents (except for an oral gift by a Muslim) must be registered under the Registration Act of 1908. Failure to register any document makes the document legally ineffective under the Land Registration Act. No time limit is prescribed for the registration.

Stamp duties, exorbitant land transfer and land registration fees and collateral wealth tax liabilities have all been major factors in discouraging the proper recording of land transactions in Pakistan. Over-time, these incentives have created a current system which is extremely inaccurate, confusing, subject to fraud and very difficult to work with in legal proceedings.

This uncertainty in land titling and registration makes it very difficult for financial institutions to lend in the housing sector when the collateral is based on the land and housing improvements on the land. Poor titling and land registration has made it equally difficult for the courts to provide timely remedies to financial institutions in the case of defaulted loans.

- (i) A good land titling, transfer and registration system is a necessary first step for the establishment of a strong housing finance industry in Pakistan. Indeed, such a system is a necessity for making the legal system more effective and responsive and would have a positive effect on government and the country's economy. For government, it would provide a firm basis for collecting land revenue and wealth tax etc. It would have an even greater effect on the general economy. Land and the improvements on land affect the lives of most of the people on a daily basis. Regularizing transactions in land registration, transfer and titling would facilitate the creation of new wealth and development in Pakistan. India is painfully aware of the constraints placed on development by its antiquated land registration system and is starting to do something about it. Pakistan should do the same.

Land registration, transfer and titling reform is a difficult long term task which will take many years to accomplish. However, the current system is crippling the development process and will continue to do so as long as it remains in place. This is a central finding of this study and it is strongly recommended that the Shelter Resource Mobilization Program (SRMP) attempt to focus government attention on this issue so that dialogue begins, and actions follow, which address the problems of land registration, titling and transfer in Pakistan. In the same connection it is further recommended that SRMP use the National Land Code in Malaysia as an example of a land system that works. Whatever land registration and titling system is found to be appropriate for Pakistan, it should include some of the following elements:

- (1) land identification (survey and demarcation)
- (2) land tenure
- (3) standardized registration of title to land
- (4) standardized documents and procedures for transfer of land
- (5) system of leases and charges that can be registered on the title
- (6) revised system of land revenue collection
- (7) Standardized zoning and land conversion system

(ii) It is also necessary to address the problem of very high fee associated with the registration, transfer and titling of land in Pakistan. For example presently in Lahore, the cost of registering a sale of immovable property is as follows:

- Registration fee 2%
- Stamp duty:
 - (i) for property valued upto Rs. 300,000.00 8.5%
 - (ii) for property valued over Rs. 300,000.00 10.0%
- Corporation charges 6%

This is an exorbitant cost which is avoided by almost everyone in Pakistan. It has two negative results. The land value is almost always underestimated at the time of registration reducing the amount of tax received; and the majority of land transactions are made outside the formal registration system to completely avoid the exorbitant taxes and fees.

An immediate step government could take to improve the existing system would be to introduce a much lower, standardized land registration, transfer, and titling fee and tax structure. It would provide the government with more revenue and stimulate development by increasing land transfers and other normal transactions dealing with land and housing improvements on the land. It would also have the same positive effect on a multitude of other industries and economic sectors.

It is recommended that SRMP take the reduced fee structure enjoyed by the House Building Finance Corporation and use it as a model for legislative action which would extend lower fees to the private sector.

(iii) It is recommended that the land record system in Pakistan be streamlined so that the record kept by the Land Revenue Department and the title to land derived therefrom, may provide a non-rebuttable claim to the ownership/leasehold right etc., of the land. This would necessitate a detailed study which could be carried out by the Pakistan Land Commission. This study should also address the problems arising out of oral sales/gifts and the present delays in arranging mutation in the records of rights by persons acquiring ownership of land by inheritance.

adopted to wear down the lender to an ultimate compromise. The borrower in the present system knows that sale of his property can be prevented even at the last moment by deposit of the amount due and his strategy is usually to settle with the lender at an even lower figure before such an eventuality arises. The lender is constrained to compromise because of the delay involved and the fact that the ultimate sale of the mortgaged property may not yield enough funds especially if the borrower is influential.

It is thus arguable that the right to foreclose should be made more extensive and applicable to all types of mortgages which are in vogue. This will act as an incentive for borrowers to settle with the lender earlier since the ultimate sanction is not merely a sale which can be avoided but an irreversible transfer of title to the lender. Any argument that this will further add to use of delaying tactics would not be tenable as the use of such tactics is already at a peak as evident from the case studies in report No.1. But a mere right to foreclose may not per se be of much use unless the vagaries of the execution stage are streamlined. In the present system, persons other than the defendant, who have an interest in the mortgaged property, can prolong execution proceedings for quite sometime as discussed in Report No.1. Another tactic which can be deployed by a borrower is to create a statutory tenancy in favour of a third party so that the lender is unable to get vacant possession.

It is thus vital that on passing of a decree for foreclosure the lender should be able to get vacant possession so that the property is of its actual worth. However, the extension of the right to foreclose simpliciter to the types of mortgages in vogue especially in the hands of the private sector may lead to draconian results as there would be an incentive for such lenders to file a suit for foreclosure at the slightest pretext specially at times when real property prices are booming, in order to take windfall profits. It would therefore, be advisable that certain safeguards should be built into the system to prevent misuse of the right of foreclosure. This could possibly be achieved by restricting the right to certain chronic and culpable types of defaults eg., a default which continues for more than six months and the borrower has failed to provide evidence of any special circumstances due to which he has been unable to pay the dues to the lender, despite his best efforts. Through such a mechanism, the onus of proof that grant of foreclosure decree would be unconscionable and oppressive, would then be on the defendant and a discretion will thus vest in the

court whether to grant a decree for foreclosure or for sale of the mortgaged property. Thus, unless a borrower satisfies a court that he is not at fault (i.e., the default is on account of circumstances beyond his control), and that grant of foreclosure decree in the circumstances would be oppressive or unconscionable, a decree for foreclosure should normally be granted.

Draft legislation on the basis of this recommendation suggesting amendments in the Transfer of Property Act and the Civil Procedure Code will form part of Report No. 3.

- (ii) The question of forum for adjudication of disputes, does not call for setting up of any new Tribunals or Special Courts. It would be adequate to include the HFCs as banking companies in the schedule to the Banking Tribunals Ordinance 1984.

The working of the Tribunals, when functional, has proved to be comparatively expeditious though far short of the statutory time limits prescribed in the Ordinance. The delay is primarily attributable to the inadequacy of the number of tribunals e.g. in the whole of Punjab there is only one Tribunal which finally started to function in 1992. It is recommended that more tribunals be set up and manned by whole time judges rather than adding to the load of work of already over-burdened District and Sessions Judges.

- (iii) Besides increasing the number of Tribunals, it is recommended that the following changes be introduced in the working of the Tribunals:
 - (a) Judges appointed as members of a Banking Tribunal be required to attend refresher courses to learn more about the business practices and requirements.
 - (b) The time limit prescribed in the Banking Tribunals Ordinance, 1984 should be treated as mandatory. This can be done through an appropriate amendment in the law which will be included in Report No. 3.
 - (c) No adjournments should be granted by the Tribunals and if so, always by imposition of adequate costs (amendment in law to be suggested in Report No. 3).

- (d) Execution of decrees passed by the Banking Tribunals should be streamlined so that on passing of a decree all persons in occupation of the mortgaged property be required to vacate the same notwithstanding their rights as tenants under any other law in force and police assistance for this purpose be made mandatory if called for. Draft legislation to this effect would form part of Report No. 3.
- (iv) There is already a provision in the CFC empowering the courts to order payment of costs by the litigants counsel if they request for adjournment. It is recommended that recovery of heavy costs from counsel seeking adjournment be made mandatory under the CFC.
- (v) Presently a lot of time is wasted on effecting service. Court bailiffs connive with defendants and return the court process unserved. One solution for this could be, as in Malaysia, to have service through advocates. However, the certificate/affidavit of an advocate will be challenged as being false and concocted; as a matter of fact, actual filing of false affidavits by some advocates cannot be ruled out. It is, therefore, recommended that a better solution would be to resort to and adopt expeditions procedure for service as in vogue in the Banking Tribunal suits.
- (vi) HBFC is now proceeding against the defaulters under the Land Revenue Code as well as under Section 30 of the HBFC Act. The Corporation, however, has not been very successful in obtaining relief from the District Judges who often tend to favour the defaulting borrowers and allow them to pay the arrears in instalments. Consequently the HBFC has been pressing the Ministry of Finance to take suitable steps to bring about certain amendments in the existing laws. Discussions were held with HBFC on this issue and draft amendments in the legislation to be proposed in Report No. 3 will take into consideration the HBFC views as well.

6.4 THE FINANCIAL SYSTEM

- (i) The dishonouring of a cheque due to lack of adequate funds in the bank account be made a criminal offence under the Negotiable Instruments Act. A draft of a amendment in the Act will be proposed in Report No. 3.

- (ii) The advantages of a Project Development Account system such as is in force in Malaysia were discussed earlier in this report. This is a necessary safeguard against unscrupulous developers and will reduce the risk for both lending institutions and home buyers. Such a system may be introduced in Pakistan also. It is suggested that a study may be arranged by SRMP to recommend a suitable law/system after consulting developers, banks and HFCs and some house buyers. Such a study is necessary because a lot of unaccounted for income is invested in the housing industry by the builders/developers and also individual house buyers.
- (iii) The profession of licensed evaluators also needs to be developed in Pakistan so that the HFCs, customers and land developers may be able to have an objective evaluation of the land/house. The professional evaluators with adequate experience and proven integrity be trained and properly licensed by the local councils/development authorities.
- (iv) It is also recommended that SRMP commence a dialogue with government on the need to require all banks to provide some level of mortgage financing to the housing sector. This is done both in Malaysia and India and, if implemented in Pakistan, would signal government's real commitment to the housing sector in Pakistan.
- (v) Standardized loan application forms, underwriting standards and other industry standards should be developed as soon as possible to guarantee the quality of credit appraisal and to assist in providing uniform underwriting standards as the basis for future secondary market development. No work has been done in this field and it is recommended that a study in this respect may be organised by SRMP.