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**HOUSING FINANCE AND THE ECONOMY: REGIONAL TRENDS
SOUTH ASIA: PERSPECTIVES**

by

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Abstract: While South Asia is the second fastest growing region, it continues to remain one of the poorest regions in the world. The region's large and growing urban population is spurring governments to rethink their strategies on housing related activities. Mortgage penetration is very low and eludes the lower income groups. South Asian mortgage markets have been evaluated from a practitioner's perspective, with specific focus on private sector initiatives. A clear emerging issue is that private capital is imperative to create permanent and supportive housing solutions.

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Regional Overview

In terms of economic growth, the South Asia region continues to be the second fastest growing region in the world after East Asia. The region, encompassing Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan and Sri Lanka has recorded an average annual growth rate of over 5% in 2003. Despite the fact that most of these countries have a strong agrarian economy, the thrust in GDP growth in the recent period has emanated from the services sector, accounting for 40% to as high as 60% of GDP. Ironically, the South Asia region continues to remain one of the poorest regions in the world. Forty-five per cent of the region's population lives below the international poverty line of USD 1 a day. This region, most notable for its large population is also home to about 40% of the world's poor.

GDP Growth (%)

Country	2001	2002	2003(E)	2004(E)
Bangladesh	5.3	4.4	5.3	5.7
India	5.8	4.0	7.3	7.4
Nepal	4.6	-0.4	2.6	4.0
Pakistan	2.2	3.4	5.1	5.5
Sri Lanka	-1.5	4.0	5.5	5.0

Source: World Bank Reports

Urban Demographics

South Asia is in a period of transition as it strives to implement effective economic, political, social and legal structures to support sustained growth. The challenges are particularly great because of the speed at which their populations are growing. During the last fifty years, India's total population more than doubled, while the urban population grew by more than five times. In 1996, the urban population in Bangladesh was 23 million. By 2020, it will increase to 58 million. The urban population in Nepal, during the same period, will grow from 2.6 million to 7.7 million, and in Sri Lanka it will double to more than 8 million. (USAID, *Making Cities Work – South Asia Brief.*)

Urban Profile

Country	Urban Population	*Annual Growth Rate of Urban Population	Urban Population in Poverty
Bangladesh	25%	3.7%	37%
India	28%	2.7%	31%
Nepal	12%	4.9%	23%
Sri Lanka	24%	3.1%	25%

**Estimates for the period 2000-2015*

Source: Urban Fact Sheets, Making Cities Work, USAID

The pressures caused by geometric population growth create huge environmental, health, housing and infrastructure problems and if left unattended often results in social unrest.

It is perhaps these mounting pressures that have spurred governments to rethink their role in delivering basic social needs to its people. There has been a distinct recognition by most governments of South Asia of the need to move away from their role of being 'providers' of social needs to being 'facilitators' by creating the required enabling environment. This paradigm shift has perhaps been most noticeable in the area of housing and housing finance.

Penetration of Housing Finance

Macroeconomic stability or instability and the housing sector are inextricably linked. However, in contrast, while South Asia's GDP growth rate in the recent period ranks among the best in the emerging countries, the same unfortunately, cannot be said about its housing sector.

In India, which is the most advanced market in South Asia, the mortgage to GDP ratio is estimated at 2%. In Pakistan it is less than 0.5% and other countries of South Asia, mortgages as a percentage to GDP is insignificant. This compares to a mortgage to GDP ratio of over 51% in USA. However, even if one were to benchmark with more comparable counterparts, the ratio ranges between 15-20% for South East Asian countries. The penetration level of mortgages is miniscule when compared with the shortage of housing units.

Role of the Government

Most of the countries of South Asia recognise housing as a constitutional right. India, Pakistan and Bangladesh have clearly enunciated national housing policies. Admittedly, for many years, housing policies have predominantly remained statements of intent rather than being translated into implementation.

In the past, most South Asian governments viewed housing as a social rather than an economic sector. For these governments, housing and subsidies were synonymous and hence the tendency was to view housing finance from the angle of its cash budget and not as a developmental activity with tremendous spin-offs to the economy. Today, this has clearly changed.

The most significant step taken by the governments has been the fostering of 'public-private partnerships'. Governments appear to have recognised that monopolistic state owned providers of housing finance are not be the most efficient or cost effective mechanism to develop and deepen the mortgage market. Merits of private sector dedicated housing finance institutions have been recognised and encouraged. Some of the recent successful private sector initiatives in South Asia include NDB Housing Bank (Sri Lanka), Delta Brac Housing Finance Corporation and National Housing Finance and Investment Limited (Bangladesh) and International Housing Finance Limited (Pakistan). These finance companies are admittedly still at a nascent stage and given the extant housing shortage, the dearth of housing finance continues.

Structure of the Mortgage Market

From a regional perspective, the mortgage markets in South Asia are small and fragmented with the unorganised sector continuing to play a dominant role, especially at the lower income strata. Further, key data that reflects the performance of housing markets such as housing starts, sales volumes, movement of house prices, size of the mortgage market and defaults on mortgage loans are insufficient, incomplete and not updated regularly.

As regards the organised segment, there are distinct commonalities that characterise some of the mortgage markets of South Asia – a heavily subsidised monolith-like state run institution, a fledgling private sector catering to the middle and upper income segments and players from the banking sector who provide housing finance as a part of their retail portfolio. The mortgage markets in Sri Lanka, Bangladesh and Pakistan are such archetypes. A brief overview of the structure of these mortgage markets are given below. The Indian mortgage market, the largest and most developed in South Asia has seen turnaround that merits separate treatment as a case in point.

Mortgage Market in Bangladesh- Private Sector Players Gaining Ground

Bangladesh is most notable for its high population density. Its capital Dhaka, is the prime market for housing finance. Recent estimates indicate that over 70% of housing is rented in Dhaka and there is an annual requirement of over 60,000 new homes per annum. In 2000, total outstanding housing loans were about BTK 31 billion (USD 515 million), with the public sector dominating a market share of over 80%. The government owned specialised housing finance company, Bangladesh House Building Finance Corporation (BHBFC) is the market leader with a share of 52%. BHBFC, reputed to be not very market savvy compared to existing private sector players is now plagued with high defaults of over 30% and no additional funding from the government. Private sector players like Delta Brac Housing Finance Corporation, National Housing Finance and Investment Limited, Industrial Development Leasing Company and private sector commercial banks are fast gaining ground on fresh disbursements. Most of the private sector players, though relatively new have non-performing loans (NPLs) of under 1%, though their cost of funds are significantly higher than BHBFC.

It is estimated that transfer taxes add 30% to the cost of property acquisition and though tax rates are lower compared to other South Asian counterparts, there are no tax exemptions on housing loans. Real estate prices in Dhaka continue to remain high and the house price to income ratio is estimated at over 16 times. The mortgage market currently targets the middle and upper income segments.

Mortgage Market in Pakistan – Strong Commitment to Reforms

Currently, the total formal mortgage lending is estimated at PKR 22 billion (USD 380 million). The market is dominated by House Building Finance Corporation (HBFC), a public sector housing finance corporation with a market share of 82% and is funded directly by State Bank of Pakistan, the central bank.

Three private sector housing finance companies were set up in the 1990s, of which International Housing Finance Corporation remains the sole survivor. Current macroeconomic conditions such as reduced government borrowings, ample liquidity, de-

dollarisation of the economy and rising inflows from remittances have resulted in a low interest rate regime. With easy availability of credit, the margins of banks have reduced and hence banks have had to look at alternative lending opportunities. Housing finance provides an attractive opportunity as both, profit margins and recovery rates are higher for mortgage finance than corporate/project lending and hence banks have become active in this area.

The international community has shown considerable interest in the Pakistan mortgage market following the rapid policy initiatives on housing finance taken by the government and the State Bank of Pakistan. For instance a standing Advisory Group has been constituted to advise on the sequence of reforms in housing finance. Sweeping fiscal incentives have been introduced in the Federal Budget 2003-04 to encourage mortgage finance. Banks' exposure to housing finance has been enhanced to 10% of their net advances, the maximum per party limit has been increased to PKR 7.5 million with a debt equity ratio of 80:20 for a period of up to 20 years.

With strong commitments from the authorities, the mortgage market in Pakistan has tremendous potential. However, a strong vigil will be required to ensure that lenders maintain credit quality.

Mortgage Market in Sri Lanka: State Sponsored Funding is Unviable

According to the Ministry of Housing and Plantation Infrastructure, the overall shortage of houses in Sri Lanka could reach 650,000 units by 2010 from the current level of 400,000 units.

Sri Lanka has traditionally concentrated on state sponsored and funded housing development strategies. But this system has increasingly become unviable on account of diminishing availability of funds due to budget constraints. The governments have recognised that there is a need to develop a self-sustaining housing finance market.

State owned players include the State Mortgage & Investment Bank (SMIB), Housing Development Finance Corporation – Sri Lanka, National Housing Development Authority (NHDA), National Savings Bank (NSB) together which account for 65% of market share. The balance portion of the market is catered by commercial banks. NDB Housing Bank Limited began operations in 2001 as the only specialised private sector housing finance institution.

Collection ratios of housing finance institutions are estimated to be in the range of 80-95%. While there is a framework to support foreclosure norms, it continues to be a contentious issue. Parate rights, (the right to execution whereby a creditor can sell his debtor's assets mortgaged to him without intervention of the court) have been selectively accorded to banks and licensed specialised banks. Critics have pointed out that it is this discrimination that has discouraged the entry of more specialised housing finance institutions.

However, on a more practical note, actual implementation of Parate rights have not been very successful. Socio-political pressures have been brought upon state owned banks to condone delayed payments or grant loan waivers. Clearly, Parate rights are no substitute for prudent lending norms.

India: A Turnaround Story

The housing finance sector in India has undergone unprecedented change over the past five years. The importance of the housing sector in India can be judged by the estimate that for every Indian rupee (INR) invested in the construction of houses, INR 0.78 is added to the gross domestic product of the country and the real estate sector is subservient to the development of 269 other industries. The real estate sector is also the second largest employment generator in the country.

Traditional Structure of the Mortgage Market in India

The government's support to housing had traditionally been centralised and directed through the State Housing Boards and Development Authorities. In 1970, the central government set up the Housing and Urban Development Corporation (HUDCO) to finance housing and urban infrastructure activities. In 1977, Housing Development Finance Corporation (HDFC) was the first housing finance company in the private sector to be set up in India.

The public sector insurance companies – Life Insurance Corporation of India (LIC) and General Insurance Corporation of India (GIC) were also mandated to support housing finance activities, both directly through their housing subsidiaries (both established in 1989) and indirectly through a mandated requirement to invest a certain proportion of their annual accretion in socially oriented schemes which includes housing.

In 1988, the National Housing Bank (NHB) was established as a 100% subsidiary of the Reserve Bank of India, (the central bank of the country), to promote housing finance through a refinance mechanism to banks, housing finance companies (HFCs) and other institutions and also to function as the supervisory and regulatory body for housing finance companies. Currently there are 29 HFCs approved for refinance assistance from NHB.

Although commercial banks were the largest mobiliser of savings in the country, traditionally banks were rather reluctant to lend for housing as they preferred financing working capital needs of industry. Several banks had set up housing finance subsidiaries which functioned as independent units with little support or interest from their parent bank.

The Trigger of Change

Towards the end of the 1990s, against the backdrop of lower interest rates, industrial slow-down, sluggish credit off-take and ample liquidity, commercial banks recognised that if they had to maintain their profit margins, they needed to shift their focus from the wholesale segment and build their retail portfolios. The lower interest rate regime, rising disposable incomes, stable property prices and fiscal incentives made housing finance attractive business. Further, housing finance traditionally has been characterised by low non-performing assets (NPAs) and given the vast demand for housing loans, almost all the major commercial banks plunged into the business of housing finance and thus began the roller-coaster ride!

Outstanding Housing Loans

(Rs. in million)

	2000	2001	2002
Commercial Banks	185,248	254,124	328,259
Housing Finance Companies	253,260	332,498	418,436

*Source: Report of Trend and Progress of Housing in India – June 2002
Basis Statistical Returns - RBI*

Some commercial banks devised extremely aggressive marketing campaigns to ramp up the size of their housing portfolios. This included intensive advertising campaigns, waivers of processing and administration fees, gift offers and other incentives, on the spot loan approvals without sufficient documentary evidence and loan to value ratios that exceeded 100%. This was supplemented by cut-throat competition on the pricing front, with each new player trying to undercut the other.

This led critics to argue that the traditional players in the housing finance industry were fast losing ground. Admittedly, the smaller HFCs were struggling to match the aggressive pricing strategies of the new players and the survival of dedicated housing finance players were increasingly being debated.

HDFC, the largest housing finance company has a clear mandate on pricing of its loans – it is a function of its cost of funds and the corporation has traditionally worked on small spreads. A reduction in its cost of funds has always translated into a reduction in the cost for borrowers. But perhaps the intense competition did spur HDFC to re-price and re-negotiate its high cost borrowings more aggressively. This of course was also possible given HDFC's dominant presence in the finance sector, its high credit rating and thus its ability to raise funds at rates comparable with the best in the market. Ironically, it was during this period of intense competition that HDFC's spreads began to increase.

Over the last year, however, banks have realised that while the demand for housing loans is tremendous, there is no substitute for prudent lending policies. Some banks have withdrawn from the housing loan market after being saddled with an unduly high amount of non-performing loans. Further, the Reserve Bank of India has sounded several warnings to banks directing them to exercise caution in lending for housing finance.

Sufficient Room for all Players

Critics had also raised the bogey that the Indian mortgage market could reach levels of saturation with the rise in the number of players. But this argument has been quickly put to rest in view of the vast demand for housing loans and continuing paucity of funds.

The total number of houses that would be required cumulatively during the Tenth Plan period (2002-2007) is estimated at 22.44 million dwelling units. However, this official estimate is based on the 1991 Census and unofficial estimates peg the current housing shortage in India at 40 million units. Further, the Tenth Five Year Plan has estimated an outlay of INR 7,263 billion to the housing sector, of which the contribution envisaged from public institutional sources is only INR 4,150 billion. Therefore, substantial contribution from private sector players would necessarily be required to tackle the growing housing shortage.

While the furore in the housing finance industry has finally abated, clearly the biggest winner has been the customer. The housing finance industry today has been transformed into a 'buyer's market' with service standards having to keep pace with the ever-rising customers' expectations. Given the wide range of choice, the customer is armed with bargaining power and if not served to his/her satisfaction, the customer can effortlessly take his business elsewhere. Today, customer retention is the greatest challenge for the Indian housing finance industry.

Sources of Funding

Paucity of funds is the commonality of all housing finance industries in South Asia. But a distinct and positive trend emerging is the recognition that subsidised funding for state owned housing finance entities creates distortions in the market place and must stop. For instance, in the case of BHBFC (Bangladesh), for the past two years, no subsidised funding through the government or government guaranteed debt has been availed. Similarly, in the case of HBFC (Pakistan), funding directly from the State Bank of Pakistan is unlikely to continue.

As debt markets are not very deep, access to long-term funding for housing finance institutions is difficult. Most banks use their short-term funds from savings and current accounts and deploy these funds in long-term housing loans, thereby creating an asset liability mismatch. In India, the Reserve Bank of India has warned banks of the dangers of borrowing short and lending long. In Pakistan, banks have been permitted to float long-term mortgage bonds to match their mortgage assets. To mitigate interest rate risks and given the prevailing low interest rate regime, most assets and liabilities are on a floating rate basis.

In India, there has been a long-standing demand to allow pension and provident funds to invest in housing finance. These funds are suppliers of long-term capital. They typically have a low risk tolerance but do crave for diversification. The mutuality of interest is strong between homeowners and long-term institutional investors.

Going forward, to tide over the paucity of funds, it is imperative to develop the secondary mortgage market. Securitisation ensures recycling of funds. While some countries in South Asia have issued mortgage-backed securities, most transactions are sporadic and ad-hoc. Rigidities in the legal framework, high stamp duties and lack of uniformity in underwriting norms are some of the hindrances in the development of a secondary mortgage market.

Loan Products

A housing loan is inherently different from any other retail loan. This is because a house is probably the single largest investment a person makes in his/her lifetime. It has been noticed that a customer seeking a housing loan does not just require finance – they also need ancillary services like loan counselling or legal advice to ensure the title of the property is clear or technical advice to ensure that the structural aspects of the property are in order. It is these add on services that distinguish the calibre of services rendered.

The typical mortgage borrower of South Asia belongs to the upper or middle class, is of an average age of 35-40 years, typically a first time home buyer and by and large a salaried employee.

Most loan products are fairly standardised – a pure vanilla home loan product, home improvement and extension, land loans, loans for non-residential premises and the newer breed of loans include home equity and top-up/personal loans. HDFC has been in the business of housing finance for almost 27 years and has been observed that the greatest demand is for the simple home loan product. Though HDFC has a wide range of products, these essentially have been developed to offer customised solutions to its borrowers.

Against the backdrop of lower interest rates seen across the region, most home loans are floating rate loans. At HDFC, the floating rate is benchmarked to its Retail Prime Lending Rate. In India, it had been noticed that several customers were opting for floating rate loans without understanding the inherent risks involved. Even most of the existing fixed rate loans have been converted into floating rates. HDFC continues to make a conscious effort to explain to its customers that interest rate cycles are inevitable and a long-term view on interest rates has to be taken, given that housing loans extend over a long period of time. To tide over the dilemma of whether to opt for a fixed or floating rate loan, blended options are being offered wherein the customer can hedge part of the interest rate risk by opting for a combination of fixed and floating rates.

In the Indian market specifically, cross-selling of products and services is rather popular. Thus a person looking for a housing loan is also offered life insurance, home protection insurance, and other privileges on banking facilities.

Today with high levels of automation and off-the-shelf availability of software and other technology to support the business of housing finance, it is virtually effortless to replicate loan products. At the end of the day, the only product patent that distinguishes one player from another is the quality of customer service rendered.

Distribution

Today, customers are significantly more discerning. With a rise in the number of players in the housing finance industry, banks and housing finance institutions have to reach out to customers rather than vice versa. Banks have the inherent advantage of capitalising on their large network, but the quality of service rendered may lack focus as housing loans are one of the many activities performed by a bank. For a dedicated housing finance company, building up a large network is often time consuming and expensive.

While HDFC no doubt had a head-start over its competitors, it has developed a unique distribution model. HDFC has a total office network of 173 offices across the country and one international office in Dubai to service non-resident Indian clients. Of the 173 offices, 22 are parent branches while the rest are service centres. A service centre is a small office, typically manned by two or three individuals who perform all front office functions, but back office activities are supported by the parent branch. In addition, HDFC also conducts outreach programmes which essentially are like mobile offices. Outreach programmes are conducted at regular intervals in locations where HDFC does not have a permanent presence but where there is scope for business. If business from these outreach programmes exceeds the target and there is potential for incremental business, the location gets converted into a service centre. This model has helped to effectively reach out to more customers.

Direct Selling Agents: The Indian Experience

An outcome of increased competition in the financial services industry has been the birth of direct selling agents (DSAs). When 'feet on the street' became the new marketing mantra, DSAs who hitherto were confined to selling credit cards and personal loans entered the housing finance industry. DSAs typically service high net worth individuals who want door-step service.

As competition intensified in the housing finance industry, several players handed over the reins to DSAs to ramp up their business. Understandably, a DSA's objective is to obtain his/her commission. A number of DSAs neither had the requisite skills nor training to sell a housing loan. As a result, several loans were given to those who were not credit worthy and a frequent occurrence of miscommunications began to arise on account of the intermediary.

HDFC recognised that it did not have sufficient manpower to send out on the field, nor did it want to risk its reputation or dilute its credit quality, but not using DSAs could result in a loss of potential customers. So HDFC devised a DSA model of its own. The DSAs are restricted only to sourcing the application while the credit appraisal is done entirely by HDFC. HDFC also insists on at least one interface with the customer. Thus the DSA only acts as a sourcing agent for HDFC. This model has worked well for HDFC. In FY 2004, DSAs accounted for 22% of total individual loans approved by HDFC.

Recent Lessons

The desire for a safe and secure home is timeless and universal. Still, different nations have different policies on home ownership and different systems to support housing. But one clear emerging issue is that private capital is imperative to create permanent and supportive housing solutions.

From a regional perspective, the formal housing finance sector continues to elude the lower income groups. The twin problems of affordability and accessibility that thwart the progress of housing in South Asia need to be addressed. For this, governments have to withdraw from direct participation in the housing and housing finance sector and instead need take on the role as facilitators to create the enabling environment to encourage private sector capital. Further efforts of the government are required to strengthen foreclosure laws, land records need to be computerised and archaic land laws especially rental laws need a complete overhaul. Small steps such as encouraging credit bureaus, introducing mortgage insurance, allowing real estate mutual funds and creating a favourable environment to facilitate foreign direct investment in housing will help stimulate the housing finance sector. The road is long but not untenable.

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