A BLUEPRINT FOR THE DEVELOPMENT OF HOUSING FINANCE IN PAKISTAN

Prepared for
the U.S. Agency for International Development/Pakistan

Prepared by
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May 31, 1994

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Prepared for

United States Agency for International Development
Shelter Resource Mobilization Program
USAID Mission to Pakistan and Afghanistan

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ABSTRACT

The purpose of this paper is to assess the need and prospects for the growth and development of the nascent housing finance sector in Pakistan. It discusses the resource mobilization issues and the problems the sector must overcome to ensure a sufficient flow of financial resources to meet the overwhelming need for housing. The ramifications of the State Bank of Pakistan's (SBP) approval to use $15 million in Housing Guaranty funds to establish a Housing Refinance Facility within the SBP are covered and suggestions are made on how this Window would operate to provide some needed liquidity to the sector. It takes into consideration the concerns of the monetary authorities and the housing finance companies, particularly as regards the integrity of the system and the mobilization of resources. Finally, the paper explains how the sector might be structured to ensure its success, including the possible role of a central organization to regulate as well as provide liquidity to the sector.

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LIST OF ACRONYMS AND ABBREVIATIONS

ADB	Asian Development Bank
BFI	Bank Financial Institutions Division of the SBP
BTN	Bank Tabungan Negara (Indonesia)
COI	Certificates of Investment
DIM	Dual Index Mortgage
FNMA	Federal National Mortgage Association
FY	Fiscal Year
GDP	Gross Domestic Product
HBFC	House Building Finance Corporation
HDFC	Housing Development Finance Corporation (India)
HFC	Housing Finance Company
HG	Housing Guaranty (USAID)
NHB	National Housing Bank (India)
HRF	Housing Refinance Facility
IBRD	International Bank for Reconstruction and Development (World Bank)
LTV	Loan to Value Ratio
NBFI	Non-Bank Financial Institutions Division of the SBP
SBP	State Bank of Pakistan
USAID	United States Agency for International Development
WAPDA	Water and Power Development Power Authority

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Executive Summary

The Government of Pakistan has authorized the establishment of a private sector housing finance system. As a contribution to the new system, the State Bank of Pakistan will set up a Housing Refinance Facility within the SBP to provide liquidity in the amount of Rs 450 million to the housing finance companies. The provision of these funds to the HFCs will permit them to make more mortgage loans, which in turn will improve their financial condition and give them breathing room to grow and profit over the short run. It is not intended, however, that the HRF will resolve all the HFC's financial resource problems. In the long run, only through the mobilization of savings, coupled with the development of local capital markets, will adequate resources be generated to meet the housing finance need.

The structure of the new private sector housing finance sector in Pakistan is predicated on the following principles:

- that the propensity to save within the domestic economy is enhanced as a result of an increase in the flow of financial resources and a concomitant increase in mortgage loans;
- that the increase in resources reflect real mark-up rates, and that government subsidies will not be required to mobilize these resources; and
- that the instruments and institutions through which these resources flow will lay the groundwork for a capital market in secondary mortgages.

Similarly, the State Bank of Pakistan needs assurances:

- that the companies comprising the housing finance system be formed of individuals and groups of the highest integrity, so as to assure the public and the monetary authorities that the companies will fulfill honestly their commitments to the saving and borrowing public; and
- that the companies are properly managed, and are taking necessary safeguards to assure that the assets and liabilities are reasonably matched and that depositors' funds are protected.

The State Bank of Pakistan recognizes the importance of housing finance in the overall economic context. It understands the need to nurture these housing finance companies so that they can fulfill the promise of providing housing finance to the people. Moreover, the SBP is aware that the development of the housing finance system offers a unique opportunity to demonstrate how a new financial group should be organized, regulated and supported, since the very newness of the HFCs permits the SBP to start out with a clean slate. Thus, this learning experience can benefit the entire financial sector.

This communality of interests between the companies and the SBP presupposes a close and almost collegial relationship. The companies must be open with the SBP, even insisting that the SBP make on-site inspections of the companies so that they will be better able to comply fully with the Prudential Regulations. The SBP should assign at least one full-time agent to regulate the companies, who would spend time with the companies learning about their problems and their business operations. There should be periodic and, in fact, frequent meetings and exchanges of information between the two, recognizing that the more they know about each other, the more they will understand the other's needs and problems. An environment of trust must be created. But if this new direction is not taken, then the usual "us versus them" attitude will prevail, with the result being similar to the strained relationship that appears to exist between the SBP and other financial institutions in Pakistan.

It is important for the HFCs to recognize that the Government of Pakistan is in the process of modifying and refining its fiscal and monetary policies. These changes are due in large part to a need to reform its financial sector to fulfill commitments to the IMF and the World Bank, as well as a recognition that the government deficit has to be restrained. As a result, the old system of financial advances, subsidies, guarantees and outright favors are being curtailed and in some cases eliminated. This means essentially that the HFCs will not be the beneficiaries of the same kind of treatment that other financial institutions had when they initiated operations. This does not mean that the HFCs are being treated unfairly; it is just that the rules have changed. The HFCs must recognize and accept this fact.

The immediate next step to enhance the growth of the housing finance system is for the State Bank to activate the Housing Refinance Facility, based in part on the recommendations in this paper. The SBP must formally issue the rules and regulations for the HFCs to gain access to this Facility. At the same time, the Ministry of Finance must enter the US capital market to borrow the Housing Guaranty funds. The State Bank should aim to open this Facility no later than July 1, 1994.

Government regulations now permit HFCs to accept savings accounts, essentially Certificates of Investment with a 30-day or more maturity date. Concurrently, the State Bank should consider the question of the HFCs being authorized to accept foreign currency accounts, and if approved, it should issue a circular to this effect, again no later than July 1, 1994. These two actions by the State Bank will give a real as well as a psychological boost to the housing finance sector. It will show that the Government supports the sector, and just as importantly, it will not result in any cost to the Government. In fact it will be a benefit to the Government insofar as it will allow the Government to tap a very inexpensive source of foreign currency, the Housing Guaranty funds. In addition, this action will encourage the other groups to carry on with the necessary steps to obtain their licenses to do business as housing finance companies. Finally, the Government should consider a number of tax-related incentives to encourage savings, to promote home lending and to strengthen and enhance the financial soundness of the housing finance companies.

While the State Bank goes ahead with its plans to open the HRF, the HFCs should continue with their efforts to mobilize financial resources utilizing those avenues now available to them. Either individually or jointly, they should explore the possibility of designing and utilizing some sort of specialized savings-linked mobilization program such as a Contract Savings Scheme. This would demonstrate to the State Bank that the HFCs are very serious about the need to mobilize domestic savings and are fully aware of their responsibilities in this matter. These schemes would include both the use of foreign currency accounts and rupee-based accounts. The HFCs should commit themselves to devising at least one comprehensive savings-linked scheme by July 1, 1994. At the same time, one or more HFC would begin to issue Certificates of Investment to mobilize domestic savings.

INTRODUCTION

The purpose of this paper is to assess the need and prospects for the growth and development of the nascent housing finance sector in Pakistan. It discusses the resource mobilization issues and the problems the sector must overcome to ensure a sufficient flow of financial resources to meet the overwhelming need for housing. The ramifications of the State Bank of Pakistan's approval to use $15 million in Housing Guaranty funds to establish a Housing Refinance Facility within the SBP are covered and suggestions are made on how this Window would operate to provide some needed liquidity to the sector. It takes into consideration the concerns of the monetary authorities and the housing finance companies, particularly as regards the integrity of the system and the mobilization of resources. Finally, the paper explains how the sector might be structured to ensure its success, including the possible role of a central organization to regulate as well as provide liquidity to the sector.

This report was prepared over a two-month period in the Spring of 1994. The Contractor, PADCO, Inc., under its Housing and Urban Development Indefinite Quantity Contract, provided the services of two finance experts to undertake the assignment. They were Daniel S. Coleman, PADCO Housing Finance Specialist, and James Wright Ladd, Financial Consultant. The consulting team made two trips to Pakistan, with the second trip culminating in a formal presentation of the report and its findings to the Governor of the State Bank of Pakistan.

The team received valuable assistance from the principals of 21st Century Consultancy and Management Services, who have been working diligently over the past few years to create a housing finance industry in Pakistan. The principals, Mr. Askari Taqvi and Dr. F. A. Rabbani, were exceedingly helpful in providing information and advice to the team. Mr. Jon Wegge, the very able and dedicated USAID housing advisor as well as project manager of the Shelter Resource Mobilization Project, who has devoted four years of his life to promoting housing finance in Pakistan, deserves our utmost thanks for guiding and directing us all along the way in the preparation of this paper.

1 The Housing Finance Situation in Pakistan

After years of gestation, in a quiet, persistent and deliberate fashion, a new type of private financial institution was born in Pakistan. It was created in a time of turmoil, when governments were changing, financial institutions failing and everywhere there was doubt as to whether another type of financial institution was really necessary. But there were a few businessmen—looking always to the future, seeing what the people ready needed and willing to take a chance—who realized that Pakistan desperately needed housing and needed to look at new ways to finance that housing. Also there were those in government who realized that a country like Pakistan could not afford to let the housing situation continue as it had been. Thus, with a little help from Pakistan's friends, the private sector housing finance system came into being.

What was it that drove these businessmen and bureaucrats to create the new financial system? First of all, it was clear that the supply of standard, affordable housing was not meeting the overwhelming demand, and in fact the housing situation was deteriorating. While financial assistance in the form of subsidized loans was being provided through the House Building Finance Corporation and developed lots supplied by local development authorities and provincial bodies, this was far from sufficient. In light of the reduction and eventual cut-off in the supply of fresh funds to the HBFC, home lending from the public sector was drying up. Accordingly most families were still required to accumulate sufficient cash in hand to purchase or build a home in private sector developments. Long-term housing finance, the key to a well-developed housing sector everywhere in the world, was not available to the vast majority of Pakistanis, regardless of income.

This huge gap between the supply and the demand for housing, they realized, was due essentially to this chronic shortfall in the availability of sufficient financing at affordable terms. Only the private sector could mobilize the necessary financial resources to meet the demand for housing. The creation of a new and viable housing finance system that could meet this demand was the right way to proceed, and that further delays in the development of the system would only exacerbate the housing situation. At last, the time to act was ripe and they acted.

The private sector housing finance system is now functioning. Two companies are licensed and making mortgage loans, a third company is expected to start-up in a matter of weeks, while three other groups are waiting in the wings. Yet as they have become immersed in resource mobilization efforts and mortgage lending operations, the magnitude and complexity of the task they have undertaken has become clearer. A housing finance operation, which requires huge amounts of funds to be loaned for the long term, is quite unlike any other type of financial activity. The Government, which supports the new housing finance system, has also begun to realize the uniqueness of housing finance. It is in this context that a blueprint is presented which both the housing companies and the government can make use of to guide the housing finance system to success.

2 Economic Benefits of a Housing Finance System

The benefits to be derived from an active and vibrant housing sector are clearly evident because investments in this important sector give rise to multiplier effects throughout the economy. Studies in a number of countries have shown that for each unit of currency—in this case rupees—invested in housing, about two rupees of additional economic activity are generated in other sectors. While this multiplier effect in housing is not much different from investments in other sectors, benefits from the housing sector are spread throughout the economy since nearly all economic sectors are affected by investments in housing.

A second major argument for housing is its effect on employment. In all countries, regardless of the level of development, the employment of one worker in the construction sector, including housing, will generate about two additional jobs in other sectors. By investing in the housing sector, the combination of these two linkages—investment and employment—provide a broad stimulus to the economy. But the reverse is also true. Continuing to neglect the housing sector will have a lingering and negative impact on the economy of Pakistan which will be felt well beyond the sector itself.

The housing sector has a significant impact on savings in a variety of ways. Without doubt, the possibility of purchasing or building a home is a major incentive for nearly all families to save. This is particularly true among large segments of gainfully employed middle income workers, whose prospects for ever purchasing a home are limited due to lack of mortgage finance, high prices, and little incentive to save. If housing finance is made available at affordable prices, then it has been shown in most countries of the world that families will increase their savings in order to accumulate the required up-front capital contribution to qualify for a mortgage loan. There is no reason to believe that the situation is any different in Pakistan.

Proof of this propensity to save for housing is reflected by comparing different housing finance systems. In Germany and France, where contract savings schemes are responsible for a large percentage of funds for housing finance, mortgage loans as a percentage of GDP are 33 and 35 percent respectively, which reflects the need for a potential borrower to save a large amount of the price of a house to qualify for a mortgage loan. Often families in those two countries must save about one-third of the cost of the home, with the remaining two-thirds consisting of a mortgage loan. In the US and Denmark, however, where contract savings schemes do not exist, and high loan-to-value mortgages are common, mortgage loans as a percentage of GDP are much higher, 47 and 44 percent respectively. In those two countries, 80 percent and higher loan-to-value mortgages are standard, indicating that savings is a less important factor in purchasing a home.[1] This analysis clearly shows how savings can actually increase when there is the opportunity or the requirement to save in order to purchase a home.

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[1] See Table in Appendix B.

Another aspect of savings relates to the relationship between savings and the price of housing. Although empirical evidence is limited, it has been argued that as the price of housing rises, savings decline, and vice versa. Housing prices frequently rise because the supply of housing does not meet the demand of a growing population with increasing means to acquire housing. And the reason why the supply is not increasing is because of a lack of housing finance resources to facilitate the purchase of housing. Thus, an adequate supply of housing finance will lead to an increase in the production of housing, lower prices and a concomitant increase in the rate of savings.

The availability of housing finance will frequently lead to better use of personal savings by facilitating alternative investments in other economic sectors. The argument here, which is clearly relevant to Pakistan, is that access to a long-term mortgage loan will permit the borrower to make an alternative investment in a business opportunity rather than use all of his savings to finance his home. In this way, new investment and employment are generated, all of which is beneficial for the economy of Pakistan and her people.

Access to housing finance will lead not only to an increase in the rate of savings and in the production of housing, but it will result in the growth of home ownership. Over time, the equity accumulated in a personal residence will be the source of capital many entrepreneurs use to initiate new businesses, many of which will be small businesses which are the incubators of employment. While this general use of home equity for business purposes is probably some years away in Pakistan, the creation of a housing finance system today will accelerate the time when enterprising businessmen can seize this unique financing opportunity.

3 The Missing Ingredient: A Housing Finance System

Pakistan's private sector housing finance industry is clearly in its infancy. Through the intensive efforts of USAID over the past half decade, coupled with the entrepreneurial skills of a few far-sighted Pakistani businessmen, two housing finance companies (HFC) have been licensed and begun operations. But even as these companies start to make mortgage loans, it is obvious that there are still many hurdles to overcome if they and the companies to follow are to succeed as specialized housing finance institutions, much less meet the needs of millions of Pakistanis for housing finance.

The institutional framework for housing finance in Pakistan consists essentially of two and, shortly, three privately owned housing finance institutions and a sector regulatory function which is housed in the State Bank of Pakistan. The Ministry of Finance licenses the housing finance companies, although this function is expected to be transferred to the State Bank of Pakistan at a later date. A state-owned financial institution, the House Building Finance Corporation, makes housing loans with funds channeled from the State Bank of Pakistan, but it is not a housing finance institution in the true sense of the word. Commercial banks, Investment Banks and other financial institutions provide some loans for housing finance, however, loans provided for this purpose are seldom officially classified as housing loans, rather they are structured as personal loans. By regulation, commercial banks are prevented from placing more than 1 percent of their loan portfolios in housing loans.

The House Building Finance Corporation has functioned for decades as the primary provider of housing loans in Pakistan. It receives an annual budgetary allocation in the form of an advance from the State Bank of Pakistan, which in turn it uses to make housing loans. It is also able to use its mortgage loan reflows to make additional housing loans since it does not repay the SBP advances. As of the end of FY 93, the HBFC had an outstanding loan portfolio of about Rs 16.3 billion, which was derived from SBP advances. The final SBP advance to HBFC will take place this fiscal year, after which the HBFC must become fully self-supporting and self-sustaining. However, it is not clear if the HBFC will have to repay any of the advances to SBP. If these advances are not repaid, then HBFC will maintain a lending base of about Rs 16 billion, which it can use to continue making mortgage loans. Currently most of HBFC's loans are offered at a markup of 10 percent, which is considerably lower than the rate being offered by the new HFCs, giving it a competitive edge over the HFCs. If HBFC improves its collection record, then it could continue to make as much as Rs 1.3 billion available for mortgage lending annually, which was its lending level over the past two years. Yet even if the HBFC is able to continue home lending at its current rate, its loans will cover only a pittance of the estimated demand of Rs 18 billion and even less of the need. Clearly, input from other financial sources is required.

The government's purpose in authorizing the creation of a private sector housing finance system was to permit this sector to mobilize private financial resources for investment in long-term mortgage loans to qualified families. The availability of mortgage loans would not only lead to a significant increase in the supply of housing, thus reducing the housing deficit, but also stimulate savings insofar as savings is the backbone of a vibrant housing finance market and a healthy economy. In the year or so that the system has been in operation, the first two companies have identified a number of obstacles that have inhibited their development as well as the establishment of additional companies. While the managers and directors of these housing finance companies were generally aware of these obstacles prior to initiating operations, they were not fully cognizant of the impact until after they tried to raise funds from the public and to solicit loan applications. After all, housing finance is a new concept in Pakistan, and all the issues and problems could never have become known until the specialized companies initiated operations.

The largest single obstacle the two existing HFCs have encountered is a lack of access to capital at rates which will allow a profitable markup and an on-lending rate that the ultimate mortgage clients can afford. The HFCs are unable to compete with the government of Pakistan in attracting capital at rates that would permit the HFCs to on-lend that capital to prospective homebuyers at affordable rates. Moreover, government paper offers tax-and zakat-free benefits that HFCs are unable to match. The HFCs will continue to be at a competitive disadvantage with the Government, whether the rates the Government pays go up or down; HFC paper, while arguably of high quality, will always be valued less than government paper. Government paper is the surest investment in the domestic economy and establishes a benchmark or floor for all other paper.

The HFCs are also finding it difficult to compete with government-owned and controlled financial institutions for domestic capital. Because these institutions are well-established, have a track record with the public and, most importantly, have an explicit or implicit government guarantee, they are able to attract financial resources at more favorable terms than the new HFCs. It can be said that the new housing finance system is paying the price for the failure of the Government of Pakistan to regulate and control other financial organizations, which, in the past, have frequently mismanaged their funds and/or defrauded the public, the latest being the finance cooperatives. The public is rightly wary to put their trust once again in a new type of institution. Thus the HFCs are unable to compete for funds from the "pure" savers, that is, savers who are simply looking for the highest return while at the same time seeking to place their money in the safest institution.

On the other hand, the pedigree of the new housing finance companies is impeccable. The Ministry of Finance chose to authorize only the most credible of the applicants to proceed with applying for a housing finance license, finally authorizing only seven of the 24 groups to proceed. The result has been the incorporation and licensing of a stellar group of housing finance companies, headed by the two institutions now operating. Citibank Housing Finance, owned fully by its world renowned parent, and International Housing Finance Limited, among whose owners are International Finance Corporation, Commonwealth Development Corporation, PICIC and Cresbank, represent the highest type of institutional credibility. It is clear that these institutions typify the level of integrity so necessary to provide the general public and the government regulators with confidence in the system. Yet they still have been unable to devise instruments which would permit them to compete effectively with other parts of the banking sector. To use a common cliché, the playing field is still not level.

To date, the two operating institutions are making some housing loans, utilizing their equity capital as the source of lending funds. When this source has been fully committed to mortgage lending, they may be able to access their parent companies for additional funding, either in the form of equity or loans. However, these funds are expensive, since the parent companies must on-lend at rates that they would ordinarily make for competing uses. They are a limited resource since the parent companies are not set up to provide long-term loans to subordinate companies. Besides this defeats the purpose for creating the housing finance system in the first place: remember that the purpose was to mobilize new financial resources from domestic markets for on-lending for housing. Moreover, lending from an equity base alone is not a viable business, as illustrated in the computer based simulations in Section 6.3.

The limited amount of funds coupled with their high cost means that the market is restricted to borrowers in the higher income brackets. A Rs 300,000 mortgage loan at 20 percent for 12 years requires a monthly payment of about Rs 5,500, a payment that only a small percentage of families can afford to make. To qualify for this mortgage loan which is sufficient to finance the purchase or construction of a basic housing unit, a family must have a monthly income in the Rs 16,500 range. But, quoting a 20 percent markup on long-term loans appears to discourage prospective borrowers. The HFCs have been dismayed to see highly qualified borrowers walk away from loan application interviews either because they cannot afford the high markup loans or because they are reluctant to take on relatively high cost debt. There are a number of ways to mitigate the damage high markups have on the mortgage market, not least being the use of adjustable rate mortgages. One of the most successful in recent years is the Dual Index Mortgage, which is very effective in countries with moderate inflation. While such mortgages are not allowed in Pakistan now, the continuation of high markups would warrant future consideration of the problem of affordability. Annex A discusses the use of Dual Index Mortgages in inflationary economies.

4 Structuring the Housing Finance Sector

The structure of Pakistan's housing finance sector is predicated on the following principles:

- that the propensity to save within the domestic economy is enhanced as a result of an increase in the flow of financial resources and a concomitant increase in mortgage loans;
- that the increase in resources reflect real mark-up rates, and that government subsidies are not required to mobilize these resources; and
- that the instruments and institutions through which these resources flow, will lay the groundwork for a capital market in secondary mortgages.

Similarly, the State Bank of Pakistan and the Ministry of Finance need assurances:

- that the companies comprising the housing finance system be formed of individuals and groups of the highest integrity, so as to assure the public and the monetary authorities that the companies will fulfill honestly their commitments to the saving and borrowing public; and
- that the companies are properly managed, and are taking necessary safeguards to assure that the assets and liabilities are reasonably matched and that depositors' funds are protected.

Finally, the housing finance companies need the support and the intervention of Government to fulfill their mandate. The HFCs cannot operate in an environment where they do not have equal access to resources and the equal opportunity to compete for those resources. If they do not have this access, then the Government must intervene in the market to assure the flow of resources to the HFCs. This assumes, further, that the Government wishes to have a viable housing finance sector and the HFCs meet the Government's standards of performance. How this could be accomplished is addressed more fully in Section 5.3 of this document.

4.1 Key Elements

4.1.1 Savings Aspects

Section 2 of this paper covered the importance of housing within the economy and the relevance of a strong housing finance sector in generating domestic savings. While there is no assurance that domestic savings will grow through the development of the housing finance sector, there is enough evidence to demonstrate that there is a strong relationship between a buoyant housing finance system and the rate of domestic savings. It is also clear that as long as the housing finance sector remains in its infant stage of development, no appreciable increase in domestic savings generated by this industry will occur. Only through the overall growth of the housing finance industry will savings increase and only the SBP, with the blessing of the Ministry of Finance, has the capacity to ensure the growth of the system.

4.1.2 Real Market Rate Terms

The suggestions made in this paper on resource mobilization (Section 5) will in no way require the SBP or any other government institution to subsidize the HFCs in their efforts to attract financial resources.[2] If a saving mobilization program, such as a Contract Savings Scheme as suggested in the next section, is deemed feasible, savers may be paid a lower markup on their savings because in return they are being offered the opportunity of obtaining a housing loan at a predetermined time. This is not a subsidy.

HFC lending rates are determined principally by their cost of funds. The Companies cannot make a decent return on capital if they do not lend at terms in excess of the cost of capital and operating expenses. Thus it is not in the scheme of things for the private sector financial institution to subsidize their borrowers, nor as private sector institutions do they intend to request subsidies to do so.

4.1.3 Secondary Markets

The development of the Housing Refinance Facility (see Section 6) within the SBP sets the stage for the eventual creation of a secondary market. It is impossible to determine how this secondary market will develop or function. Nevertheless, the development of the HRF within the SBP is a necessary precondition for the creation of a viable secondary market. It is through the development of the HRF that the SBP and the housing finance system will gain the necessary experience to establish a true capital market for mortgages.

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[2] This does not preclude the HFCs from acting as conduits for funds or subsidies that the Government of Pakistan might direct exclusively to poor families who are not the usual HFC clients.

4.2 The Regulatory Environment

The State Bank of Pakistan is rightly concerned about the safety of any funds it makes available to refinance loans originated by the HFCs, as is currently contemplated. However, this risk can only be mitigated through a strong and well-functioning regulatory process which is the responsibility of the SBP itself. The SBP has, or will have shortly, the responsibility for:

- licensing new housing finance institutions[3];
- writing the Prudential Regulations for these same institutions; and
- enforcing the Prudential Regulations.

If the Non-Bank Financial Institutions Division (NBFI) of the SBP undertakes its responsibility properly, then the twin risks associated with institutional failure and mortgage default will be minimal. Normally, it is when a regulatory institution is lax, incompetent or subject to government interference that problems arise within the regulatory system.

It is important, moreover, that the SBP be strict but fair in carrying out its regulatory functions. It should not be arbitrary in the licensing of new institutions. Instead it should let the market determine how many and which institutions the market can support. If attrition occurs, it will not affect the operation of the Housing Refinance Facility as long as the SBP holds a first lien on the mortgages provided as security for its loans.

4.3 Housing Policy

Throughout this study, it became evident that there is no real guidance or direction of the housing sector, much less the housing finance sector. There is no written national housing policy, nor is there a central agency that is articulating housing policy, written or otherwise. The National Housing Authority of the Ministry of Housing and Works is charged with the responsibility of preparing a national housing policy. Apparently, such a policy has been drafted, but it has not been approved or enacted by the Government. This policy dearth is being filled by what could be called an implicit housing policy, which could be defined as follows:

- housing assistance, such as subsidies, is directed mainly to selected groups in Pakistani society, such as the civil servants and military personnel;
- minimal housing assistance is provided to the segments of society which are too poor to provide themselves with standard housing;
- the public sector housing finance agency continues to provide loans to those segments of society that are able to obtain housing loans through influence;

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[3] The licensing function is now the responsibility of the Ministry of Finance; however, the SBP will assume responsibility at a future date.

- private sector housing finance institutions are permitted, however barriers are put in the way of mobilizing financial resources;
- transfer and registration of property, which inhibit the development of mortgage markets, are discouraged through the imposition of onerous fees and stamp duties: and
- finally, a clear, concise housing policy has not been articulated.

A more plausible and explicit policy, and one that is generally in force in countries that have vibrant housing sectors, include the following elements, written or otherwise:

- subsidies are only directed to groups that are too poor to afford adequate housing solutions;
- adequate land regularization and property titling and transfer systems are in place to facilitate housing development and are a governmental priority;
- mortgage finance is the responsibility of the private sector, and the role of government is to facilitate the flow of resources to the sector;
- the major role of government in the production of housing is to ensure that cost recoverable infrastructure is made available to the populace at large; and
- the government will articulate a housing policy that promotes the concept of free markets as the most effective way to meet the housing need.

Both the implicit Pakistani housing policy and the suggested explicit housing policy as described above are too simplistic, however, they are representative enough to indicate that what Pakistan does in the policy arena is far removed from policies in countries with successful housing programs. The problems facing the young housing finance sector primarily result from an inadequate policy environment in which they can function effectively. In the long run, the Government of Pakistan will have to develop a housing policy, including the financial elements within that policy, that will create an environment where housing production blossoms. Until that day, the housing finance sector faces an uphill struggle, despite all that is recommended in this paper.

4.4 A Housing Constituency

The housing finance sector suffers from a lack of organized groups actively supporting improvements in and the development of housing. This missing constituency sorely hampers any efforts by the individual HFCs and their shareholders to bring about the necessary legislative and regulatory reforms that they deem to be necessary for the well-being of the sector. An important and recent step in rectifying this situation was the naming of a full-time Secretary General of the Housing Finance Trade Group. Through this group and its Secretary General, the industry will be able to speak with a single voice. The individual HFCs must strongly support this effort. The history of trade associations in Pakistan and throughout the world shows that they work for the good of all their membership.

5 Resource Mobilization Issues

5.1 Resource Mobilization Worldwide

As the housing finance system grows, it must have access to larger and larger amounts of funds. The key financial concept used here is LIQUIDITY. Liquidity in the housing sector simply means the availability of sufficient money to meet the demand for housing finance. A liquidity crunch occurs when funds do not flow in sufficient quantities to satisfy this demand, and therefore housing finance institutions are unable to grant all the housing loans requested. A liquidity crunch can also occur when the terms and conditions of the available funds do not match those for which for which the funds are intended.

Liquidity may be provided by the public sector, i.e., a government agency, or by the private sector. The provision of liquidity in general differs greatly in developed countries versus developing countries. The public sector in developed countries almost never provides liquidity directly to the housing finance sector, although in some cases, public funding is used to provide either loans or subsidies, or both, to poor families whose financial condition does not permit them recourse to the private sector. On the other hand, governments in developed countries often create the incentives and conditions, sometimes through direct intervention, whereby the private sector can provide the necessary liquidity.

In developing countries, the reverse is the rule. Governments frequently provide liquidity directly to the market. Moreover, where these governments intervene, more often than not the funds flow not to poor people as supposedly intended, but to the middle and upper income groups. On the other hand, governments in developing countries do not create the conditions whereby the private sector can provide liquidity, and more often, actually impede the involvement of the private sector in the housing finance sector. This is certainly the case in Pakistan, although there is some evidence that this is changing. The cessation of SBP funding to the HBFC is a step in the right direction.

Financial resources for housing purposes are derived from a variety of sources. In developing countries, loans and grants from external donors can be a major resource, however, funding from this source can never be sufficient to meet more than a fraction of the financing needs. For this reason, external funding has been found to be more effective to an individual financial institution rather than an entire system. In recent years, foreign donor funding has been used more often to leverage change in the housing sector, rather than as a solution to the physical housing need. In addition, foreign commercial loans are being viewed as a possible source of housing finance.

All countries, to some degree, allocate funds directly from the Central Government. In developed countries, direct government funding generally takes the form of subsidies for low-income families. But, in developing countries, it more often consists of direct lending through a government-owned or controlled financial institution to selected segments of the market. Government Housing Bank in Thailand is considered a good example of an institution that is generally free of government interference, provides loans based on need and operates on market principles. A bad example is when a housing finance institution is used to promote a political agenda, provides loans based on influence and operates at a loss, requiring constant injections of capital.

The major portion of financial resources or liquidity, particularly for the private sector institutions, is derived from two basic sources:

- deposits in home lending institutions, in the form of passbook and time deposits from individuals and businesses; and
- capital Markets, in the form of loans, bonds, securitized debt and a wide variety of financial instruments issued by housing lenders or specialized financial intermediaries.

Financial institutions mobilize deposits in general by focusing on two distinct savings markets: the pure savers who are seeking an investment vehicle and the linked savers who are seeking to utilize their savings for a specific purpose. Pure savers are always attracted by the yield on their savings, commensurate with the risk, and for that reason, savings deposits from this market segment can be very mobile as the depositor is constantly seeking the highest return. Moreover the potential market is large since most people in the middle or higher income brackets do have some disposable income to be saved. Linked savings is more stable, however this savings universe is probably much smaller. The initial concept of Building Societies in the UK and Savings and Loan Associations in the US were for all practical purposes attuned to savers who used their savings to access a housing loan, although there was no formal contract or agreement to that effect.

Most developed countries utilize both deposits and the capital market to mobilize resources, although the proportion will vary depending on a number of factors. For example, primary mortgage lenders in the UK mobilize over 90 percent of their housing resources from deposits, while in Denmark, specialized credit institutions generate 80 percent of their housing resources through the capital markets. In the US, the proportion has been changing rapidly since the 1970s when deposits from the savings and loan associations funded 55 percent of all housing loans while by 1991, deposits fell to only 33 percent. The trend in the US as well as in many other countries has been towards growth in the capital markets as the principal supplier of financial resources for housing, at the expense of deposits.

The housing finance sector in India has also experienced a change in the composition of its financial resources. The first, and still India's largest housing finance institution, the Housing Development Finance Corporation, initially mobilized resources by tapping the capital markets, principally loans from other financial institutions. To complement these domestic sources, HDFC relied on international donor agencies, the largest being a USAID Housing Guaranty loan ($125 million) and an IBRD loan ($250 million), which were instrumental in not only providing large amounts of liquidity, but also helped to provide credibility to the institution. HDFC has now expanded its outreach by utilizing a variety of ways to generate resources. In particular, it has focused on individual and company deposits by offering a variety of instruments with varying maturities to appeal to different investment objectives. Today, 35 percent of HDFC resources are derived from deposits. Capital market resources include long-term bonds purchased by trusts, insurance companies, corporations and banks, as well as shorter-term loans provided principally by commercial banks.

The establishment of the National Housing Bank (NHB) in India was supposed to open up a new source of liquidity for the growing number of housing finance companies in India. However, a securities market scandal has affected the ability of the NHB to raise capital for on-lending to primary sector housing finance companies and it has been unable to function completely as a secondary housing finance institution so far. Whether it will overcome its managerial credibility problems to fulfill its financial mandate is still open to question.

Indonesia has addressed the liquidity issue in a manner similar to Pakistan. A state savings bank, Bank Tebungan Negara (BTN), provides almost 90 percent of all housing loans. It receives funding from the Bank of Indonesia (the Central Bank) and interest-free loans from the Ministry of Finance. However, it also has had access to large IBRD low-cost housing loans. These sources contribute about two-thirds of BTN's lending resources, with internal resources consisting mainly of deposits and savings contributing the rest. BTN is experimenting with a contract saving plan, although to date its success has been limited. Another state institution, P.T. Papan Sejahtera, provides some housing loans, generating its funds from Bank of Indonesia credits, but also raising funds through bond placements that carry below-market interest rates. Finally, commercial banks provide relatively short-term mortgage loans only to upper-income Indonesians.

To date, Indonesia, like Pakistan, has been able to tap only a minimal portion of domestic savings and local capital markets for home lending purposes. It has relied instead on direct government funding and external funding as the major funding sources. The Indonesian Government has not permitted the establishment of specialized finance institutions, as has Pakistan, nor has it put in place those conditions which would permit commercial banks, which can make housing loans, to maximize use of the capital markets. The result is that the conditions of Indonesia's housing are clearly substandard and, in fact, they are quite similar to the housing conditions in Pakistan.

The consensus among housing finance experts is that there is no right way to mobilize resources for the housing sector. Nor is there a formula for determining the proportion of use between different resource instruments. Institutions in most countries experiment with a variety of instruments and techniques, selecting those that work best at the time they are being tried and used. Moreover those institutions understand the economic and political realities under which they are working and design resource mobilization programs accordingly. It is clear that until domestic savings are mobilized and the capital markets freed up, no country will be able to generate sufficient funds for housing finance purposes.

5.2 Resource Mobilization in Pakistan

The ability of the HFCs in Pakistan to gain access to domestic capital markets and/or attract deposits is very limited at this time. The Government taps the domestic capital market extensively to finance its deficit, although the pressure on Government to reduce its reliance on debt for this purpose is constant. It is virtually impossible for private sector financial institutions to compete with the government as long as the latter's markup on deposits remains at today's high levels. Recently, a blue chip textile company has to pay a markup of 19.68 percent on a 5-year term loan from the capital market. Even a large public agency such as the Water and Power Development Authority (WAPDA) has tried, so far unsuccessfully, to borrow up to Rs 15 billion at a 19 percent markup, even though these bonds can be treated as approved security for the purpose of investment by trusts and insurance companies to the same extent as prime government securities. The lack of an explicit government has been the main reason why WAPDA has had difficulty marketing this issue. These high rates contribute to the HFCs inability to attract the pure savers.

For a fledgling HFC to obtain a similar loan, it would have to pay a higher rate on deposits, which would require the HFC to make mortgage loans at a markup of around 25 percent, which is clearly too steep for even the wealthier Pakistanis. The limited experience to date in the HFCs indicates that the market for mortgage loans appears to dry up at 17 percent, and even at that rate it reaches only a tiny fraction of the market. However, these high markups, driven by inflation, are a relatively new development, and it is still unclear what impact such rates will have on the market over the long run.[4]

Deposits are an even less likely prospect as a lending resource. HFCs are not permitted to offer demand or passbook savings, although 30-day time or term savings deposits are allowed. Nevertheless, the HFCs believe that it is very difficult for these time deposits, called Certificates of Investment, to compete with similar instruments being offered by government institutions, such as SBP (13 percent on 6-month T-Bills). However, an HFC must be very careful in utilizing short-term deposits to finance long-term loans. The danger of mismatching assets and liabilities is well-known even to the most casual observer of housing finance systems. Yet this danger can be mitigated, but not eliminated, by the existence of well-functioning capital markets which offer liquidity for long-term mortgage instruments.

In the long run, the solution is simple. The government must step aside and stop competing with the private sector in the pursuit of financial resources while at the same time, place a high priority on the creation of a long-term bond market. It must also permit the HFCs more leeway in the mobilization of resources. Accordingly, the Government must work with the HFCs to create an environment whereby the HFCs can compete successfully with the rest of the financial market for resources. In the short run, however, there are some

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[4] See Appendix C for a brief discussion of the impact of inflation on the housing finance sector.

immediate steps the government could take to bolster the HFCs and permit them to carry out their assigned mandate to provide housing finance to all Pakistanis.

5.3 Specific Remedies

The SBP appears to support the new housing finance companies. Yet, it is clear that the SBP is very concerned about the capacity and the capability of the HFCs to carry out their objectives, that is to mobilize resources and make mortgage loans, all the while demonstrating to the public and the government that they will not wreak havoc on the economy in the same way as have other financial institutions. The government is demonstrating its willingness to support the housing sector by activating the Housing Refinance Facility in an efficient and expeditious manner. Additional assistance will depend on the HFCs performance, but there is no assurance from Government that more assistance, other than that deriving from the new facility, will be forthcoming.

The HFCs should initiate several resource mobilization activities that do not require specific SBP approval since they would fit within the current SBP authoritative and regulatory framework. In the case where SBP approval would be required for a particular activity, the State Bank might have to issue a circular to ciarify its approval. It should not be necessary to change the NBFI Prudential Regulations for any of the activities listed below.

5.3.1 Other Funding

Additional funding to the SBP Housing Refinance Facility (see Section 6), possibly through the SBP Housing Credit Fund, should be considered at an appropriate time, although SBP's current policy will not permit it to provide any more funding. Further, any additional funding should be in the form of loans, not advances or grants, to the HFCs, under similar terms and conditions as the proposed HRF. Such funding should be contingent on the HFC's overall performance and their successful utilization of their quota under the HRF. Consideration of new funding should be taken up only when at least two of the HFCs have exhausted their quotas of Rs 75 million in initial loan refinancing from the HRF.

The HFCs do not require direct funding from the Government of Pakistan or its specialized agencies, rather they require the opportunity to compete with other financial institutions in the mobilization of financial resources. To accomplish this, the Government might have to resort to some sort of direct intervention in the form of guaranties, insurance, or tax benefits, as is found in most countries that have vibrant housing finance industries. A full or partial guarantee would permit the HFCs to tap the domestic capital market for the additional funds as discussed above. To repeat, this sort of Government intervention does not require direct financial contributions to the companies, which is neither recommended nor desirable. In all instances, these types of interventions should be enacted only within the country macroeconomic context and policy.

5.3.2 Savings Schemes

The HFCs should consider devising some sort of linked savings plan, such as a Contract Savings Scheme, which would tie the opening and maintenance of a personal savings account to an opportunity to obtain a mortgage loan at a predetermined ratio. This type of scheme could strongly promote savings in general in Pakistan, but more importantly, could possibly generate large amounts of funds for mortgage lending. The cost of marketing such a scheme is likely to be relatively high, therefore the HFCs should focus now on designing a scheme and then market it when their mortgage loan portfolios increase. Schemes should be developed for Foreign Currency as well as Rupee accounts. There are ample experiences worldwide, in both developed and developing countries, where the use of a linked savings scheme has been successful as one tool among a variety of savings and loan incentives. It should be pointed out that this sort of scheme has not been very successful in India because the group targeted by this program has a limited capacity to save. For it to work in Pakistan, a scheme would have to be addressed specifically to those income groups that the HFCs have identified as having sufficient incomes to participate in a linked saving program.

The real advantage of any linked savings scheme is that normally savers will accept a lower markup than that offered by other saving programs because at the end of a specified period the saver will be eligible for a mortgage loan equal to fixed percentage of the amount saved. The saving must be constant over a number of years to demonstrate to the lending institution that the saver/borrower is creditworthy. Usually, there is a significant penalty if the saver withdraws from the scheme. It should be pointed out that the lending institution must structure the scheme in such a way that borrowings do not exceed the available lending funds in the institution. In Germany, for example, the ratio is 2:1, meaning each mark saved under their scheme will permit two marks to be borrowed over a 7-year term, which has been sufficient to meet the borrowing demand. In Pakistan, the ratio might be as little as 1:1, at least in the initial stages of a scheme.

5.3.3 Foreign Currency Deposits

The HFCs are permitted to accept local currency savings accounts. Therefore the HFCs should also be allowed to accept foreign currency deposits as one way to promote the mobilization of savings. Investment Banks and Modarabas, which are also Non-Bank Financial Institutions, are currently permitted to set up foreign currency accounts. Since HFCs have to meet the same reserve requirements as those two financial institutions, they should be permitted to accept and maintain foreign currency deposits. This recommendation might very well be moot if, within the near future, the Government permits full convertability of the Rupee coupled with adoption of market rates for foreign exchange cover.

5.3.4 Certificates of Investment

The HFCs should utilize Certificates of Investment (COI) to generate short-term resources for mortgage lending. To overcome the disadvantage of competing with the Government of Pakistan for funds, the HFCs should utilize the COIs to mobilize savings deposits in conjunction with a linked savings scheme. HFCs are currently permitted to issue COIs with as little as a 30-day maturity and possibly as much as ten years. Given the expected terms of the mortgage loans, a weighted average of a 5-year term on the COIs should be sufficient to match the maturities of fixed rate 12-year loans. While short-term COIs will not and should not be a primary general funding resource, particularly when standing alone, due in large part to the asset/liability mismatch issue, the availability of this relatively low-cost source of funding can help to reduce the overall cost of funds. Moreover, the HFCs should try to devise ways to utilize COIs in a more creative way as a source of funds.

5.3.5 External Funding

The cessation of USAID operations in Pakistan will end all US financial and technical assistance to the housing finance sector. Nevertheless, the IBRD and the ADB will continue to be a potential source of external assistance for the housing sector. Although no housing projects are in the pipeline of either bank, the IBRD Financial Deepening Project with $200 million in loans for private sector financial institutions is one possible source of assistance to the HFCs. For HFCs to qualify for loans under this Project, certain conditions in the IBRD loan agreement would have to be modified or waived. The Government of Pakistan would have to concur with the incorporation of the HFCs in this program since it is providing the full faith and credit loan guaranty to the IBRD. If they are able to participate, the HFCs should be prepared to respond to the implementation conditions attached to this loan.[5]

5.3.6 Other Sources

It has been suggested that the HFCs have access to the same financial resources that commercial banks now have. Assuming the SBP agrees to that request, the HFCs would then have to adhere to the same SBP-mandated reserve requirements, including the requirement to invest 30 percent of all deposits from non-financial institutional sources in government paper, rather than the 15 percent now mandated by the SBP for HFCs. If this occurred, HFCs would have fewer funds to loan for housing finance purposes, and moreover, due to the tenure of those deposits, the HFC would probably have to divert some lending to non-housing purposes to ensure a proper asset/liability match. This is not an argument against permitting the HFCs more access to other types of resources, but merely pointing out the

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[5] It should be pointed out that the deepening of the financial markets would surely involve the development of a capital market for housing, and for this reason, the incorporation of the new private sector housing finance system into this project would seem to be a natural fit.

cost of doing so. The HFCs should consider carefully whether the benefits of converting essentially to commercial banks would outweigh the benefits of remaining specialized HFCs.

6 Government Incentive Measures

Wishing alone the existence of a vibrant and strong housing finance sector will not make it happen. As indicated above, the HFCs can take some measures to improve their operations within the context of the current government rules and regulations. However, if the Government of Pakistan truly desires the development of a housing finance sector that can contribute to the economic growth and development of the country and to the mobilization of savings, then it may have to enact a number of industry-wide incentives. Surveys of both developed and developing countries show that without some economic incentives, the housing finance industry will not flourish. Incentives the Government might consider are the following.

6.1 Depositor Incentive Package

Income from deposits are now subject to the payment of income tax. Under this incentive, depositor savings in the housing finance companies would be exempt from payment of any tax on income earned from these deposits for a specific period, usually at least one year. This would encourage the flow of savings, particularly pure savings, into the HFCs, since elimination of this tax would increase the return to savers.

6.2 Loan Incentive Package

The present tax code in Pakistan strongly discourages the granting of loans for the acquisition of a home. At the present time, a homebuyer must pay income tax on both the principal and mark-up portions of a loan to purchase a residential property for personal use, while loans for rental property are exempt from income taxes. Eliminating the tax completely on the mark-up portion while exempting all tax on the first Rs 50,000 of the principal would be a strong incentive to the industry. This, in turn, would encourage savings through linked savings plans related to the purchase of residential property.

6.3 HFC Incentives

Increasing capital reserves of the housing finance companies is necessary to enhance the financial soundness of the industry. Yet the current tax laws require the HFCs to pay tax on profits which hinders the growth of capital reserves through earnings. The Government could either eliminate all tax on all or part of HFC earnings up to an amount equal to paid-in equity, or declare a tax holiday for a number of years, perhaps the first five years of operation. Either of these two measures would permit the HFCs to achieve the required financial soundness, and thereby improve their tax paying capacity in future years.

6.4 Commercial Bank Incentives

Presently, commercial banks may invest up to 1 percent of their deposits in housing loans. To encourage commercial banks to invest that amount and more in the housing sector, any funds in excess of 1 percent should be treated as part of the commercial bank's investment in approved securities for liquidity purposes, insofar as this investment is made through one of the licensed housing finance companies. This would help ensure an increase in the flow of funds to the sector.

7 The Housing Refinance Facility

The purpose of the Housing Refinance Facility (HRF) is to provide a limited source of liquidity to the HFCs through the refinancing of mortgage loans originated by the various HFCs. Initially, the HRF will be funded with the equivalent of $15 million in funds obtained from a US Housing Guaranty, which will generate the Rupee equivalent today of about Rs 450 million. Other financial resources may be made available through the HRF, if and when they are identified and tapped. To be eligible to participate in this Facility, an HFC must be licensed under the Statutory Regulations that establish the legal framework for HFCs.

SBP will establish an operating group for this Facility within the institution. Day-to-day responsibility for managing the Facility will reside with the same division that manages the other five Funds in the SBP. As its contribution, the NBFI division will provide information on the financial condition of the HFCs and the overall quality of each's portfolio of mortgages. The Deputy Governor for Policy will set the terms and conditions under which the HRF will function.

7.1 HRF Operations

HFCs wishing to participate in the HRF operations will continue to originate mortgages using their internally generated funds. These mortgage loans will carry market rates based on an HFC's cost of funds and its lending policies. When a particular HFC originates a total of at least Rs 10 million in mortgages, the HFC will have the option of presenting this package of mortgages to the SBP for refinancing. The package will be submitted to the NBFI division, which will review the package to ensure that the mortgages meet the criteria for refinancing. At the same time, the NBFI will certify that the HFC is in compliance with the SBP Prudential Regulations.

7.1.1 Loan-to-Value Ratio

Assuming compliance with the regulations, the SBP, through the HRF, will refinance the mortgage package in an amount equal to 80 percent of the face value of the mortgage package being presented by the HFC. The 80 percent rule seems to be universally accepted as the appropriate loan-to-value (LTV) ratio for long-term mortgages on owner occupied, single family residences which are secured by a lien on the residence itself.

7.1.2 Loan Servicing and Prepayment

If one or more of the individual mortgages in the mortgage package is prepaid, then the HFC must replace the mortgage with another mortgage of comparable value and terms. The originals of the mortgage loan documents will be cancelled and copies of the new documents submitted to the SBP. The HFC will continue to be responsible for servicing all mortgage loans held in the custody of the SBP, including collecting monthly payments. In turn, the HFC will make monthly payments to the SBP on the 80 percent financed loan. The HFC must continue to make monthly payments on the SBP-held mortgage package regardless of the performance of the mortgages themselves.

7.1.3 Default

In the event an HFC defaults on a payment to the SBP, the SBP will have recourse to the HFC assets as it would in circumstances where there were no mortgages in the SBP's possession. Moreover, the SBP will be authorized to take title to the mortgages in its possession. The SBP cannot foreclose on any individual mortgage in the package unless the mortgagee defaults. Thus an HFC default will have no impact on the borrower's loan commitment.

7.1.4 Loan Security

The principal documents an HFC requires to authorize a mortgage loan include but are not limited to the following:

- property Funding Agreement (Mortgage Loan Agreement)
- conveyance Deed
- property Mortgage
- irrevocable Authority to Receive Conveyance Deed from the Registry of Assurances
- promissory Note
- property Valuation Report
- personal Guarantee
- employer Letters
- mortgage Insurance Policy
- comprehensive Property Insurance Policy

The HFC will submit to the SBP a certified copy of the above documents, plus any other documents required to originate a mortgage loan, which will provide the SBP with the assurance that the documentation is complete. The original documents will remain with the HFC, however they will be duly assigned to SBP, thus giving recourse to the SBP of the underlying assets. The original documents retained by the HFC may be viewed by the SBP on demand.

7.1.5 Reports

The HFC will submit to the SBP a monthly report on the status of the package of refinanced mortgages. This report will list all the mortgages in the package, giving the name of the borrower, the address of the property, the identifying HFC mortgage number and the current payment record, showing dates, payments and balances. This report will be submitted along with the other reports due to the SBP on a monthly basis.

7.1.6 Allocation of HRF Funds

Each of the seven licensed and to-be-licensed HFCs will be able to finance mortgages with the HRF in an amount up to Rs 75 million, or an amount equal to the HFCs total capital, whichever is lower. If one or more of the HFCs does not initiate utilizing its allotment within two years from the date the HRF is opened, then the remaining balance in the Window will be allotted equally among the HFCs which have utilized their full Rs 75 million authorization.

7.1.7 Program Modifications

The SBP will have the option of revising these guidelines, including the option to make exceptions to them for one or more HFCs, depending on the performance of the HFC. The SBP also may be able to exclude an HFC from participating in the HRF if that HFC is not complying with the Prudential Regulations.

7.1.8 Form Standardization

The HFCs are not now using standardized mortgage lending forms. For the Housing Refinance Facility to evolve into a more comprehensive refinancing operation, the SBP should initiate efforts to standardize these forms. The USAID MIS package, available to all HFCs, may assist in this effort. It is recommended that SBP review this package at its earliest opportunity with a view of incorporating it into the system.

7.2 HRF Terms and Conditions

The cost of these funds to the SBP consists of the interest cost to the US Lender of the Housing Guaranty Loan, plus any costs that the SBP may incur in the administration of the Facility as well as coverage for provisions and reserves. If a fixed-rate HG loan were borrowed from the US Capital Market today, the interest rate on the US funds would be about 8.25 percent (up about 1.25 percent from 6 months ago), 30-year term and a 10-year grace period on repayment of principal. Amortization of the loan will take place over the remaining 20-year life of the loan. SBP administrative costs should not exceed 1 percent of the refinanced loan. As evidenced in Section 7.2.2 of this report, HFC should not be charged for the foreign exchange coverage.

7.2.1 Mark-Up Rate and Term to the HFCs

If a mortgage package were presented to SBP under the above conditions, then the markup on the SBP refinancing loan to the HFC would be in the 9 to 10 percent range. The SBP should justify a higher rate, if that is required. The maturity date of the refinancing loan will be no more than 12 years, depending on the composition of the mortgages being refinanced. For example, if a package consisted only of 3-year reviewable mortgages, it is conceivable that the SBP could refinance this package over a 3-year period. The reason for selecting 12 years as the maximum term is that the longest fixed-rate loan now being made by an HFC is 12 years. Reviewable loans are being made for longer terms, but the loans will be recalculated at an earlier date, usually 3 years, at which time the markup may be changed.

7.2.2 Foreign Exchange Cover

The HFCs should not be required to pay a foreign cover fee on the Housing Guaranty for the following reasons:

- At no point in the foreign currency transaction process will the HFCs have access to the foreign currency, nor will they be a party to the negotiations or a signatory on the loan agreement between the borrower (Ministry of Finance) and the US lender. The SBP, and only the SBP, will have access to or make use of the US Dollars. Thus, there is little justification for imposing this cost on the HFCs.
- Secondly, the HG loan is a long-term, 30-year loan, not short-term like almost all the foreign currency deposits and loans flowing into Pakistan. To try to estimate an equitable fee to be fixed over a 30-year period is not only impossible, but very possibly onerous to the HFCs if inflation is tamed as the Government of Pakistan and the international monetary authorities expect.
- Thirdly, as a result of the HG program, the Government of Pakistan will have access to hard currency at terms that are impossible to obtain elsewhere in the private sector. The use of these loan funds to refinance more costly loans from other sources would be a likely use to which only the SBP can avail.

7.3 Financial Impact on the HFCs

It is important to assess the impact of additional sources of funds on the ability of the HFCs to function as viable financial institutions. To undertake this assessment, it was necessary in the first instance to prepare pro forma financial statements for a typical HFC which will utilize its equity capital as the one and only source of funds for mortgage loans. Next, the impact of an inflow of Rs 75 million in loan refinancing on the typical HFC was analyzed to show how it would affect the typical HFC's financial condition. Finally, the third analysis showed the importance of domestic savings on the financial health of the company. It should be stressed that a typical HFC was assumed for analytical purposes. The actual situation in each of the operating or soon-to-operate HFCs will vary.

The three financial analyses of a typical Housing Finance Company draw primarily on the Financial Planning Models in Appendix A. The models are integrated 5-year summary financial statements, showing the income and funds flow statements, and balance sheets of a typical Housing Finance Company. The supporting schedules and footnotes attached to the Models set forth the basic revenue and expense assumptions and distribute beneficiary payments between principal and markup. Preliminary iterations or runs of each model can be described as follows:

7.3.1 Run # 1: The Equity Model

This Model reflects the condition of an operating HFC as presently constituted. The sole source of capital is shareholder's equity; thus, the debt to equity ratio is zero. Lending activity has begun and a monthly volume of Rs 4.9 million is assumed at an average of seven loans of Rs 700,000 each. In order to sustain this modest volume of lending, additional capital is required in about the eighth month of operation, and again in years 2 and 4. Profits as a percentage of net equity range from -4.6 percent in year 1 to about 5 percent in year 4 and year 5. Operating expense as a percent of total assets ranges from 13.3 percent in year 1 to 9.6 percent in year 5. This operating expense ratio compares with an average of about 1.3 percent in the British Building Societies and reflects primarily the low volume of HFC lending activity in the Pakistani market.

7.3.2 Run # 2: Utilizing the Housing Refinance Facility

This Model assumes a contribution of Rs 75 million and shows the impact of the Housing Refinance Facility on the typical HFC. Assuming the same volume of lending and no further source of capital, the HRF funds are utilized in full in about month 21. The major impact of this Facility on the HFC is to delay the requirement of a third contribution of additional equity capital from year 2 to year 4. The impact of the HRF on profitability and operating efficiency is otherwise minimal. The debt to equity ratio is 0.64 in the year of drawdown, but in the absence of other sources of capital it is reduced steadily to 0.28 in year 5. Profitability actually is reduced in years 3 and 4 because an assumed 60 percent of the profit margin is paid to the State Bank of Pakistan to service the refinancing loan. Again this highlights the low overall volume of operations and the critical need for mobilizing additional resources.

7.3.3 Run # 3: Utilizing both Savings Deposits/COIs & the Housing Refinance Facility

This Model assumes that savings are mobilized at the rate of Rs 10.0 million per month for the 60-month cycle of the model. Also the Housing Refinance Facility is utilized to the full extent of the proposed initial line of credit, i.e., Rs 75 million. The net influx of savings deposits/COIs of Rs 600 million over the 5-year period enables the HFC to operate without recourse to additional equity capital after the second contribution of Rs 60 million is paid in toward the end of year 1. Thus, paid in capital remains constant at Rs 120 million in years 2-5. Profitability shows steady if modest gains in years 2-5, increasing from 7 percent to

10.6 percent as a percent of net equity. Overall efficiency is likewise enhanced as reflected in the ratio of operating expense to total assets, which declines from 6.4 percent in year 1 to 3.1 percent in year 5. This result may be overstated as the basic assumptions of operating expense were not changed in the three runs of the Model. Arguably, operating costs will increase somewhat with the implementation of a savings schemes. On the other hand, the absolute volume of savings mobilized is not large. The debt to equity ratio rises gradually from 2.4 in year 2 to 3.5 in year 5 under the assumptions of Run # 3, well below the 7:1 and 10:1 ratios foreseen in the Prudential Regulations.

The results of these pro forma Model runs confirm the critical need of the HFCs to mobilize savings in far greater volume than so far contemplated. Model run # 2 shows that the Housing Refinance Facility provides valuable support to the industry by alleviating the need for excessive injections of equity capital in years 2 and 3, thus giving it further time to organize its marketing efforts. Access to the Housing Refinance Facility also provides the HFCs with some additional capital, during which time, they will be able to develop and initiate savings programs as contemplated in the next Model. Model #3 demonstrates clearly the need for the companies to have access to domestic savings as one of the two primary sources of housing finance. Finally, the models show that the development of the housing finance market is a medium- to long-term project, at best. It further justifies the need for the authorities to consider ways to accelerate the development of the industry via the granting of other special incentives to assure that a significant impact is made on reducing Pakistan's housing deficit in the foreseeable future.

7.4 Risks to the SBP

Opening the Housing Refinance Facility will require the SBP to address three major risks:
- Failure (bankruptcy or closure) of an HFC;
- Repayment of the underlying Mortgages; and
- Foreign Exchange Risk.

7.4.1 Failure of an HFC

The SBP has in place a set of Prudential Regulations through which it exercises a large degree of control over the HFCs. Prompt and active enforcement of these Regulations will ensure that all HFCs are and will remain financially sound companies during the period when their mortgages are held by the SBP. However in the event an HFC utilizing the Housing Finance Facility encounters financial difficulties, the SBP has covered this risk by not allowing that HFC to refinance from the HRF an amount in excess of its equity capital. Once the financial difficulties become known—and it is incumbent on the SBP, through its off-site monitoring and on-site supervision of the HFC, to be aware of those difficulties—then the SBP must act with alacrity to ensure that it recovers its funds from the HFC, as it should in any instance where a financial institution encounters financial or management difficulties.

7.4.2 Repayment of the Underlying Mortgages

HFC mortgage loans are granted at no more than a 60 percent loan-to-value ratio, that is, the amount of the mortgage loan is only 60 percent of the appraised value of the property which guaranties the loan. Further, the SBP is discounting the mortgage at 80 percent of the face value of the mortgage. Thus the value of the refinanced loan at the time of origination with the SBP will be only 48 percent of appraised value of the property and this figure will begin to decline the moment the first monthly mortgage payment is made. SBP's security will increase over time, as the loan-to-value declines and the value of the property increases.

SBP's increased security on loans to the HFC does not provide cover from the inability of lenders to foreclose legally and quickly on past-due loans in Pakistan. However it should be recognized that the failure of an HFC to collect regularly, thereby preempting foreclosure, is significantly different from what a public financial institution like HBFC might do. If a loan is not collected, income will fall and with it, the possibility that the HFC's capital will be exposed. At this point, the HFC's shareholders will face losses and the prospect of shareholder's loss of capital helps ensure full and prompt recovery of mortgage loans. Should an HFC fail, the SBP will devise a mechanism whereby the mortgage loans will continue to be serviced and the SBP will recover its refinanced loan.

7.4.3 Foreign Exchange Risk

The SBP can mitigate its foreign exchange risk by keeping the US Dollars off-shore for use in export financing or some other activity requiring US Dollars for financial transactions overseas. It could also lend the US Dollars to an entity that needs Dollars and is willing to provide the SBP with the requisite risk cover, as determined by the SBP.

7.5 Foundation for a National Mortgage Market

As the balance on the mortgage loans held by the SBP declines over time, an individual HFC could begin to consider the possibility of refinancing the SBP mortgage package with a third party. After a few years, the mortgages could become more attractive as an investment to the private sector because it will have been demonstrated that they have been repaid promptly by the borrower, that is, they have been "seasoned." The SBP will be able to certify that the monthly payments have been paid fully and promptly and that the HFC has not experienced any problems in servicing the mortgages in the refinancing loan package. Moreover the loan balance will have declined even further, leaving a much more favorable loan-to-value ratio.

By refinancing this package of mortgages with the private sector, a first step will be taken to initiate a type of secondary mortgage market whereby the HFC would use these "seasoned" mortgages to raise money in the private capital market, which would then be used to redeem the mortgages from the SBP. In turn, the SBP would then be able to refinance a new package of mortgages that the HFC originates. And so on. In this way a secondary market is seeded.

7.6 Closure of the HRF

The SBP has permitted the establishment of the Housing Refinance Facility to assist the HFCs to gain access to additional funds in the short term, at least until the HFCs are able to tap other sources of capital and deposits. It is not, nor was it ever intended to be, a major or a permanent source of liquidity for the companies, although additional funds could be funneled through the HRF to the HFCs if they are forthcoming from other sources. As the incubator of a national mortgage market, it would be possible for the HRF to evolve into a private sector secondary mortgage institution, albeit with some sort of government guaranty. It is also possible that the HRF will be closed at a future date as other sources of capital are found, and the proceeds of the HRF could be used for other related financial purposes that could be more germane to the housing finance system at that future date.

8 An Apex Bank

It has been suggested that Pakistan might benefit from the creation of a central housing finance institution, which might be called an apex housing bank, to provide liquidity to the sector as well as give it some guidance and leadership. Other elements of a viable housing finance sector, including a national policy, are also lacking, and a central organization might be helpful in filling these gaps. Before determining if this organization is truly needed, it is necessary to define what an apex bank is, as well as review the experience, history and role of similar institutions in other countries.

8.1 What an Apex Bank Is

In general, an apex housing bank is an all-powerful central organization that essentially controls completely the housing finance sector. At the very least, it should undertake two major functions:

- license and regulate the industry[6]; and
- provide liquidity to the primary housing finance companies.[7]

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[6] Regulatory functions can include controls on issues such as lending and savings rates, loan ceilings, etc.

[7] A distinction should be made between primary and secondary housing finance institutions. Primary institutions, sometimes called retail institutions, deal directly with the public for savings and loan purposes. Secondary or wholesale institutions deal only with primary institutions, generally in the provision of liquidity to the latter.

In a broader sense, other functions such as the formulation of housing finance policy, the design of financial programs and in general, promotion and representation of the entire industry could be included within this one institution. In practice, in those countries where apex banks exist in one form or another, the number of functions it is responsible for does not include all the functions listed above.

Apex banks are usually creatures of government, and are either a parastatal organization or a wholly owned subsidiary of one of the major government agencies or ministries associated with the housing or finance portfolios. Generally, the staff of the institution is comprised of civil servants, and the Government has a strong influence over the policies and actions of the institution regardless of the fact that the usual charter usually gives it a large degree of autonomy.

Apex banks are frequently established in countries where the private sector, particularly the finance sector, is weak, and where the government has inhibited, deliberately or otherwise, the development of a private sector housing finance industry. Apex banks may also be created to implement a particular government finance incentive, such as a government tax or levy to fund housing. At one time, apex banks were strongly encouraged by the donor community as the answer to a lack of private sector housing finance institutions in developing countries. Then, but not now, the donor institutions felt that creating one central finance institution for housing would be more effective and have a speedier impact on the housing sector than trying to start up private sector institutions in countries where capital was short and human resources wanting.

8.2 Examples in Developed Countries

Apex housing banks do not exist in the developed countries. A review of the literature on housing finance systems does not reveal one single fully developed country, i.e., the 24 OECD countries, where a single institution provides both of the major functions: liquidity to and regulation of the housing finance system. Instead a variety of institutions are involved in these two functions as well as the ancillary functions mentioned in the previous section.

8.2.1 Regulatory

This function is almost always carried out by a government or parastatal agency. The United Kingdom has one major regulatory body, the Building Societies Commission, for institutions that accept savings as well as make loans, while Denmark also has one regulatory body, but oddly enough, this body is the Ministry of Industry. One of the most logical systems is in France, which has a regulatory system governed by three entities under the Ministry of Economy, Finance and the Budget and the Governor of the Bank of France. In that country, the Committee on Banking Regulations writes the regulations, the Committee on Credit Institutions approves the regulations and the Commission on Banking oversees or enforces the operations.

8.2.2 Liquidity

The provision of liquidity to the housing finance system is as varied as there are countries. In Germany and France, housing contract schemes provide a steady flow of liquidity as new savers provide the funding for savers who have completed their savings contract period. In Denmark particularly, but in all other countries as well, the mortgage lending institutions have access to liquidity by issuing mortgage bonds whose proceeds are used to finance housing loans. But it is only in the US where a true secondary mortgage market exists.

Three nationwide financial organizations raise huge amounts of funds from the US capital market, which in turn they use to buy mortgages from qualified primary institutions. The largest and most important of these institutions, the Federal National Mortgage Association (FNMA), is a publicly held, private corporation, although it was originally a government agency. It obtains funds to purchase mortgages through the sale of its own debt and mortgage backed securities, and provides a corporate guarantee of timely payment of principal and interest on these securities. By virtue of its special status and connection to the government, FNMA enjoys an important advantage in the debt market as investors perceive that there is no default risk on its debt. That perception derives not from high corporate risk ratings, but rather from FNMA's origins as a public agency coupied with the belief that the federal government will not let it fail.

In this case, the US government has assured the flow of funds to mortgage markets, that is, liquidity, at NO COST TO THE GOVERNMENT OR THE TAXPAYER. The same is virtually true with respect to the other developed country institutions providing liquidity to the mortgage markets. The lesson to be learned here is that the role of government is to facilitate the flow of funds to the markets, while at the same time, not incurring any costs in this effort. There is no reason why Pakistan should not strive to emulate this type of system.

8.2.3 Policy

In most developed countries, Housing Ministries, along with the Government agencies or ministries that make monetary and fiscal policy, provide the policy framework within which these housing finance systems operate. In the US, for example, the Department of Housing and Urban Development (HUD) makes housing policy to include housing finance policy, but this Department is influenced strongly by the Office of Management and Budget in fiscal matters and the Department of the Treasury in monetary matters. Policy is also set by the various Institutions that provide liquidity to the sector, such as FNMA's policy (in conjunction with HUD) on the loan ceiling for FNMA-qualified mortgages. Input on policy decisions is derived from the various trade associations as well as from consumers, that is, the mortgage borrowers.

8.2.4 Promotion and Representation

Usually there is a strong trade association that promotes the sector and provides the constituency support that is so critical to the success of the sector. In all cases, this trade association is supported by dues from its membership. It is almost unheard of for an individual financial institution to forgo membership in this trade associate; the stigma is just too great and the herd mentality too strong. A good example of a trade association is in the United Kingdom trade association, where the Building Societies Association has been active since 1869. It acts as the collective voice for the building societies, representing their interests to government, parliament, the media and other trade bodies. It also provides information and explanations of all legislative and regulatory developments to its membership. With the growing involvement of other institutions in the provision of mortgage lending in the UK, the Council of Mortgage Lenders was created in 1989 to serve this expanding membership.

8.2.5 Product Development

The development of financial programs is usually left to the individual institutions, and in countries where individual institutional initiative and innovation in this aspect is encouraged, the institution that first develops a new saving or loan instrument usually gains a competitive advantage. In countries that are more rigid in their acceptance of innovation, new instruments are usually borrowed from other countries, albeit slowly. Securitization of mortgages, which is the issuance of liquid debt instruments secured by pools of mortgages, originated in the US, but is slowly expanding to some European countries.

8.3 Examples in Developing Countries

Developing countries in general have weak housing markets. Most housing in provided through the informal sector, with institutional finance playing a relatively minor role in the provision of housing. National governments undertake a disproportionate role in the management and control of the financial sector with the result that free market initiatives are limited. Where they exist, private sector housing finance institutions are often severely restrained in their savings and lending activities. They are able to operate only at the sufferance of government institutions and bureaucrats.

A distinction should be made between primary and secondary national housing banks. Many developing countries have what are called "national housing banks," but most of these banks are primary lending institutions that directly serve the public and are usually wholly owned government subsidiaries or parastatals. They make mortgage loans to individuals, usually loans to lower income segments of the population, although in practice this is not always the case. In some cases, they also accept deposits from the public. Within the universe of national housing banks, two types exist in developing countries. One is a market driven institution, with little government interference, that is able to compete with the private sector for resources and to make mortgage loans at market rates. A good example of this type of institution is the Government Housing Bank of Thailand. Other than the fact that it is owned by the government of Thailand, its commercial operations are little different from any other private sector financial institution that mobilizes financial resources to make mortgage loans.

A second type of primary housing finance institution on the national level is one that exists primarily to direct funds to selected segments of the society at below market or subsidized lending terms. This type of primary institution is able to lend for housing at these rates because it obtains low-rate financing resources from the government or other subsidized sources. Most often it undercuts any private sector institution trying to compete in the market, and always distorts free-market conditions. In Asia, a good example of this type of institution is Indonesia's Bank Tabungan Negara. For all intents and purposes, the HBFC in Pakistan is a primary national housing bank of this second type, although the cessation of government advances will force it to compete on the financial markets if it is to prosper and grow.

The secondary housing finance or apex bank model could be applicable to Pakistan since primary housing finance institutions from the private sector need a secondary institution at least to provide liquidity. This is particularly relevant since the HBFC could or should fill the role of a public sector institution providing financing for individuals whose incomes do not permit them to access the private sector institutions. Yet examples in other developing countries of an apex housing bank serving the primary housing finance sector are rare. The most relevant is India's National Housing Bank. This institution was created in 1988 to regulate and control the private sector housing finance companies, provide liquidity to these same institutions, mobilize funds, promote the industry, design new financial products and in short, carry out almost any function as long as it was deemed beneficial to the industry. It was created to be an all-encompassing apex housing bank.

It was created at a time when one privately held company, HDFC, was extremely successful, and the success of this one institution was spawning additional companies at a rapid pace. In many circles, it was felt that the time had arrived to create a central organization to undertake most of industry's central functions, including assuming the regulatory functions of the Reserve Bank of India. Most importantly, it was felt that the Bank would be more successful at raising capital for all the housing finance companies than each institution could accomplish through its own efforts.

Unfortunately, the Bank was involved in the security market scandal in 1991, whose ramifications continue to be felt today. To some degree, this scandal has permeated the entire financial sector, thus it is impossible to determine how much the scandal had affected the viability of the Bank, or whether the concept of a central housing finance bank in India is a flawed one. The fact remains that the Bank has not been very successful in carrying out its mandate. It continues to license and regulate the industry, following the procedures set up by the Reserve Bank, of which the National Housing Bank is a wholly owned subsidiary. Insofar as India is operating under less than free-market conditions, the Bank controls the companies in the sense that it sets interest rates, authorizes types of deposits, limits access to the capital market, etc. This type of control is felt by some observers to be contradictory to the Bank's role as the provider of liquidity. With this authority, it is possible for the Bank to influence rates to assure a flow of funds to itself at the expense of the primary institutions.

The scandal has sorely affected the ability of the Bank to raise capital in the financial markets. The Reserve Bank provided an initial funding of 600 crore, which the Bank is using to provide loans to eligible housing finance companies. The largest housing finance company, HDFC, has not sought access to these funds, having been able to raise sufficient funds for on-lending through its own marketing efforts. Most companies have been able to mobilize capital resources equally as well as the Bank, meaning that Bank does not have any innate advantage as a Central Housing Bank, owned by the Government. While the Bank has raised some funds through bond issues, it has not been able to establish itself as a secondary mortgage institution, providing liquidity to the sector.

The National Housing Bank of Indian has not been successful in carrying out the twin functions of promotion and product development, due in part at least to the scandal. Nevertheless, it is probable that the Bank would have had difficulty carrying out these two functions anyway, given the lack of skills and capabilities within the Bank in these two areas.

It is impossible to say what will happen to the Bank. The scandal has put the Bank in a defensive mood, and until the scandal is put in the past, it will not be possible for it to attempt to fulfill its mandate. Some observers believe that the Bank should consider lowering its sights, and instead focus on providing only a few services well. Continued services would include the enforcement of Prudential Regulations, which implies preparing a kind of credit rating for all housing finance companies regulated by the Bank. The financial control functions would not be handled by the Bank since, as shown above, it might influence its decisions regarding mobilizing capital. The Bank should also continue to function as a source of liquidity so long as the liquidity is rationed to low-income families. Many experts believe that if the Bank were to carry out these basic functions well, while leaving to the companies and their trade association the remaining functions, then the Bank could be said to fulfill a needed role in the housing finance industry.

8.4 An Apex Bank for Pakistan?

In Pakistan, the basic functions of an apex housing bank are, or are not, being fulfilled in the following manner:

8.4.1 Regulatory

The State Bank of Pakistan writes and enforces the regulations for the housing finance companies and the Ministry of Finance licenses the companies. According to the World Bank, while the "SBP has strengthened substantially its supervision oversight..... it needs to do more in particular with regard to capital adequacy, other prudential requirements, off-site monitoring and on-site inspection." Assuming the SBP is assigned the licensing function, and further that the State Bank continues to improve its regulatory capacity, then this function is fully covered.

8.4.2 Liquidity

The SBP intends to open the Housing Refinance Facility which will provide Rs 450 million in liquidity to the HFCs. While this amount will help the nascent HFCs, it is woefully inadequate to meet their liquidity needs. Even the addition of the Rs 700 million from the SBP Housing Credit Fund or any other source will fall far short of actual needs. The Housing Sector will eventually need to access billions of rupees to meet the housing finance requirements. Clearly this function is not being met now, although the creation of this Facility might be a first step in the development of a capital market for mortgages, as has been mentioned previously, which would generate the necessary funds over the long run.

8.4.3 Policy

Both the Ministry of Finance and the State Bank of Pakistan provide some guidelines and direction for the industry, however there is no written policy or consensus on what the housing finance policy is in Pakistan, notwithstanding the mandate of the National Housing Authority to formulate a housing policy.

8.4.4 Promotion and Representation

The HFCs have started a trade group, including hiring a full-time executive secretary as of May 1994. This is an excellent start, however, the size of its membership will limit the resources it can use to promote the system. Since trade groups or associations are supported financially by their membership, the small membership base here is inadequate now to support an active trade association without outside assistance, as will be required for the first year of existence of the trade association and perhaps longer.

8.4.5 Financial Instruments

The HFCs design their own savings and loan instruments and financial products. No central institution in Pakistan has the demonstrated capacity to carry out this function now and it is dubious whether any type of institution other than the HFCs could gain sufficient experience to carry out this in the housing finance market.

8.4.6 Conclusions

This leads to the question as to whether a central organization is required now in Pakistan. The State Bank of Pakistan is currently functioning as a de facto central or apex housing finance organization. It is, or soon will be, carrying out all the necessary regulatory functions and it is the only institution that will be providing liquidity to the system, albeit meager. Thus it is fulfilling the two basic functions of an "apex housing bank." Whether the SBP is able to fulfill completely these two functions is another issue. No doubt the housing finance system will require additional liquidity, and although the SBP is adamant it will not provide this liquidity from its own resources, it will support funding from other sources. It is not evident that a new central organization would be any more effective in providing or promoting access to this liquidity than the SBP.

There remains a housing policy vacuum in Pakistan. A comprehensive housing policy is necessary because of the inter-sectorial nature of housing and its relation to and impact on other economic sectors. Instead, ad hoc decisions have become a substitute for a coherent, written and explicit policy. In the housing finance sector, the SBP is now making some housing finance policy determinations which emanate from its actions and decisions. But it is abundantly clear that the lack of a housing policy, of which housing finance is a major component, is impeding the development of the sector. However, the preparation of a housing finance policy by the SBP or a central organization will be relatively futile if it is not integrated into an overall housing policy. Whether the National Housing Authority is able to have its housing policy or any other such policy accepted is an unknown at this time.

In most countries, the consensus is that a strong collective voice in the form of a trade association—divorced from the government—is the most effective tool that a group of individuals or institutions can devise to represent them. The HFC's efforts to organize and make operational the housing finance trade group is probably the most important step now being taken in this direction. This group has the potential to become the true spokesman or representative and thus bring about the necessary changes to make the housing finance system successful. A central organization such as a apex housing bank with its close government ties cannot take the place of a trade association, although it could complement the trade association, assuming a good working relationship. Finally, the design of financial instruments and products is a function better left to the HFCs.

It can therefore be concluded that it is premature to consider the creation of a central housing finance institution. This does not mean that the establishment of such an organization, however structured, would not be necessary at a later date. This issue should be revisited once more housing finance companies are operational, the Housing Refinance Facility is functioning and the Trade Group is carrying out its responsibilities fully. While it is difficult to determine the date that the issue of an apex bank should be addressed once again, it is probable that it should be carried out no later than two years hence or mid-1996. Nevertheless, another assessment on the need to establish a central organization could be carried out whenever there is a consensus on the need to do so.

9 Next Steps for Pakistan's Housing Finance Sector

9.1 Conclusions

The private sector housing finance system is very new in Pakistan. To achieve success, the system must overcome significant barriers to mobilize resources for mortgage lending, and it must design mortgage instruments that are affordable and marketable to Pakistani families that desperately need new and better housing. At the same time, the companies must be able undertake these functions profitably, thus satisfying their owners and shareholders. To this end, it must gain the support of the government, and in particular, the State Bank of Pakistan, which is undertaking an important role in the development of the new system.

The State Bank of Pakistan recognizes the importance of housing finance in the overall economic context. It understands that it needs to nurture these institutions so that they can fulfill the promise of providing housing finance to the people. Moreover, the SBP is aware that the development of the housing finance system gives the SBP the unique opportunity to demonstrate how a new financial group should be organized, regulated and supported, since the very newness of the HFCs permits the SBP to start out with a clean slate. Thus, this learning experience can benefit the entire financial sector.

This communality of interests between the companies and the SBP presupposes a close and almost collegial relationship. The companies must be open with the SBP, even insisting that the SBP make on-site inspections of the companies so that they will be better able to comply fully with the prudential regulations. The SBP should assign at least one full-time agent to regulate the companies, and he should spend time with the companies learning about their problems and their business operations. There should be periodic and, in fact, frequent meetings and exchanges of information between the two, recognizing that the more they know about each other, the more they will understand the other's needs and problems. An environment of trust must be created. But if this new direction is not taken, then the usual "us versus them" attitude will prevail, with the result being similar to the strained relationship that appears to exist between the SBP and other financial institutions in Pakistan.

It is important for HFCs to recognize that the Government of Pakistan is in the process of modifying and refining its fiscal and monetary policies. These changes are due in large part to a need to reform its financial house to fulfill commitments to the IMF and the World Bank as well as a recognition that the government deficit has to be restrained. As a result, the old system of financial advances, subsidies, guarantees and outright favors are being curtailed, and in some cases, eliminated. This means essentially that the HFCs will not be the beneficiaries of the same kind of treatment that other financial institutions had when they initiated operations. This does not mean that the HFCs are being treated unfairly; it is just that the rules have changed. The HFCs must recognize and accept this fact.

The SBP has made a commitment to the HFCs; it is activating a Housing Refinance Facility, and making Rs 450 million available to refinance mortgage loans. The HFCs must continue to make loans, thereby gaining access to this Facility, and try new ways to mobilize resources, using those mechanisms now permitted under the existing regulations. For its part, the SBP must cooperate with the HFCs in their search of ways to mobilize new resources and it must seriously consider the creation of some incentives to promote the housing finance sector. If the HFCs are successful over the next few months or years, and the new cooperative relationship between the two groups succeeds, there is no doubt that the SBP will throw its weight behind the efforts of the HFCs to generate more housing finance activity in Pakistan.

Throughout this paper, many suggestions and recommendations have been made about what the housing finance companies and the Government of Pakistan should do to ensure the success of the housing finance system. The next paragraphs attempt to put those recommendations in sequence and to designate responsibilities.

9.2 Immediate Actions

The initial step requires the State Bank to activate physically the Housing Refinance Facility, based on the recommendations in this paper. The SBP must formally issue the rules and regulations for the HFCs to gain access to this Facility and set up an operational structure. At the same time, the Ministry of Finance must enter the US capital market to borrow the Housing Guaranty funds. The State Bank should aim for this Facility to open no later than July 1, 1994.

Concurrently, the State Bank should consider the question of the HFCs being authorized to accept foreign currency accounts, and if approved, issue a circular to this effect, again no later than July 1, 1994. These two actions by the State Bank will give a real as well as a psychological boost to the housing finance sector. It will show that the Government supports the sector, and just as importantly, it will not result in any cost to the Government. In fact it will be a benefit to the Government insofar as it will allow the Government to tap a very inexpensive source of foreign currency, the Housing Guaranty Loan funds. In addition, this action will encourage the other groups to carry on with the necessary steps to obtain their licenses to do business as housing finance companies. The State Bank, along with the Ministry of Finance, should also begin to consider the use of tax incentives along the lines suggested in this report to support the housing finance system.

While the State Bank goes ahead with its plans to open the HRF, the HFCs should continue with their efforts to mobilize financial resources utilizing those avenues now open to them. Either individually or jointly, they should explore the prospect of designing and utilizing some sort of savings linked scheme to mobilize resources. This would demonstrate to the State Bank that the HFCs are very serious about the need to mobilize domestic savings and that the HFCs are fully aware of their responsibilities in this matter. These schemes would include both the use of foreign currency accounts and rupee based accounts to mobilize savings. The HFCs should commit themselves to devising at least one comprehensive savings linked scheme by July 1, 1994. At the same time, one or more HFCs will begin to issue Certificates of Investment.

The actions listed above are not one-sided. Both key players in the housing finance sector—the State Bank of Pakistan and the housing finance companies—are being asked to take steps to support the system. If each party agrees to take actions along these suggested lines, then the Housing Finance System is off to an excellent start.

APPENDICES

Appendix A

Financial Models

EQUITY ONLY — HFC-PLANNING MODEL — RUN # 1

INCOME STATEMENT	Year 1	Year 2	Year 3	Year 4	Year 5
Interest Income Ops	5,358	16,874	28,074	38,888	49,231
Fee Income (1)	882	882	882	882	882
Investment Income (2)	5,241	5,946	4,972	6,215	2,206
Total Income	11,481	23,702	33,928	45,985	52,319
Personnel Expense (3)	12,000	13,800	15,870	18,251	20,988
Other Oper. Expense (4)	3,600	4,140	4,761	5,475	6,296
Interest Expense	0	0	0	0	0
Total Expense	15,600	17,940	20,631	23,726	27,284
Net Income Before Tax	(4,119)	5,762	13,297	22,260	25,034
Allowance for Income Tax (5)	0	(893)	(4,787)	(8,013)	(9,012)
Net Profit After Tax (NPAT)	(4,119)	4,869	8,510	14,246	16,022
Allow. Loan Losses (6)	(1,176)	(1,176)	(1,176)	(1,176)	(1,176)
Net After Allowances (NPAA)	(5,295)	3,693	7,334	13,070	14,846
NPAA/NET EQUITY	-4.6%	2.0%	3.9%	5.0%	5.3%
OPERATING EXPENSE/TOTAL ASS	13.3%	9.8%	10.7%	8.8%	9.6%

FUNDS FLOW STATEMENT					
SOURCES OF FUNDS	Year 1	Year 2	Year 3	Year 4	Year 5
NPAT	(4,119)	4,869	8,510	14,246	16,022
Add Back Allow.Loan losses	1,176	1,176	1,176	1,176	1,176
Repayment of Principal	581	2,024	3,784	5,929	8,545
Capital Contribution	120,000	60,000	0	60,000	0
REFINANCE FACILITY	0	0	0	0	0
Savings Deposits/COIs	0	0	0	0	0
Foreign Currency Deposits	0	0	0	0	0
Long Term Foreign Loans	0	0	0	0	0
RE-FINANCE FACILITY	0	0	0	0	0
Reduction in Working Capital	(58,839)	(9,269)	45,330	(22,551)	33,057
Total Sources	58,800	58,800	58,800	58,800	58,800
USES OF FUNDS					
Loan Disbursements	58,800	58,800	58,800	58,800	58,800
Fixed Assets	10,000	0	0	0	0
Total Uses	58,800	58,800	58,800	58,800	58,800

BALANCE SHEET					
ASSETS	Year 1	Year 2	Year 3	Year 4	Year 5
Cash	3,466	2,040	2,291	3,073	3,376
Short Term Investments	45,372	56,068	10,487	32,256	(1,104)
Housing Loans O/S	58,219	114,994	170,011	222,882	273,136
Housing Loans RFF/SBP	0	0	0	0	0
Residual Interest	0	0	0	0	0
Fixed Assets	10,000	10,000	10,000	10,000	10,000
Total Assets	117,057	183,102	192,788	268,211	285,409
LIABILITIES					
Accounts Payable	0	0	0	0	0
REFINANCE FACILITY	0	0	0	0	0
Savings Deposits/COIs	0	0	0	0	0
Foreign Currency Deposits	0	0	0	0	0
Long Term Foreign Loans	0	0	0	0	0
Allowance for Loan Losses	1,176	2,352	3,528	4,704	5,880
Capital	120,000	180,000	180,000	240,000	240,000
Free Reserves	(4,119)	750	9,260	23,507	39,529
Net Equity	115,881	180,750	189,260	263,507	279,529
Total Liabilities	117,057	183,102	192,788	268,211	285,409
Debt:Equity Ratio	0	0	0	0	0

Notes:
(1) Fee income is estimated at 1.5% of the value of new loan originations.
(2) Excess cash is invested in short term instruments at an assumed rate of 16% p.a. (see Schedule of Investment In
(3) Personnel Expense is estimated at Rs1.0 million per month, increasing by 15% annually.
(4) Other expenses are estimated at 30% of Personnel expense.
(5) See Schedule of Income Tax Calculations below.
(6) Allowance of loan losses is estimated at 2% of new loan originations.

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UTILIZING REFINANCE FACILITY — HFC-PLANNING MODEL — RUN # 2

Borrowing Limit: Rs75,000,000

INCOME STATEMENT	Year 1	Year 2	Year 3	Year 4	Year 5
Interest Income Ops	5,358	16,874	28,074	38,888	49,231
Fee Income (1)	882	882	882	882	882
Investment Income (2)	5,241	6,726	6,681	5,968	11,574
Total Income	11,481	24,482	35,637	45,738	61,687
Personnel Expense (3)	12,000	13,800	15,870	18,251	20,988
Other Oper. Expense (4)	3,600	4,140	4,761	5,475	6,296
Interest Expense		2,245	8,837	8,589	8,316
Total Expense	15,600	20,185	29,468	32,315	35,601
Net Income Before Tax	(4,119)	4,297	6,169	13,423	26,086
Allowance for Income Tax (5)		(236)	(2,221)	(4,832)	(9,391)
Net Profit After Tax (NPAT)	(4,119)	4,061	3,948	8,591	16,695
Allow. Loan Losses (6)	(1,176)	(1,176)	(1,176)	(1,176)	(1,176)
Net After Allowances (NPAA)	(5,295)	2,885	2,772	7,415	15,519
NPAA/NET EQUITY	-4.6%	2.4%	2.2%	3.9%	5.8%
OPERATING EXPENSE/TOTAL ASSETS	13.3%	9.1%	10.3%	8.9%	7.9%

FUNDS FLOW STATEMENT					
SOURCES OF FUNDS	Year 1	Year 2	Year 3	Year 4	Year 5
NPAT	(4,119)	4,061	3,948	8,591	16,695
Add Back Allow.Loan losse-	1,176	1,176	1,176	1,176	1,176
Repayment of Principal	581	2,024	3,784	5,929	8,545
Capital Contribution	120,000	0	0	60,000	60,000
REFINANCE FACILITY		75,000	0	0	0
Savings Deposits/COIs		0	0	0	0
Foreign Deposits		0	0	0	0
Foreign Loans		0	0	0	0
Reduction in Working Capital	(58,839)	(23,016)	51,802	(14,774)	(25,264)
Total Sources	58,800	59,245	60,709	60,922	61,152
USES OF FUNDS					
Loan Disbursements	58,800	58,800	58,800	58,800	58,800
RFF-Debt Service Principal		445	1,909	2,122	2,352
Fixed Assets					
Total Uses	58,800	59,245	60,709	60,922	61,152

BALANCE SHEET					
ASSETS	Year 1	Year 2	Year 3	Year 4	Year 5
Cash	3,466	1,699	1,891	2,621	3,432
Short Term Investments	45,372	70,156	18,162	32,206	56,659
Housing Loans O/S	58,219	21,827	79,314	134,904	188,158
RFF - 80%		74,534	72,558	70,382	67,982
RFF - 20%		18,634	18,139	17,595	16,996
Fixed Assets	10,000	10,000	10,000	10,000	10,000
Total Assets	117,057	196,849	200,064	267,708	343,227
LIABILITIES					
Accounts Payable					
REFINANCE FACILITY		74,555	72,646	70,524	68,171
Savings Deposits/COIs					
Foreign Deposits					
Foreign Loans					
Allowance for Loan Losses	1,176	2,352	3,528	4,704	5,880
Capital	120,000	120,000	120,000	180,000	240,000
Free Reserves	(4,119)	(58)	3,890	12,481	29,176
Net Equity	115,881	119,942	123,890	192,481	269,176
Total Liabilities	117,057	196,849	200,064	267,708	343,227
Debt:Equity Ratio	0	0.64	0.61	0.39	0.28

Notes:

(1) Fee income is estimated at 1.5% of the value of new loan originations.
(2) Excess cash is invested in short term instruments at an assumed rate of 16% p.a.
(3) Personnel Expense is estimated at Rs1.0 million/month, increasing by 15% annually.
(4) Other expenses are estimated at 30% of Personnel expense.
(5) See Schedule of Income Tax Calculations below.
(6) Allowance of loan losses is estimated at 2% of new loan originations.

06/02/94

SAVINGS DEPOSI ******Per Month
REFINANCE FACILI******Limit

HFC-PLANNING MODEL

RUN # 3

INCOME STATEMENT	Year 1	Year 2	Year 3	Year 4	Year 5
Interest Income Ops	15,309	48,213	80,212	111,108	140,659
Fee Income (1)	2,520	2,520	2,520	2,520	2,520
Investment Income (2)	6,620	11,491	15,906	13,293	12,357
Total Income	24,449	62,224	98,638	126,921	155,537
Personnel Expense (3)	12,000	13,800	15,870	18,251	20,988
Other Oper. Expense (4)	3,600	4,140	4,761	5,475	6,296
Interest Expense	8,800	23,600	54,571	73,501	91,724
Total Expense	24,400	41,540	75,202	97,227	119,008
Net Income Before Tax	49	20,684	23,436	29,694	36,528
Allowance for Income Tax (5)	(346)	(8,067)	(8,437)	(10,690)	(13,150)
Net Profit After Tax (NPAT)	(296)	12,617	14,999	19,004	23,378
Allow. Loan Losses (6)	(3,360)	(3,360)	(3,360)	(3,360)	(3,360)
Net After Allowances (NPAA)	(3,656)	9,257	11,639	15,644	20,018
NPAA/NET EQUITY	-3.1%	7.0%	7.9%	9.4%	10.6%
OPERATING EXPENSE/TOTAL ASSET	6.4%	4.0%	3.5%	3.2%	3.1%

FUNDS FLOW STATEMENT					
SOURCES OF FUNDS	Year 1	Year 2	Year 3	Year 4	Year 5
NPAT	(296)	12,617	14,999	19004	23,378
Add Back Allow.Loan losses	3,360	3,360	3,360	3,360	3,360
Repayment of Principal	1,661	5,783	10,810	16,940	24,415
Capital Contribution	120,000	0	0	0	0
REFINANCE FACILITY	0	75,000	0	0	0
Savings Deposits/COIs	120,000	120,000	120,000	120,000	120,000
Foreign Deposits	0	0	0	0	0
Foreign Loans	0	0	0	0	0
Reduction in Working Capital	(80,924)	(48,316)	20,740	10,817	(801)
Total Sources	163,800	168,445	169,909	170,122	170,352
USES OF FUNDS					
Loan Disbursements	153,800	168,000	168,000	168,000	168,000
RFF-Debt Service Principal	0	445	1,909	2,122	2,352
Fixed Assets	10,000	0	0	0	0
Total Uses	163,800	168,445	169,909	170,122	170,352

BALANCE SHEET					
ASSETS	Year 1	Year 2	Year 3	Year 4	Year 5
Cash	4,042	3,560	3,681	4,783	6,234
Short Term Investments	62,683	111,480	90,419	78,700	78,050
Housing Loans O/S	166,339	235,388	395,048	548,828	695,412
RFF - 80%	0	74,534	72,558	70,382	67,982
RFF - 20%	0	18,634	18,139	17,595	16,996
Fixed Assets	10,000	10,000	10,000	10,000	10,000
Total Assets	243,064	453,596	590,046	730,288	874,674
LIABILITIES					
Accounts Payable					
REFINANCE FACILITY	0	74,555	72,646	70,524	68,171
Savings Deposits/COIs	120,000	240,000	360,000	480,000	600,000
Foreign Deposits	0	0	0	0	0
Foreign Loans	0	0	0	0	0
Allowance for Loan Losses	3,360	6,720	10,080	13,440	16,800
Capital	120,000	120,000	120,000	120,000	120,000
Free Reserves	(296)	12,321	27,320	46,324	69,703
Net Equity	119,704	132,321	147,320	166,324	189,703
Total Liabilities	243,064	453,596	590,046	730,288	874,674
Debt:Equity Ratio	1.0	2.4	2.9	3.3	3.5

Notes:

(1) Fee income is estimated at 1.5% of the value of new loan originations.
(2) Excess cash is invested in short term instruments at an assumed rate of 16% p.a.
(3) Personnel Expense is estimated at Rs1.0 million/month, increasing by 15% annually.
(4) Other expenses are estimated at 30% of Personnel expense.
(5) See Schedule of Income Tax Calculations below.
(6) Allowance of loan losses is estimated at 2% of new loan originations.

02-Jun-94

Appendix B

Comparison of Housing Finance Systems

Comparison of Housing Finance Systems

The purpose of comparing housing finance systems in other countries was to determine what, if any, experiences would be applicable to Pakistan. Systems in five developed countries—UK, France, Germany, Denmark and the US—were reviewed, along with those in two developing—India and Indonesia. The situation in Pakistan was also included to give perspective to the other country situations. Some seven different indicators were compared in each country, where that information was available. The attached chart summarizes that information.

Homeowner Mortgage Debt as a Percentage of GDP

This ratio generally gives a good indication of the depth of the housing finance market. A high ratio as is found in the developed countries, means that the housing finance sector is well-developed and that mortgage loans are readily available to the majority of the population. A low ratio indicates the reverse. Not surprisingly, the five developed countries have high ratios, with the US the highest at 47 percent, while the two developing countries, plus Pakistan, have low ratios, generally in the single-digit range.

Existence and Role of an Apex Bank

This indicator was included to ascertain whether the concept of an apex housing bank was a common feature. The information, both in the chart as well as elsewhere, indicates that an apex bank, meaning a centralized secondary housing finance institution with multiple regulatory and financing roles, is not common. None of the developed countries have apex banks, while only India has such an institution, and in this case, the jury is still out as to whether it is successful. On the other hand, national housing banks providing direct loans, usually to low-income borrowers, are quite common throughout the world, although they are not universally successful. Successful housing banks that serve low-income families with targeted loans, while at the same time being market driven, do exist in Thailand, Korea, Jordan and several other countries. More common are cases where the national housing banks are highly politicized, money losers and unfocused in their lending policies.

Sources of Mortgage Lending

This indicator shows that there are essentially two institutional sources of mortgage lending: specialized mortgage credit institutions and deposit institutions, including commercial banks. The information available does not indicate which source is the better, since all the developed countries have successful housing finance systems that utilize these two major sources in different percentages. One trend which is not shown on the chart is the increasing use of mortgage credit institutions because of a need to hedge against changes in the cost of funds for mortgage lending. In developing countries, external loans are a third source, and in fact, both Indonesia and India have had access to World Bank, ADB and

USAID Housing Guaranty loans. In addition, developing countries also make use of direct government advances for housing. Other studies have indicated that the greater the reliance on use of government grants and external loans as a source of mortgage lending, the more likely the housing stock in that particular country is in a poor condition.

Funding Instruments

Deposits by individual savers are still the major method of mobilizing resources for on-lending for housing purposes. This is truer in developed countries than in developing countries, because in the latter, government financial assistance plays a larger role. The use of capital markets to mobilize housing funds is increasing throughout the world, and even in developing countries, collateralized and non-collateralized debt is becoming more widely used. Techniques such as savings linked loan programs have also been shown to be a major resource in a few countries, and is probably worth more consideration that it has been given in other countries. The greater the development of the capital market, the higher the use of specialized secondary market instruments such as mortgage backed securities.

Tenure and Type of Mortgage Loans

The trend is for longer and longer tenure loans, although the maximum tenure seems to have leveled off at 30 years. Fixed-rate loans continue to be the most common type of loan, although the longer the tenure, the higher the interest rate. Adjustable rate and reviewable loans have become more common in recent years in the developed countries as lenders have tried to protect themselves against rises in their cost of funds. In turn, this has led to the increase in the use of specialized credit institutions as a major source of mortgage lending and the capital markets as a more likely way of mobilizing resources (see above). In developing countries, the tenure is generally shorter than in developed countries, while the use of fixed-rate loans is more common. Inflation, which is more of a problem in developing countries, clearly is a factor here. The longer tenure in developed countries reflects the higher degree of sophistication and market depth.

Role of Government in Regulatory/Control Aspects

At one extreme is the limited role of the government as expressed in the development and enforcement of Prudential Regulations as is the case in the UK. At the other extreme is an all-encompassing role of government where the government requires the lending institutions to seek permission to initiate any new housing finance activity or program. But even in the developed countries the role of most governments is more active in controlling and regulating the housing finance market than in the UK. Areas where government is commonly involved include deposit and mortgage insurance, as in the US; some financial institution ownership, as in Germany and France; setting of mortgage contract terms, as in Denmark. In nearly all developing countries, the government is much more heavy-handed in its regulatory and control requirements, although enforcement of these regulations tends to be either lax, selective, or politically motivated.

Setting of Lending Rates

In developed countries, it can be said that the market sets the lending rates, while in developing countries, the government sets those rates. However, in the developed countries, the market is influenced, as it should be, by the amount of down payment the borrower lays out and by his credit rating. Insurance programs that cover some of the risk also influence lending rates in some developed countries. The fact is that the more market oriented countries, which also tend to be the developed countries, let the free market hold sway.

As a developing country, Pakistan has a long way to travel before it reaches the point where it is providing housing finance to the masses. With less than two percent of GDP in homeowner mortgage debt, it is an understatement to say that the housing market lacks depth.

COMPARISON OF HOUSING FINANCE SYSTEMS

Country	Homeowner Mortgage Debt as a % of GDP	Existence and Role of an Apex Bank	Sources of Mortgage Lending	Funding Instruments (in order of importance)	Tenure & Type of Mortgage Loans	Role of Government in regulatory/control aspects	Setting of Lending Rates
US	47% (1991)	Does not exist	Deposit Inst: 30% Com. Banks: 30% Mortgage Credit Inst: 35% Other:5%	Mort. backed securities; Deposits; Collateralized debt	30 year fixed and adjustable rates	Govt. deposit insurance, support for secondary market agencies, mortgage insurance	Market pricing for up to 80% LTV; Govt & private insurance programs set price above 80%
UK	NA	Does not exist	Deposit Inst: 94% Other: 6%	Deposits; Uncollateralized debt; Mort. backed securities	25 year reviewable rate	Prudential regulation	Market pricing up to 80% LTV; insurance premium sets price over 80% + loans
Germany	33% (1990)	Does not exist	Deposit Inst: 55% Mortgage Credit Inst: 22% Contract Inst: 13% Other:10%	Deposits; Mortgage bonds; Contract savings; Uncollateralized debt	10-30 year fixed and 25-30 reviewable rate	Control over terms and inst. use of bonds & contract savings, limits on insurer investments, subsidized contract savings, state-owned savings banks	Rate based on borrower credit risk and LTV ratio
France	35% (1990)	Does not exist	Deposit Inst: 85% Banks: 10% Other: 5%	Contract Savings; Deposits; Collateralized debt	15 year fixed rate	Subsidized contract savings, deposit rate regulation, state ownership of some banks	Rate based on borrower credit risk and LTV ratio
Denmark	44% (1990)	Does not exist	Mortgage Credit Inst: 80% Deposit Inst: 12% Other: 8%	Mortgage Bonds, Deposits	20-30 year fixed rate	Control over Credit inst. entry, mort. contract terms, insurance/pension investments	Rate based on borrower credit and LTV ratio
India	< 5 %	Exists to promote, regulate and provide liquidity to the sector.	Deposit Inst: NA Gov't Housing Institute: NA	Deposits, Term Loans, Uncollateralized debt, External Loans	7-30 year fixed rate, reviewable	Deposit and lending rate regulation, Loan ceilings, LTV regulation.	Rate based on borrower income assessment, giving an average LTV of 55%
Indonesia	< 5%	Does not exist	Govt. owned Credit Inst: 95% Others: 5%	Govt. Loans, Deposits, External Loans	20 yr fixed (govt Inst.), 10-15 yr (Com. Banks)	No private HFCs	NA
Pakistan	2%	Does not exist	Govt. Credit Institution: NA	Govt. Loans,	10-14 yr fixed, 3 yr renewable	Prudential Regulation	60%

NA-Not Available

Appendix C

The Impact of Inflation on Housing Finance

The Impact of Inflation on Housing Finance

The transition from state control to a market-oriented economy has almost always been accompanied by high rates of inflation. Pakistan appears to be no exception to this rule as evidenced by the large number of deficitary public enterprises and the high share of financial market borrowing of the Government. Inflation rates in excess of 10 percent per annum are reflected immediately in the market cost of money and lenders are reluctant to commit funds much beyond one to three years. Commercial bank lending becomes extremely profitable as low cost sight deposit funds are lent at rates of 20 percent and higher.

In this environment the mortgage markets are among the first to suffer, as evidenced by numerous examples throughout the world economy. In the United States, for example, the period of high inflation and high interest rates from 1978 to 1986 brought about a complete transformation of the highly developed mortgage markets. The Savings and Loan institutions (thrifts) which dominated the funding of residential mortgages were constrained by regulation and given tax incentives to invest almost exclusively in fixed-rate, level-payment mortgages funded by insured depositors. As so-called "low cost" funds dried up in the face of inflation in excess of 10 percent and interest rates approaching 20 percent, the availability of fixed-rate savings deposits dried up. Depositors withdrew their money from the thrifts in favor of money market mutual funds and other high interest bearing short-term investments. Deregulation of the mortgage markets caused further competition from the commercial banks and specialty mortgage lenders. The thrifts tried to adapt to the new market conditions by buying increasingly expensive short-term money (through Certificates of Deposit) and directed their lending activities into high risk, short-term real estate development schemes. The result was widespread failure and a drain on the Government-sponsored insurance fund which was itself bankrupt.

Despite this spectacular turn of events which received widespread publicity, the resilience of the US economy was such that the mortgage markets emerged strengthened, if anything, from the experience. The markets adapted to the high nominal cost of money via a shift to Adjustable Rate Mortgages and the development of a major secondary market for mortgage-backed securities sold in the capital markets.

Today the US residential mortgage market is divided about equally between the three major types of institutions: the thrifts who survived the crisis of the 1980s, the commercial banks who entered the market in a big way, and the specialty mortgage originating institutions. All three types of financial institutions rely heavily on the ability of the capital market to absorb huge amounts of mortgage-backed securities through the intermediation of three government-sponsored secondary market institutions: FNMA (Fannie Mae), FHLMC (Freddie Mac) and GNMA (Ginny Mae). Fannie Mae, created by the Government during the depression of the 1930s, was wholly privatized in 1968, and is by far the largest factor in the secondary market. It buys the mortgages of some 2700 participating institutions and in March 1994 had **days when it was originating up to US$20.0 billion** in new securities. This amount is equivalent to the current **annual** lending rate of the World Bank.

Developing economies have generally had less success in coping with inflation. The first casualty of high inflation and concomitant high interest rates is usually the long-term mortgage market. The breakdown of the long-term, fixed nominal rate mortgage contract in the face of inflation and the difficulty of replacing it with other contractual forms has led to the virtual disappearance of private, unsubsidized mortgage lending in many developing countries. Economists have long studied this phenomenon and discovered a rather simple explanation, which resides in the nature of the annuity payment contract. The higher the nominal rate of interest the higher is the proportion of interest in the early year payments. This results in initial payments which are not affordable to the vast majority of the population and is described as the annuity "tilt" which, although in large part artificial, is nonetheless real. The effect is that contracts are distorted and therefore inequitable; borrowers cannot afford the payments in the early years when they pay too much interest; lenders are penalized in later years when the interest portion of the equalized payment is too low. The result is that few contracts clear the market at these high nominal rates. The experience of the HFCs in Pakistan tends to confirm the "tilt" at work. Both operating companies lending at nominal rates of 20 percent per annum report that only a small percentage of potential borrowers can afford these rates.

Dual Indexed Mortgages (DIMs), a Possible Solution

One solution to the problem of inequitable contracts created by inflationary distortion is provided by the Dual Indexed Mortgage (DIM), which has been successfully implemented in Mexico in recent years and is being introduced in Hungary and other former socialist economies. In the Dual Indexed Mortgage the principal balance outstanding is adjusted annually to an agreed Index, say the CPI. Payments of the borrower, in turn, are pegged to a percentage of his annual income, say 30 percent maximum. As the borrowers wages or other income rises over time (largely inflation adjusted) so do his nominal monthly payments. The fundamental equity of this kind of contract was perceived by the financial institutions and the general public in Mexico and the DIM is now the generally accepted mortgage instrument in that economy.

An example of a DIM was calculated and compared to the typical 12-year, 20 percent annuity offered in Pakistan. Worthy of note is the fact that the DIM carries about a 3 percent annual cushion, the amount by which the wage index might lag behind the CPI or other index applied to the principal payments. The effect of a mismatch in indexing may result in payments extending beyond the nominal 12-year period. The risk of loss is so small, however, in terms of the Present Value of money, that in Mexico the financial institutions are willing to cap a contract and absorb any eventual residual loss. In Mexico the terms are typically a nominal 15-year mortgage with payments capped at the end of 20 years. In Pakistan the impact on affordability of a DIM such as illustrated in the example is dramatic. Initial monthly payments are about **half** on the same amount of borrowing. Even with a lag in payments of about 3 percent per annum, which is extremely unlikely in a growing economy over the long term, the contract could be capped after a 15-year period with a residual amount of only Rs 518 (to be written off) on an original loan of Rs 1,000,00

It should be pointed out that indexation of loans is not permitted in Pakistan today. The purpose of this example is to show how one type of indexed mortgage could function in Pakistan in the event circumstances permitted this type of mortgage.

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