HOUSE BUILDING FINANCE CORPORATION OF PAKISTAN:

NEED FOR A FUNCTIONAL CHANGE

by

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(1967)

**SUBMITTED TO THE DEPARTMENT OF
URBAN STUDIES AND PLANNING
IN PARTIAL FULFILLMENT OF THE REQUIREMENTS FOR THE DEGREE
OF**

MASTER OF CITY PLANNING

**at the
MASSACHUSETTS INSTITUTE OF TECHNOLOGY**

May 1991

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Submitted to the Department of Urban Studies and Planning in partial fulfillment of the requirements for the degree of Master in City Planning

Massachusetts Institute of Technology

ABSTRACT

This thesis describes the acute housing shortages faced by Pakistan and analyzes the country's House Building Finance Corporation (HBFC), a wholly government-owned institution, which dominates the formal housing finance system. HBFC makes subsidized loans for construction of houses to a group of borrowers only partially and loosely targeted towards lower income levels. The institution, in turn, gets its financing entirely through loans from the government central bank; it raises no resources in the market place.

Also evaluated is the Housing Development Finance Corporation (HDFC) of India, a similar institution operating successfully in the private sector. Over the years, HDFC has demonstrated that funds can be effectively mobilized for housing by reliance on private sector initiatives.

A key conclusion of this thesis is that with the government looking to shift more of its programs to the private sector and indicating that it will reduce or eliminate its subsidized lending to financial institutions, there is an urgent need for HBFC to mobilize its working funds from all possible sources in order to convert itself from being an administered department of the government into a commercially viable institution.

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ACKNOWLEDGEMENTS

I will always be deeply grateful to my advisor, professor Paul Smoke of the Department of Urban Studies and Planning. His inspiration, suggestions, and support helped me formulate the original proposal for this work. Despite his busy schedule, he spared no time or effort in guiding my research throughout the entire period.

My deepest thanks go also to Professor Ralph Gakenheimer of the Department of Urban Studies and Planning, my thesis reader for his guidance, support and the valuable comments based on his experience in the developing countries.

I feel very privileged to have the support and guidance of professor Karen Polenske of the Department of Urban Studies and Planning, who gave me valuable guidance in familiarizing myself with the art of research and acquiring computer skills.

I gratefully acknowledge the financial support, extended to me by the Agency for International Development, for completing my study program at M.I.T.

To all those whom I met during the course of interviews and with whom I corresponded in the course of my research for this thesis and to all my friends who unfailingly encouraged and supported me, I am also very grateful for their generous assistance.

Last but not least, my sincere thanks to my wife Sabahat, for sympathy, support, and constant encouragement on long distance calls, despite herself undergoing a major surgical operation towards the end of my studies. Special thanks are offered to my children Salman, Henna, and Aiman for their sweet forbearance and understanding, especially during the time when I had to be away from them. Their outstanding academic performance in the last two years was a continuous source of encouragement for me to accomplish this task.

TABLE OF CONTENTS

LIST OF TABLES

LIST OF ANNEXES

CHAPTER ONE

INTRODUCTION

For the past several years, there has been a growing appreciation on the part of the housing analysts in Pakistan about the pivotal role which mobilization of financial resources play in determining Pakistan's rate of progress in easing its housing problems. The issues involved in expanding the resources available to the sector -- in part by developing or strengthening the formal housing finance system dominated by the House Building Finance Corporation (HBFC)-- are quite complex. HBFC currently gets all of its new funds as an annual loan from the State Bank of Pakistan (SBP), which it must repay. The accrued profit/share of SBP is repaid on annual basis and the original loan amount is scheduled to be paid in the form of an accumulated payment at the end of ten years. Although in theory, it can take deposits and borrow money or issue bonds on the market, it does not do so because the market cost of funds would not permit it to continue its current lending charges. It is felt that HBFC as it is currently functioning, tends to deter the development of a private housing finance system, is a drain on government resources and will soon no longer be financially viable.

There could be many aspects of the current structure of HBFC and its operations which are causing HBFC to perform so poorly, including resource mobilization, lending and recovery operations, organizational set up and government policies. The purpose of my study is to understand and analyze resource mobilization efforts by HBFC, and its effects on HBFC's operation in the historical perspective. Then, based on the successful experiences of similar institutions in other countries, I will identify and explore approaches that could be followed in order to achieve the goal of maximizing resource mobilization, minimizing the problems associated with the development of a viable financial institution and effecting public policy to encourage the development of a cost effective housing finance system in Pakistan.

BACKGROUND

In order to evaluate the HBFC's operations with a particular emphasis on the procuring and processing of funds for further on-lending, some background on the housing sector in Pakistan and the current performance of HBFC are required.

There is a multiplicity of housing problems in Pakistan. They are generated mainly by the very rapid increase in our population, which grew from 84.3 million in 1981 to 107 million in 1989. At the current growth rate of over 3 percent per annum it is expected to reach 120 million by 1993, and 140 million by the year 2000.[1]

As population is growing, the housing deficit is piling up. The shortage of housing units in the country was estimated to be about 1.5 million in 1973 and over 3 million by 1985.[2] It is assumed that the constraints of housing lie not on the demand side, but rather in the inadequate response on the supply side. There are a number of supply constraints operating in Pakistan's housing market such as land and services, rent control, building standards, construction materials, taxation and housing finance.[3] A review of the World Bank Mission to Pakistan in 1987 found that less than 20 percent of the housing units constructed in Pakistan are financed from formal sources, with most financing coming from savings, sale of assets and informal borrowings.

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[1]Seventh Five Year Plan (1988-93) and Perspective Plan (1988-2003), Report of the Working Group on Urbanization, Planning Commission, Government of Pakistan, Islamabad. (July, 1987).

[2]National Housing Policy of Pakistan, Vol-1, June, 1989. Environment and Urban Affairs Division, Ministry of Housing and Works, Government of Pakistan, Islamabad.

[3]Ibid, p.2

HOUSE BUILDING FINANCE CORPORATION

Pakistan's formal housing finance system is dominated by the House Building Finance Corporation (HBFC), the only institution in the country lending on a highly subsidized basis. It provides some Rs. 1.2 billion per year in new financing for 20 - 25,000 units. This contrasts with commercial banks, which provided only Rs. 190 million in residential housing finance in 1987-88, with additional amounts coming from employers for their employees and the government for civil servants.[4]

The HBFC is an independent financial institution established in 1952 by act of Parliament with its share capital fully subscribed by the government. The primary objective of the HBFC is to provide long term loans to low income people in order to finance the construction of their own house. Over the past five years, the number of annual loan approvals has averaged 22,600, more than 13 times the average level before 1972, whilst the average loan size has quadrupled in real terms between the two periods. By end June 1988, HBFC had a total loan portfolio of over Rs. 12.3 billion; 91.5 percent of this portfolio comprises some quarter of a million loans to individual borrowers, which have been made on an Islamic banking "profit & loss sharing" (PLS) basis since 1979. The remainder of the

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[4]Interviews in Planning Commission, Government of Pakistan, Islamabad.

portfolio is divided equally between bridging finance to public corporations and special flood relief loans issued at Government behest. The maximum limit of an individual loan is Rs. 150,000. HBFC provides funds for about one-fourth of the total investment in ownership of dwellings in the economy.[5]

The present "simplified" schedules include a range of 44 different rates of return to HBFC from a lowest of 6.5% in the rural low income sector to a highest of 15.5% for purchasers of upper-income apartments in Karachi; the whole portfolio currently averages around a 9-10% return to HBFC as compared to the prevalent market rates of 14-15 %. It provides only about 30% of the cost of an individual house construction. HBFC is employing approximately 1,500 officers and staff and has established a network of 7 zonal and 58 district offices spread over most of the significant urban centers in Pakistan.[6]

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[5]USL International. May, 1988. <u>Policy and International Study of Housing Finance in Pakistan</u>, Study done for the Office of Housing and Urban Programs, United States Agency for International Development.

[6]Interviews with staff at HBFC, Karachi.

STATEMENT OF THE PROBLEM

The HBFC has made a remarkable contribution to the housing sector, but for some time now, there have been clear signs that the size and nature of HBFC's operation have outgrown the methods and systems used to control them. Loan recoveries are poor, at an estimated 50% on the PLS loans and 27% on the previous interest-bearing loans.[7] There is general accounting disarray on both borrowers' and other accounts, which has led to the qualification of the annual accounts by the external auditors over the past several years.

Staff calibre and morale are low. Management tend to react to crises rather than follow a pre-planned strategy. For a financial institution engaged in long-term lending, the return the Corporation achieves on its funds is too low and inflexible; it is also undercapitalized and its assets are illiquid.

In short, HBFC can be characterized as an institution struggling to remain solvent, relying totally on government loan resources to operate and which it must repay, lending with a sliding structure of returns on its loans that is far below market and faced with high delinquencies.

These hard facts certainly compel an exploration of the possibilities of mobilizing long-term resources in the

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[7]Ibid.

form of deposits and term debt and of transforming short-term resources into long term housing investment. Such an exploration includes:

- What is the stated rationale of HBFC in terms of generating the resources?
- How well is HBFC suited to do these in the light of its current operations?
- What are the outcomes of the current practice of generating the resources?
- What alternate sources must HBFC explore to procure and process the funds for on-lending?
- What are the policy implications of developing HBFC into a self sustaining organization?

RATIONALE OF THE STUDY

Like any other government, the Government of Pakistan has also a determined goal for housing: decent shelter for every one.[8] But it is evident from the statement of the problem that the government has not succeeded in solving the housing problems in the country, particularly for low income families. So clearly what is wanted and needed if progress is to be made in solving the housing woes is an improved approach which serves the interests of the low income group and the policy makers.

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[8]Seventh Five Year Plan, Planning Commission, Government of Pakistan, Islamabad.

Designing such an approach requires looking into the housing finance system with a particular emphasis on broadening the resource base, so that the resources and efforts of the government could be exploited. It is also necessary to look into the operation of various other similar financial institutions such as the Housing Development Finance Corporation (HDFC) of India, which has been operating successfully on a self sustaining basis. HDFC's sources of funds include 57% from deposits and 43% from various sources of borrowing, and the overall performance has been satisfactory as reflected by about a 95% recovery rate. It has provided the basis for improving the existing financial resources/policies and developing better housing finance strategies. Based upon this analysis, several areas for improvement of HBFC's resource generation have been emphasized.

OBJECTIVES

The specific objectives of this study are to determine:

1. Why the House Building Finance Corporation has failed to mobilize sufficient long term funds from sources other than the State Bank of Pakistan;
2. How the current funding of HBFC has effected its financial performance; and

3. What are the main opportunities and constraints with which HBFC will be faced in the housing finance over the next few years?

4. What are the main strengths and weaknesses of HBFC with regard to the proposed aim of developing it as a self-sustaining financial institution?

5. What type of operational reforms will be needed to enable HBFC to generate sufficient funds to support its lending operations and improve the recovery rates with an ultimate aim of transforming the organization into a dynamic, market-oriented housing finance institution.

RESEARCH DESIGN

Methodology

The study was carried out in three phases.

PHASE I

* Research proposal preparation
* Problem identification
* Objectives of the study

PHASE II

* Review of literature
* Investigations and interviews in Pakistan
* Data collection

PHASE III

* Analysis of the House Building Finance Corporation of Pakistan in respect of resource mobilization and lending/recovery procedures
* Its comparison with similar institutions in other countries
* Conclusions and recommendations

Data Collection

Since the study is exploratory, detailed interviews were held with the management of HBFC headquarter at Karachi and the zonal office at Islamabad. Efforts were made to obtain information regarding resource mobilization, factors limiting the generation of additional resources, and the capacity/capability of the organization to expand its resource base. Further information on lending and recovery procedures, accounting methods, organizational setup, and past performance was also sought. Besides the official data, I also tried to seek guidance through exploratory investigations during data collection, which involved:

i) Survey of literature on housing finance institutions available at the libraries at MIT, the World Bank, USAID, and in Pakistan.

ii) Discussions with the personnel of other financial institutions, representatives of the Ministries of Finance, Planning, Housing and Works, the National Housing Authority, and State Bank of Pakistan. I also held discussions with executives in the private sector,including in the building industry and with the management of some cooperative societies.

iii) Informal interviews with beneficiaries of the HBFC financing system, including defaulters.

The next chapter provides an overview of the housing sector in Pakistan, including the housing problems faced by the country, the importance of the sector in the national economy, current levels and quality of housing production, demand considerations and supply constraints in the sector.

CHAPTER TWO

THE HOUSING SECTOR

Problems

Pakistan has faced formidable housing problems from its birth as an independent nation because of the sudden mass influx of a million refugees in 1947. During the early years, Government's efforts in this sector were primarily directed towards providing shelter for the displaced persons, and a number of low cost housing projects were executed on an emergency basis. Most of these programs came to an end after a few years, but the inflow of refugees continued (though at a lower pace), and the situation, which had been considerably ameliorated earlier, began to deteriorate rapidly once again. The difficulties were compounded by a high national population growth rate, sustained migration from rural to urban areas and limited availability of suitably developed land. As always, the worst sufferers were the poor and deprived sections of the population, who, in increasing numbers, housed themselves in temporary shelters in squatter settlements or in low income areas which developed into slums.

The multiplicity of housing problems in the country are generated mainly by the very rapid increase in population, which grew from 84.3 million in 1981 to 107 million in 1989. At the current growth rate of over 3 percent per annum, it is expected to reach 120 million by 1993 and 140 million by the year 2000. Likewise, the urban population has increased from 20 percent in 1981 to 31 percent in 1989 and is expected to reach 34 percent in 1993 and 40 percent by the year 2000.[9]

As noted earlier, the shortage of housing units in the country was estimated at about 1.5 million in 1973 and over 3 million by 1985. The current annual requirements based on incremental population increase are estimated to be 240,000 units in rural areas and 175,000 units in urban areas. The current addition to the housing stock hardly caters to 40 percent of the population increase. The unchecked growth of slums, squatter settlements (katchi abadis) and encroachment on state and vacant lands are the direct outcome of these pressures. According to one estimate, 50 percent of urban population will be living in squatter settlements & slums by the year 2000 if the present trends are allowed to continue.[10]

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[9]Seventh Five Year Plan, Planning Commission, Government of Pakistan, Islamabad.

[10]See the National Housing Policy, op cit.

Housing in the Pakistan Economy: An Overview

The economy of Pakistan is in a strong long term growth trend. Over the past 20 years GNP grew at an annual average rate of 6.2 percent, but population is also growing rapidly. On net, per capita income rose by 80 percent over the past 20 years. GNP per household in 1988 was about Rs. 37,000 per year (equivalent to about $2115).[11] These trends imply a high and rapidly growing demand for formal housing finance.

The national budget deficit has also been growing, with much of the burden for financing it borne by an expansion of credit to the government by the State Bank. So far inflation has been kept to reasonable levels by close control of private credit expansion. The CPI rose at 9.1 percent annual rate over the past 20 years although only at a 6.5 percent rate since 1980-81. There are some concerns that inflation may trend upward in the future. Since Pakistan has no indexation system for financial instruments, raising money from the private sector requires rates of return, i.e. interest rates, to be positive at a level sufficient to more than cover inflation.

The contribution from the housing sector to national product of Pakistan is identified as net national income originating in the ownership of residential dwellings. The

[11]Economic Survey (1988-89), Ministry of Finance, Government of Pakistan, Islamabad.

contribution to income is derived in the form of rent from a tenant or as imputed rents for those owning homes and those living free. The contribution of the housing sector to the national income of Pakistan is shown in Table 2.1.

Table 2.1: <u>Contribution of Housing to National Income</u>

(Rs.billion)

Year	Income from Housing		National Income (GDP at Factor Cost)		Percentage Share of Housing in National Income	
	Current Prices	1959-60 Prices	Current Prices	1959-60 Prices	Current Prices	1959-60 Prices
1960-61	0.9	0.9	18.3	17.6	4.8	4.9
1965-66	1.2	1.0	29.0	25.1	4.1	4.0
1970-71	1.8	1.1	46.0	32.7	3.8	3.5
1975-76						
1980-81	8.3	1.6	247.6	55.2	3.4	3.0
1985-86	13.6	2.0	485.2	76.7	2.8	2.5
1986-87	14.6	2.0	537.3	82.1	2.7	2.5

Source: Economic Surveys, Government of Pakistan.

During the last three decades, the share of the housing sector in national income, whether in current prices or at constant prices, has been steadily declining. But in absolute terms, a significant increase in the amount of aggregate income from housing occurred during this period; the increase is less sharp when considered in terms of constant prices. Comparative figures indicate that the share of national income from housing is lower in Pakistan than in many other countries both developed and developing. e.g. France (8.7%) and India (3.4%).[12]

Housing Production and Conditions

The growth in real incomes and the growth in population means that an enormous amount of housing is being built in Pakistan. The growth in housing units has more or less matched that of households or about 450,000 per year recently. Such prodigious production does not mean that there are no housing problems, only that households have managed to form at a rapid rate. In fact, there is a widespread perception of serious housing problems, particularly among lower income groups.The large shortfall in formal sector housing production relative to household growth and an apparent rise in persons per room support this view.

Since no data are available on the quantity or quality of annual housing production, and short term trends in housing conditions, the nature and magnitude of these housing problems are hard to specify. Census data for 1961 and 1981 suggest that there has been a trend toward both households and housing units getting larger as shown in Table 2.2.

[12] Economic Survey 1989-90, Finance Division, Government of Pakistan.

Table 2.2: <u>Household Size and Unit Size</u>

YEAR	ALL	URBAN	RURAL
	Persons Per Household		
1961	5.51	5.84	5.41
1981	6.52	6.71	6.44
	Persons Per Room		
1961	3.3	3.1	3.3
1981-Unadjusted	3.5	3.2	3.6
1981-Adjusted	3.3	2.6	3.6
	Rooms Per Unit/Household		
1961	1.7	1.8	1.6
1981-Unadjusted	1.9	2.2	1.8
1981-Adjusted	2.0	2.6	1.8

Source: 1961 and 1982 Census of Housing and Census of Population.

These data have been quoted by the World Bank to demonstrate an apparent increase in crowding, with persons per room rising from 3.3 to 3.5. However, the World Bank[13] adjusted the data to reflect the fact that the 1981 census no longer considered kitchens to be a room, and found that the growth in room count had kept up with the growth in household size. In fact, in urban areas, persons per room fell sharply from 3.1 to 2.6, in contrast to the rise from 3.3 to 3.6 in rural areas. Thus it appears that the increases in real incomes have permitted a significant

[13]Report of the World Bank Mission to review the shelter sector in Pakistan in December 1987.

expansion in housing unit size, and, in some cases, a net decrease in persons per room. The 90 percent increase in income per capita over the same period (1961-1981) should have led to a greater decrease in persons per room if not offset by other factors. One major factor is that the price of developed land has shot up, pushing up the real cost of housing.[14]

Some Characteristics of Households

Pakistan is rapidly becoming a country of owner occupied housing. According to the Housing Census of 1980, the share of owner-occupied housing was 68 percent in urban and 83 percent in rural areas. The Housing and Housing Users Survey (HHUS) undertaken in 1988 by the Applied Economics Research Center, University of Karachi indicates that in 1988 the corresponding figures were 77 percent urban and 92 percent rural. In urban areas owner occupancy is lower (73%) in the middle income groups and higher (80%) in both the upper and lower income groups, the latter probably through force of circumstances. In rural areas 73 percent of the lower income households own their houses, but ownership is much higher in all of the other income groups.

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[14]See National Housing Policy, op cit.

House buyers tend either to construct their own homes or to supervise directly hired skilled or unskilled workers. The HHUS reveals that only 22 percent of urban and 1 percent of rural house buyers use building contractors. A partial explanation for the above is that improvements and additions to properties at different stages in the life cycle of a family appear to be a significant component of housing investment. This is particularly important as it suggests that "incremental" policies (building and financing houses in successive stages) could be an effective way of reaching the low income sector.

Another significant fact is that house owners appear to be prepared to spend much more of their income on housing than house renters. The survey reveals that while a renter household spends on average 23 percent of its income on housing, an owner household will spend 40 percent, although this latter figure most likely includes an element of dissaving.

The overriding housing problem is the inability of many households to afford the type of houses that are produced. The economic cost (without subsidy or profit and before financing cost) of a cheap new dwelling is about Rs. 45,000. A rule of thumb often used is that a dwelling whose cost is more than 2.5 times annual income of a household cannot be afforded. This indicates that 44 percent of the urban households in the country are not able to afford even an inexpensive new house.[15]

Supply Constraints on the Housing Sector

There are a number of supply constraints operating in Pakistan's housing market. Some of the major constraints are related to land and services, construction materials, taxation, and most importantly, housing finance.

Over the past several years, land prices have been rising sharply. According to one estimate, the cost of land constitutes some 40 percent of the total investment needed in a new development. The HHUS,indicates that the share of land in the total cost of housing averages 14 percent, with a higher 17 percent for urban dwellers and lower 10 percent for rural dwellers. In part the increase in land prices reflects past inflation and the demand for construction sites, but there is also an important speculative element encouraged initially by the sale of government land at below market price,to those fortunate enough to acquire it, without sufficient safeguards to prevent future speculation.

Delays in service provision are another common constraint on housing delivery. According to the "Pakistan Sector Review" (IBRD, June 1988), there are often long

[15]See National Housing Policy, op cited.

delays in the provision of the required trunk infrastructure and other amenities to a project area, which points to the need to improve coordination between the suppliers of utilities (electricity, water, etc.) and the private developers.

Construction activity is sensitive to changes in the prices of building materials. For the past five years, building material prices have increased more or less in line with general inflation, but increases in indirect taxes on steel and cement in the 1988-89 budget had an adverse short-run impact. The HHUS shows that while rising land prices have significantly affected housing investment costs in urban areas, rural areas have been more affected by an increase in building material costs, perhaps indicating increasing constraints on the supply of rural building materials.

A final important supply constraint is the housing finance. There are three sources of housing finance in the country; first, the public sector, for which budget allocations have decreased in successive National Five Year Plans; second, the private sector, mainly operating through commercial banks with low credit ceilings allowed to them for housing; third, the informal sector, comprising savings of individual families, disposal of jewelry and personal assets, and informal borrowing often at high costs. Less than 20 percent of the housing finance comes from the formal sector (public and private).

The availability of housing finance has also suffered from inflation, the small size of loans by the House Building Finance Corporation (HBFC), delinquency problems and the risks involved in investment and loaning, the lack of significant growth of the financial institution and investment in housing, and the procedural bottlenecks in making loans. The rent restriction laws have also restricted the flow of funds. Due to these difficulties, private investors have not been attracted to the housing sector except for speculation.

The private sector has also been discouraged from undertaking large scale housing projects because no construction or bridge financing for housing projects is at present formally provided in the country. No loans are available for the purchase of land nor for the building industry. Likewise, short term credit facilities for incremental house building or upgrading of katchi abadis and slums is also non-existent. The lack of secondary mortgage financing and calamity or disaster stricken housing finance are also major shortcomings. Low income households have particularly limited access to housing loans.

Having reviewed general housing issues, the detailed working of HBFC will be discussed in the next chapter. This institution dominates the Pakistan's formal housing finance system.

CHAPTER THREE

HBFC: BACKGROUND AND PROBLEMS

Establishment and Objectives

HBFC is an independent financial institution established in 1952 by act of Parliament with its share capital fully subscribed by the government. The primary objective of HBFC is to provide long term loans to people to finance the construction of their own house. For over 20 years the Corporation advanced loans only for house construction in the urban areas of Pakistan, and the level of activity was relatively low. In 1972, there were amendments to the HBFC act which enabled it to lend for house purchase in rural areas; finance the construction of housing projects; make bulk loans to development authorities and housing corporations; advance rehabilitation loans; and undertake the construction of housing projects for sale to the public.

HBFC adopted an Islamic banking approach to its operations in 1979 when it was first introduced in Pakistan.[16] Since that time its lending has been based on

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[16]The principal restriction under which the islamic system must work is the injunction against interest. However, it is important to note that what is forbidden by Islamic law is the fixed or predetermined return on

the Profit and Loss Sharing (PLS) system as well as its borrowings from the State Bank of Pakistan.[17]

Disbursements during the first 20 year period averaged Rs. 18 million per annum. Between 1971/72 and 1978/79, annual disbursements grew from Rs. 35.9 million to Rs. 483.7 million. This rapid pace of growth continued after the switch over to Islamic banking in 1979. Since then, annual loan disbursements have quadrupled to Rs. 1,936 million in 1987/88.[18]

Capitalization and Ownership

The act establishing HBFC authorizes share capital of Rs. 200 million all of which has been fully subscribed and paid-up. The Federal Government holds 62.5 percent of the shares (Rs.125 million) and the State Bank of Pakistan holds the remaining 37.5 percent (Rs.75 million). HBFC is governed by a Board of Directors that has eight members representing Federal and Provincial Governments and the State Bank. The Minister of Finance, however, also has powers to give directions on policy. The chief executive, who is both chairman of the board and managing director, is

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financial transactions, and not an uncertain rate of return represented by profits. For this reason the modern concept of Islamic banking has developed on the basis of profit sharing.

[17]For details see Annex 1.

[18]Source: HBFC, Karachi.

appointed on a 3 year rotation basis by government. The deputy managing director and chief internal auditor are also appointed for periods of around 3 years. The remaining members of top management are permanent employees of the corporation.

Organization and Staffing

HBFC has its head office located in Karachi with seven zonal offices and 58 district offices located throughout the country. The whole network currently handles some 250,000 customer accounts. The head office has two executive directors -- for Operations and Administration -- whilst the deputy managing director holds the remaining responsibilities.[19] By August 1988, the Corporation was employing 1552 officers and staff. HBFC uses both the Habib Bank and the Muslim Commercial Bank to provide some of the servicing functions for its loans.

Source of Funds

HBFC currently gets all of its new funds as an annual loan from the State Bank of Pakistan which it must repay in a balloon payment at the end of ten years. Although in theory it can take deposits and borrow money or issue bonds on the market, it does not do so because the market cost of

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[19]See the organization chart on Annex 2.

funds would not permit it to continue its current lending charges. It repays SBP on the PLS basis, i.e. out of its earnings after deducting operating costs. The return to SBP has averaged only about 2-4 percent. The annual loan amount from the SBP is determined by the National Credit Consultative Council. To supplement the funds received from the SBP, HBFC also utilizes repayments from its loan portfolio. (Annex 3 shows HBFC's Investment Budget for 1987-88).

SBP has indicated that it wants to significantly cut back on its provision of resources to government-owned financial institutions.[20] To put the cost of funds in some perspective, commercial banks are paying 11.7 to 13.5 percent on 3 to 5 year deposits, respectively. The government through its National Savings Schemes issues savings certificates paying 15 percent per annum, but if held for three years, pay 17 percent per annum. Thus, it can be seen that with a maximum equivalent lending rate of about 15 percent (the highest effective rate of return it charges on a scale of different loans), HBFC cannot currently raise funds in the market and operate without incurring a loss.

The major liabilities of HBFC are the loans made to it by the government over the years. The oldest loans are

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[20]State Bank of Pakistan, Annual Report: 1988-89.

interest bearing loans made up to July 1979. The vast majority of HBFC's liabilities are owed to the SBP, which loaned to HBFC at 8 percent per annum interest up to July 1979, and under PLS since then with the introduction of Islamic banking in Pakistan. The PLS "investments" require annual payments to the SBP based on HBFC's accrued "profits" with repayment of the principal as a single balloon payment at the end of ten years. The principal amounts increased from Rs.400 million in FY 1988 to Rs. 853 million in FY 1991 and are expected to increase to Rs. 1,239 million in FY 1992 and remain at that level for several years.

The PLS profit "sharing" arrangement has resulted in transfer of practically all of HBFC's pre-tax profit to the SBP every year. In this regard the poor quality of the HBFC's "investment" portfolio, and the lack of write-offs to reduce net assets to some reasonable level, has tended to force the HBFC to transfer large amounts of cash to SBP as "shared" profits based on accrued (but only partially received) income. This imbalance has now caused a cash crunch at HBFC which will only get worse as it tries to keep up its lending operation while also keeping up to date with its payments to the SBP.

Lending Operations

Terms

Anyone wanting to build his own house or buy a new house from a developer can apply to HBFC for a loan. The maximum loan was increased in fiscal year 1988 from Rs. 150,000 to Rs.200,000. However, in March 1988 it was abruptly dropped back to Rs. 100,000 so that more loans could be made with the available funds. The maximum size of a unit in terms of covered area is 2250 sq. ft.

HBFC provides financing up to a maximum of Rs. 90 per sq. ft. The borrower must come up with the rest. For example: HBFC provides a loan for up to Rs. 90,000 for a 1000 sq. ft. house. To put this in terms of what a borrower might have to pay, it is necessary to look at the different classifications of construction which are based on different standards. Class A construction costs around Rs. 300 per sq. ft. or more; Class C would average Rs. 100-125 per sq. ft; Class B somewhere in between. Thus, in the above example, a Class A house would cost, say Rs. 300,000, HBFC would finance Rs. 90,000 and the borrower would have to pay Rs. 210,000 from his own resources.

There is no minimum size loan nor is there a maximum cost house that a borrower can finance. However, the maximum is really controlled by HBFC's loan maximum i.e. Rs. 200,000 which is derived from the maximum 2250 sq. ft. size house that HBFC will finance. That is, somebody in theory could spend Rs. 1000 per sq. ft. but they wouldn't do this on a house that was only 2250 sq. ft. And that is what is intended; to limit the type of housing that HBFC will finance.

Borrower's Qualifications

A borrower must have land with clear title for an application to be considered. A certificate of non-encumbrance is required; that is, there must be no loans or liens against the land. A borrower must have house plans and cost estimates approved by the local authority, and he must also have proof of income and a demonstrated capacity to repay the loan. HBFC accepts 50 percent of a person's income toward repayment of a loan, which is clearly on the high side and a burden on the common man.

An individual can get only one loan in a lifetime, but a loan can be transferred to the purchaser of a house i.e. an assumable mortgage. A loan must be for a new house, either constructed by an individual or built by a developer. One cannot get a loan from HBFC to finance an existing house. The intent is that HBFC fosters the production of new houses.

HBFC provides no construction or bridging finance for developers. For a developer-built apartment project it works as follows: The developer advertises the project (condo apartment) invites people to purchase units. HBFC is approached and appraises the project, then reviews the developer's reputation and financial condition. HBFC then works out loans for individual borrowers. The developer must have completed the "structure" before HBFC disburses any money. It is usually 18 months before the second installments are made. Work up to completion of the structure is financed by deposits of buyers and the developer's own resources.

Disbursements

HBFC makes two disbursements to individual borrowers; 40 percent of the loan amount when the house reaches foundation level and the remaining 60 percent when the borrower gets the roof on.

HBFC's largest number of loans is in the Rs. 60,000 range. (Annex 5 provides information on number of loans and disbursements between 1982 and 1986).

The total portfolio of HBFC as of the end of June 1988 is shown in Table 3.1. Ninety-one and a half percent of the portfolio comprised of the main normal advances to individual borrowers. Only one main loan scheme has been operating at any particular time.

Table 3.1 HBFC Portfolio by Main Types of Loan/Advance as at 30 June 1988

	Book Value (Rs.million)	% of Total
"Normal" Loans/Advances		
Secured Loans	1,484	12.0
Investments on PLS scheme	8,616	69.9
Investments on simplified PLS scheme	1,179	9.6
Other Loans/Advances		
Flood loans	472	3.8
Loans to Cooperatives	6	0.1
Bridging loans	472	3.8
Lahore Development Authority	94	0.8
TOTAL	12,323	100.0

SOURCE: HBFC

Collection

Repayments start one year after HBFC makes its first disbursement. HBFC does not charge any "shared profit" during this period. The rationale is that the borrower is not deriving any benefit during the construction period, i.e., neither rent nor the benefit of living in the house. Therefore, there is no "profit" for HBFC to share in.

The maximum effective "profit" is 15 percent, the lowest is 6 percent, depending on the size of the loan, the size of the unit, the location of the property, and the income of the borrower. (See Annex 4 for a complete listing of the ranges of the rates and examples of the "effective" rates). Earlier, HBFC was nowhere near market, averaging around 8 percent on its loans.

Old (interest bearing) loans are serviced by Habib Bank; new loans by the Muslim Commercial Bank (MCB). Previously the borrower got a payment book and made payment in person to the MCB. Now under a new simplified system of collections, the borrower must open an account with MCB. On disbursements, HBFC sends a check directly to the account, not to the borrower. With respect to repayments, there is no deposit book but the borrower must always keep at least one payment in his account at MCB. When the payment is due MCB sends it to HBFC, i.e., it debits the borrower and credits HBFC. If a borrower falls behind MCB will notify and request him to pay. If the account continues to be behind, MCB will notify HBFC and HBFC will follow up.

Enforcement

In theory, HBFC can eventually foreclose if a borrower does not pay, but there are many factors that enter the picture. As a government agency, there are political, social and economic considerations, and these all effect recoveries. If HBFC foreclosed and sold a house it would obviously get very bad publicity. Instead, HBFC tries pressuring a delinquent borrower, issues a notice, sends someone to try and collect, shows him an attachment order, etc.

HBFC has also introduced mortgage life insurance for the "partner". The HBFC was not able to effectively collect or foreclose on a family which lost its principal salary earner. Now life insurance policy will pay off the HBFC upon the death of the "partner" or the guarantor, if the guarantor's income was used to qualify the "partner" for the original investment. The level premium is included in the monthly installment, in addition to the payment of principal and imputed rent.

Financial Performance

The financial operation of HBFC is very simple, as shown by the analysis of its source and use of funds between 1983-84 and 1987-88 in Table 3.2.

The only two sources of funds are loans from the State Bank and recoveries from previous borrowers. (The Rs. 223 million "other" source in 1987/88 largely reflects the sale of a fixed asset). These funds are used to disburse new loans and, increasingly, to service previous debt from the State Bank and from government.

Table 3.2 HBFC Source and Use of Funds, 1983/84 - 1987/88

(Rs. million)

	1987/88	1986/87	1985/84	1984/85	1983/84
Source					
SBP	1,850	1,833	1,400	1,365	1,050
IDA	55	-	-	100	-
Recoveries	1,116	934	835	690	643
All others	223	15	3	12	3
TOTAL	3.244	2,782	2,238	2,167	1,696
Use					
Disburs.	1,990	1,981	1,320	1,399	1,385
Paym.to SBP& Govt.	1,149	807	621	604	273
Admin. expenses	83	70	61	59	41
Others	15	35	76	50	-
TOTAL	3,237	2,893	2,078	2,112	1,699
Surplus Source/Use	7	(111)	160	55	(3)

SOURCE: HBFC

Some key financial indicators for 1979/80 and for the period between 1984/85 and 1987/88 are shown in Table 3.3.

Table 3.3: <u>HBFC: Key Financial Indicators</u>

	1987/88	1986/87	1985/86	1984/85	1979/80
Current Assets/ current liabil- ities	0.30	0.16	0.32	0.21	0.12
Debit: Equity	38:1	45:1	32:1	34:1	14:1
<u>% of portfolio</u>					
Return on funds	6.28	6.24	5.94	5.96	9.41
Cost of funds	4.92	5.06	5.10	5.17	7.64
Spread	1.36	1.18	0.84	0.79	1.77
Operating costs	0.71	0.69	0.69	0.76	0.69
Provision for doubtful accounts	0.34	0.31	0.14	0.04	-
Gross Profit	0.31	0.18	0.01	(0.01)	1.08

SOURCE: HBFC

The **<u>current ratio</u>** (current assets/current liabilities) has been consistently low: it should be 1.0 or over. Because HBFC's only major creditor is the government, a low current ratio does not really matter. It would matter, however, if HBFC were to switch to other sources of funds, particularly small private savings. The **<u>debit:equity ratio</u>** has deteriorated sharply since 1979/80 when it was at an acceptable level. This ratio reveals the urgent need for a capital restructuring of HBFC if it is to widen its sources of funds.

The **return on funds** fell significantly after 1979/80, reflecting the switch from interest-bearing to profit-sharing loans. There was a modest recovery in the last two years, but the return is still well below a level at which HBFC could be self-sustaining. The **cost of funds** reflects the subsidized nature of the HBFC loan operation: With interest rates on savings certificates scheme currently at 15 percent, the high level of subsidization by government is clear.

Operating costs have been remarkably constant as a percentage of HBFC's earning base (i.e. portfolio). Indeed the figures are remarkably low. Bearing in mind the sharp increase in the number of borrowers' accounts , it is, perhaps, not surprising that HBFC has been unable to control its customer accounting or recoveries. Normally one would expect operating costs to be some 1.5% to 2.0% of the earnings base and the **spread** required of a financial institution of this type to be around 2.5%.

A comparison of the key indicators of HBFC with those of the Government Housing Bank of Thailand (public sector) and the Housing Development Finance Corporation of India (private sector) given in Table 3.4 also shows how far HBFC is removed from operations which are self-sustaining.

Table 3.4 Comparison of HBFC with the Government Housing Bank, Thailand, and Housing Development Finance Corporation, India

Key Ratios	HBFC Pakistan 1986/87	GHB Thailand 1987	HDFC India 1987/88
Current ratio:			
Current assets/ current liabilities	0.16	0.15	2.03
Debt/equity ratio	45:1	9:1[21]	14:1
Return on funds/outstanding loans	6.24	11.38	14.95
Cost of funds/outstanding loans	5.06	10.18	12.12
Spread	1.18	1.20	2.83
Operating expenses/outstanding loans	1.00[22]	0.83	1.45
Gross profit/outstanding loans	0.49	0.37	1.38
Gross profit/equity	21.4	2.8	32.3
Fixed assets/equity	1.0	0.2	0.3
Average loan size (Rs. '000)	77	198	201

Source: Asian Development Bank (Report No. 1024/8904 Feb,1989)

Of course considerable care has to be taken when making these comparisons, not only because of the qualified nature of HBFC's accounts but also because of the different way of operating the three institutions. For example GHB

[21]Current liabilities and debt include demand and time deposits. If these deposits (i.e. savings deposits) are excluded, current ratio is 14.2.

[22]Includes provision for doubtful accounts.

Thailand raises 60% of its working funds in the form of demand and time deposits which, if taken as part of current liabilities, makes its current ratio look bad. However, as these are really savings deposits, the roll-over factor is high.

With this in mind, the **current ratio** of HBFC is very weak compared to the other two institutions. The **debt/equity ratio** clearly shows the relative under capitalization of HBFC. Any institution which has its loan portfolio locked up for long periods (15 to 25 years) but obtains its source of funds for shorter periods through savings and other deposits needs to have cover against the risk of fluctuations in the short term market. This cover, which is obtained through its equity, does not have to be as high as that of a commercial bank which is essentially dealing only in short-term funds. Precisely what level debt/equity ratio should be adhered to is a matter of judgement but that of both GHB and HDFC are substantially lower than HBFC. Another guideline can be obtained from nearer at home. National Development Finance Corporation (NDFC), another institution in Pakistan engaged in long term finance, has debt/equity ratio of 13.4:1.[23]

The **return on and cost of funds** for both GHB and HDFC are higher than HBFC. The better guideline is HDFC as

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[23]State Bank of Pakistan, Annual Report: 1988-89.

there is an element of subsidy in GHB, which obtains around 11% of its loan funds from government at highly favorable rates of 3-5%. On the other hand, GHB also obtains 25% of its funding from abroad and 2.6 percentage points of its cost of funds represent exchange losses. There is a fundamentally higher **operating expense** structure in GHB and HDFC because both institutions disburse substantially larger average loans than HBFC and one would normally expect their costs to be markedly lower. The higher cost structure reflects the better quality of premises, other facilities and perhaps staff in both foreign institutions, which contributes significantly to their ability to raise savings deposits and other commercial funds.

Recovery Performance

Table 3.5 shows the total portfolio as at 30.6.88 and the cumulative recovery position. The table clearly reveals the poor recovery record of HBFC, particularly on the old interest bearing secured loans. It must be emphasized however, that this is the cumulative recovery position. The book value includes capitalized unrecovered interest and penalty charges.

Table 3.5: HBFC Portfolio and Recovery Position by main category of Loan as at 30 June 1988

Loan Category	Book Value 30.6.88 Rs. m.	%	Overdue recoveries Rs.m.	Overdue as % amount
Secured Loans	1484	12.0	923	68
PLS Scheme	8616	70.0	1757	35
Simplified PLS Scheme	1179	9.6	-	-
Flood Loans	472	3.8	-	95
Co-operatives	6	-	6	100
Bridging Loans	472	3.8	143	100
Lahore Development Authority	94	0.8	-	0
TOTAL	2323	100	2829	38

SOURCE: HBFC

I was unable to assess changes in performance of recoveries over the years because of the way HBFC have collected statistical data. Total recoveries have been measured against arbitrary targets without distinguishing how much of the funds recovery occurred in a current year and how much was related to previous years. However in Table 3.6, I compare the change in cumulative defaulters with what should have been recovered on the PLS scheme during the 18 months ending December 1987.

Table 3.6: **Cumulative Recovery Position on PLS scheme as at 30.6.86, 30.6.87 and 31.12.87**

(Rs. million)

	30.6.86	30.6.87	31.12.87
Total amount due	2756.9	3520.4	4087.5
Amount not recovered	1121.0	1198.7	1462.7
Non-recovery %	40.7	34.1	35.8
Principal due	1692.7	1952.7	2252.6
Principal not recovered	797.3	681.9	826.1
Non-recovery %	47.1	34.9	36.7
Rent + charges due	1064.2	1567.7	1834.9
Rent + charges not recovered	323.7	516.8	636.6
Non-recovery %	30.4	33.0	34.7

SOURCE: HBFC

The point to note about the foregoing table is that overall total recovery performance improved markedly between June 1986 and June 1987. This improvement was mainly due to improved recoveries of principal whilst recoveries of rents and charges due worsened. As the standard procedure for crediting a borrower's account is to credit interest first, demand charges second and principal last, the figures suggest that there remained a growing backlog of old debt on which HBFC was continuing to allocate, but failing to collect demand charges and accrued interest (leading to an overstatement of profits in the accounts), but despite that the current recovery position should have been improving. In the last six months of

1987, there was a worsening of recoveries both on principal and on rent and other charges.

Table 3.7: <u>"Ageing" of Non-Recovery on Interest Bearing & PLS Schemes as at 30.6.88</u>

Years Out-standing	Number of Accounts('000) Int.	PLS	Total	%	Value of Accounts(Rs. m.) Int.	PLS	Total	%
0 - 1	4.1	41.2	45.3	33.5	8.7	195.3	204.0	7.6
1 - 3	14.5	30.8	45.3	33.5	536.5	481.7	1018.2	38.0
3 - 5	4.0	15.9	19.9	14.7	48.1	478.8	526.9	19.7
5 - 7	0.8	8.8	9.6	7.1	14.5	368.5	383.0	14.3
7 - 9	0.8	4.9	5.7	4.2	14.5	233.0	247.5	9.2
9 - 12	5.7	-	5.7	4.2	155.6	-	155.6	5.8
12 +	3.7	-	3.7	2.8	144.9	-	144.9	5.4
TOTAL	33.6	101.6	135.2	100	922.8	1757.3	2680.1	100

SOURCE: HBFC

Another way of ascertaining recovery performance is to examine the 'ageing' of defaulters on the interest bearing and PLS schemes, as displayed in Table 3.7. The statistical data in the table is somewhat misleading as HBFC calculate 'ageing' by dividing the amount overdue by the number of normal installments required to pay this off. Thus the ageing does not represent years overdue but more properly the years required to obtain payment of the outstanding amount on a regular basis. The statistics suggest that HBFC has been going through a poor period of recovery over the last three years, with no improvement last year, because 1/3 of the defaulters are new. However, 54% of the value of non-recovery is over 3 years old and this is the area of concern as it involve 44,600 accounts or 33% of the total number of accounts overdue. Quite clearly the overdue situation of the portfolio of personal home financing schemes is quite untenable for a financial institution, as 92% of the total default is over 1 year, which represents a breakdown of contractual obligations.

Reasons for poor recovery

It is not possible to identify one clear reason why HBFC's recoveries are poor; instead a complex of factors contributes to the situation. These factors include:

a) The charging of subsidized rates of return which makes it more attractive for borrowers to invest surplus money elsewhere rather than to repay HBFC.

b) HBFC's policy of lending only a minority portion (around 30%) of the total construction cost and land cost. This forces some borrowers to seek additional loans elsewhere -- particularly from relatives -- and to give priority to other creditors when it comes to repayment.

c) Poor assessment of the credit worthiness of the borrower at the time of loan authorization.

d) Lack of close contact between branch office and the borrower.

e) Late and inaccurate consumer accounts - it is difficult to follow up on defaulting borrowers when district management are not sure of the debt owed.

f) Until recently, low priority given by management to achieving recoveries.

g) Poor management information and the setting of inappropriate recovery targets.

It may be concluded that until now HBFC has seen itself basically as a department of government. It has become proficient at the rapid distribution of Government funds but very much less proficient at recovery. One reason for this is that the survival of HBFC has not depended upon its recovery performance or its ability to raise money from other sources. There has always been the assumption that funds will continue to flow from the treasury to make up any shortfall. And yet from a commercial point of view recovery is extremely important. At end June 1988 the total amount under recovery on HBFC's interest bearing and PLS accounts was Rs.2.68 billion:[24] had this been recovered and reinvested at an average 9 1/2%

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[24]Interviews with HBFC staff.

return,it would be earning an extra annual gross income of Rs.255 million for the corporation.

With the government looking to shift more of its programs to the private sector[25] and with the SBP indicating that it will reduce or eliminate its subsidized lending to government financial institutions, there is an urgent need for HBFC to mobilize its working funds from all possible sources in order to convert itself from being an administered department of the government into a commercially viable institution. A great deal needs to be done by and to HBFC in order to achieve this aim. The main opportunities and constraints with which HBFC will be faced in housing finance over the next few years are described as follows:

Opportunities and Constraints

a) The scope for financing housing on a commercial basis is large as the total market size is estimated at around Rs.12 billion growing at 10% per annum. However, slow working of legal repossession procedures and belief that recovery performance in the housing sector is poor makes private investors hesitant to enter the sector.

b) A substantial portion of total housing finance requirements is needed in the poverty income

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[25]Seventh Five Year Plan, Planning Commission, Government of Pakistan, Islamabad.

sector, and there are bound to be further government schemes aimed at this sector in the future.[26] The policies aimed at helping this sector through interest rate subsidization, however, have not been effective in the past, partly resulting from poor targeting and partly from the policy of underfinancing the real needs of the borrowers.

c) The indications are that there are substantial amounts of private domestic funding (both institutional and informal) available for attractive investment/savings opportunities, and there is also a possibility to attract overseas funds. On the other hand, the funds need institutions to mobilize them and to direct them into the housing market effectively. Such institutions must be able to charge a sufficient rate of return from borrowers to enable them to attract sufficient savings and other funds.

d) At the current inflation level, rates of return on savings are mainly positive and there are instruments such as bearer bonds available to attract funds from hidden sources of money. At present, there is a lack of experience on what

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[26]See Seventh Five Year Plan, op cit.

level of rates would attract sufficient savings and other funds, although the present marginal rate appears to be the 15% tax free rate paid by the government on savings certificates. It is also assumed that the competition for the funds available could tend to drive up the rates.

e) Mark-up and leasing are acceptable instruments under an Islamic banking system and are flexible enough to allow lending rates to borrowers to be adjusted to a level which would allow institutions including HBFC to attract funds. It is considered that Profit and Loss schemes are not suitable methods of investing in the housing market because of the relatively low rental return on house properties.

The main strengths and weaknesses of HBFC with regard to the proposed aim of developing it as a self-sustaining institution are as follows.

Strengths and Weaknesses

a) HBFC has been established in the housing finance sector for over 38 years and its name is well known both to potential borrowers and savers, but its reputation among house buyers is by no means good. Much of this has to do with the failure to keep accurate and up-to-date borrowers accounts.

b) HBFC has already established a network of zonal and branch offices covering all main population areas of the country, which places it within reasonable range of the majority of the housing users and would enable it to raise resources from savings deposits and investments by individuals living in urban areas in particular. However, it was observed during the field visits that the physical condition of many branches is poor and detracts from any image HBFC might have of being a sound financial institution. The institution does not always utilize its network to forge close link with borrowers which would help achieve good recoveries.

c) The officers and staff of HBFC have had prolonged exposure to working in a non-commercial environment but have the advantage of being familiar with the housing conditions in their areas.

d) The current range of management skills is limited as it lacks commercial thinking and know how; ability to develop forward plans; and fund raising or fund management skills. The institution also lacks a consistent and well planned training policy.There are, however, many vacancies at the officer level which gives scope for the rapid infusion of new and fresh thinking.

e) HBFC has access to low cost government funds and an implicit guarantee lies behind its operations. But HBFC is unable to raise funds other than from the government because the low yield and under recovery on its existing portfolio prevents any possibility of offering attractive terms to investors. Moreover, HBFC's weak capital and qualified balance sheet and accounts will not inspire investor confidence.

f) HBFC has previous experience of operating government schemes such as those for flood relief, but its lack of strong management skills hinders it from contributing in a positive way to government policy formulation.

Major Problem Areas

The analysis of HBFC gives very clear signs that the size and nature of HBFC's operations have outgrown the methods and systems used to control them. Such signs include the inadequate resource base, poor loan recovery performance, the general accounting disarray both on the customers' accounts and those of the Corporation, and absence of management strategy. The fundamental cause is that HBFC's role in the housing finance sector has changed significantly over recent years, but this has not been matched by a change in its management philosophy. Over the years, HBFC has become a major supplier of funds to house purchasers, particularly those of the urban middle-income group and has taken on the role of a major financial institution, but it is still administered as an arm of the government and operated on a highly subsidized basis.

In order to compare the performance of HBFC, it will be worthwhile to see and evaluate the working of another housing finance institution. In the next chapter, I will analyze in detail the working of the Housing Development Finance Corporation (HDFC), in India, which has been operating successfully since 1978 on a self-sustaining basis.

CHAPTER FOUR

THE INDIAN EXPERIENCE: HDFC

The Housing Development Finance Corporation (HDFC) began operations in May 1978, with the principal equity contributors being the Industrial Credit and Investment Corporation of India, the International Finance Corporation, and the Agha Khan Group. Initial paid up capital was $10 million. The founding of HDFC was significant in that it is the first private finance development institution dedicated to housing in India.

The primary objective of the Corporation is to provide long term finance to middle and lower income households, associations of individuals, and corporate bodies for the construction, purchase, and ownership of residential units. HDFC's purpose is to increase the housing stock in the country generally and to mobilize long-term resources in the form of deposits and term debt. A longer term objective is to lead and support the development of a national housing finance system and to foster the growth of the capital market in general. In June 1984, HDFC had nine branches scattered around the country in addition to its headquarters in Bombay.[27] However, loans have been concentrated in the West and South regions of the country; and funds mobilization has been largely concentrated at corporate headquarters.

Types of Loans

HDFC engages in four types of mortgage lending. These include loans to individuals for acquiring a home, loans to corporations for workers' housing or for on lending to workers for home acquisition (called the line of credit program), and loans to groups of homeowners who have formed an association for acquiring an apartment building. An idea of the relative importance of these different types of loans is available from Table 4.1, which shows loans made in HDFC's fiscal year 1984 and cumulative totals.

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[27] The Housing Development Finance Corporation of India: Evaluation of the Housing Guaranty Loan, Report prepared for Office of Housing and Urban Programs, United States Agency of International Development. (June, 1985).

Table 4.1: Percentage Distribution of Loans by Type[28]

	Loans made in FY 1984		Cumulative Loans made	
Loan Type	Units	Amount Lent	Units	Amount Lent
Individual	172	82	69	78
Group	--	--	2	2
Line of Credit	3	4	4	4
Corporate	25	14	25	16
Total(Percent)	100	100	100	100
Total Units/$	26,407	$100 mill.	79.760	$285 mill.

SOURCE: U.I. Project 3472. A report prepared for The Agency of International Development.

Sources of Funds

Most of HDFC's funding sources are related to the types of loans it makes. Its deposits are related to access to individual and corporate loans; its access to government-controlled term borrowing is related to the Government of India's views on the worthiness of the clientele served by its individual loans; and its access to the bond market is affected by the GOI's determination that HDFC's mortgages have a fiduciary soundness as well as

[28]. Excludes a small number of development period loans.

social utility. Table 4.2 identifies HDFC's sources of funds over time.

Table 4.2: HDFC's Selected Sources of Funds[29]

(million of rupees)

	1980	1981	1982	1983
Current Liabilities	2.7	12.3	12.9	16.5
Long Term Liabilities	38.8	239.3	258.4	506.7
Borrowings		100.0	38.7	234.7
Certificates of Deposits	38.8	139.2	219.3	268.7
Cash Flow from Operations	6.2	11.5	18.2	28.9
Total Sources of Funds	105.7	293.2	327.6	573.9
Long Term Debt as a share of Total	.367	.816	.789	.884

SOURCE: A Financial Ratio Analysis prepared for Bertrand Renaud of World Bank, 1984.

The table makes it clear that HDFC's funding sources are predominantly longer-term, i.e., not available on a demand basis. Each of these funding sources, as well as HDFC's ability to generate fee income and to tap the equity markets are discussed in turn.

29. The sources listed do not sum to the total because for simplicity minor sources have been ignored.

Deposits

HDFC's primary clientele for loans has been individual households, who take about 70 percent of the loans, followed by the corporations with 25 percent. These demanders of funds are closely related to HDFC's fund suppliers. For example, almost 85 percent of HDFC's deposits, or slightly more than half of its borrowed funds, are the deposits of the corporations. These firms are induced to make deposits with HDFC in return for the promise of mortgage loans being made available to employees or because of the yield /safety features of the deposit.

HDFC follows a similar "broader financial package" approach in its efforts to mobilize household deposits. Access to credit for households, the maturity structure of the deposit schemes, and relative safety of return for corporations are important considerations in the portfolio decisions that govern the growth of HDFC deposits. HDFC attempts to find "niches" in the market in which the whole array of services it provides, not just the explicit return on the deposit, offers the depositor the highest overall return. Thus, the growth of HDFC's deposits relies heavily upon an aggressive outreach program in which the non-price aspects of HDFC services are explained to potential customers. The growth of deposits is essential to the firm, so that funding sources will be highly diversified. Institutional credibility, market presence, and stability of the institution are the major ingredients in determining investors' confidence that the institution will not only continue to grow, but to grow in such a way that it cannot be rationed out of the financial markets.[30]

Term Borrowings

HDFC's domestic term borrowings come from: (1) the Reserve Bank of India, which provides an allocation level for funds from commercial banks; (2) three different insurance companies; and (3) a loan from the Industrial Credit and Investment Corporation of India. Its international borrowings have been the USAID Housing Guarantee Loan and an IFC line of credit. The loans made under this funding arrangement generally have a maturity of about 10 years and a 13.25 percent interest rate. The relatively long maturity of these loans and the lower level of staff effort needed to generate them makes them attractive to HDFC.

Bond Issues

In fiscal year 1983, HDFC successfully began to issue public bond offerings. The success of the issuance has potentially important implications for the firm's growth and profitability.

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[30]See Report on evaluation of HDFC, op cit.

Retrospectively, it seems that HDFC's local resource mobilization efforts are enormously successful. The firm has diversified the number and type of investors and depositors, and it has continually sought to exploit "niches" in the market that are often created or associated with an interest rate ceiling system. The firm seems particularly well placed to develop the deposit market by reliance on brokers for individual deposits and over time to take advantage of any new technologies that emerge in the gathering of deposits. However HDFC is exposed to five types of risks and financial impediments involved with resource mobilization: default risk by households, interest rate risk, corporate loan risk, commitment or sanction delivery risk, and liquidity risk.

Default Risk. In the Indian legal system foreclosure laws are such that a technical default on mortgage payment may take years to resolve.[31] As a consequence, the expected costs of default are very large. HDFC has avoided this problem through: requiring large down payments by households;[32] requiring guarantees from other individuals on about 30 percent of the individual loans; providing

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[31]. H.U. Bijlani, Housing Finance, Mortgage Insurance and Secondary Mortgage Markets, HUDCO Chairman's Paper, 1980.

[32]. Shaw, P.P., "Operational Problems and Potential Low Income Housing," In Proceedings: Housing Finance Seminar, Goa, India. Washington, D.C.: Office of Housing and Urban Programs, USAID, Occasional Paper, 1984.

technical advice to borrowers on adjustments in construction and/or portfolio plans that will permit them to fulfill their aspirations more efficiently; and by convincing state governments that HDFC loans should be eligible for payment through salary deductions.[33] On over 76,000 loans HDFC made until June 1984, there was no individual loan default, and the loans in arrears ratio was 0.3 percent, lower than those of building societies in the U.K. and considerably lower than U.S. rates.

Interest Rate Risk. The firm has carefully structured its assets and liabilities so that there is very little interest rate risk exposure. Not only is there very little imbalance between the maturities of its assets and liabilities, but loan terms also include a fall-back clause that permits HDFC to increase interest rates if it so chooses. This provision is tantamount to giving the firm a catastrophic insurance policy. A shift in the interest rate structure that had such onerous implications for the U.S. thrift institutions cannot impose similar costs on HDFC. While HDFC does perform some maturity intermediation and does not raise rates unless it has to, it nevertheless has protection against large shifts in financial circumstances.

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33. State approval is required for the use of the deduction of payments from wages. In 1984 HDFC received approval of its loans as a deductible item. In some areas of the country, Banglore for example, large portions of payments are made in this way.

Corporate Risk Exposure. Because HDFC makes loans to corporations and to blocks of employees of particular corporations, the firm is exposed to the same type of risks as a commercial bank that lends to corporate borrowers. As a part of the decision-making process for such loans, HDFC closely reviews each firm's balance sheet and prospects, which proves to be quite effective in minimizing risks.

Sanction Risk Exposure. By agreeing to make credit available if a household can get the other necessary resources together, HDFC also affects the construction of housing of those who ultimately do not make use of the commitment. Because a household knows that a certain amount of funds will be available if it liquidates other assets, borrows from parents, buys land, etc., it may be willing to undertake these actions even if in the end it does not use HDFC funds. It is estimated that about 7 percent of the loan sanctions are not disbursed. and that about half of these canceled sanctions occur because the household gets money elsewhere. HDFC minimizes its risk exposure in this area in three ways: (1) reducing the ratio of sanctions to disbursements; (2) leaving its commitment open-ended as to the interest rate it charges; and, (3) diversifying its depositors and investors, so that rationing decisions by another financial institution or government regulator have less effect on its ability to deliver on its agreement.

In sum, HDFC has clearly moved aggressively but cautiously into housing finance intermediation. The realization of HDFC's good financial record[34], as well as the development in India of a regulatory environment in which spontaneous development of a market-oriented housing finance system can occur, is in large part attributable to the firm's regulatory entrepreneurism. As the first institution of this sort in India, i.e., neither a bank nor a non-financial firm, HDFC has had to seek modifications to a number of regulations that constrained its operations. For example, initially HDFC could not advertise for deposits; its deposits had to be of at least six month maturity; trust funds could not make such deposits; mortgage payments could not be deducted from the salaries of many workers by employers; and, the firm's eligibility to receive fund allocations from other large financial intermediaries, e.g., commercial banks, had yet to be determined.

A good deal of principal staff time (approximately 15 percent) goes into the development and marketing of proposals and recommendations for regulatory changes. HDFC's regulatory entrepreneurism also plays a large role in the firm's allocations of commercial bank funds. All these efforts by HDFC helped to establish ground rules to

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[34]See Annex 6 for Income Statements and Selected Ratios.

enable the private sector to become increasingly interested in housing finance services.

As regards the targeting of funds, the records of 1984 show that 30 percent of all beneficiaries were lower income households, with a monthly income of 1200 rupees per month.[35] In a further effort to reach households who could not afford to buy, HDFC introduced in 1985, a Home Savings Plan (HSP), modeled after the West German Bausparkassen program. Through HSP, an individual contracts to deposit a certain amount with HDFC over a two to seven year period, receiving a below market interest rate, and then the individual is permitted to borrow an additional amount at a below market rate.[36]

It may be concluded that HDFC is a financially sound institution[37] whose ability to sustain itself as such in the future is virtually assured if current policies are continued. Besides the direct effect of helping to provide adequate housing for lower income households, the primary

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[35]. HDFC, "Management Report: Operations as at June 30, 1981" and "Management Report: Operations as on June 30, 1984."

[36]. The household receives 6 percent interest on deposits. When the account reaches the goal, the savings are withdrawn and HDFC lends an additional amount up to 150 percent of the amount saved, at 8.5 percent. The household can borrow further at a standard HDFC rates, but both loans are counted in the maximum 70 percent loan/cost ratio and in HDFC's calculation of the borrower's ability to service the loan.

[37]See Annex 7 for Balance Sheets.

accomplishment of HDFC has been the demonstration that funds can be effectively mobilized for this purpose by reliance on private sector initiatives. The firm has shown a good deal of creativity in exploiting opportunities that are either created by or associated with existing credit market constraints.

Learning from this successful experience in India, main policy recommendations for the reorganization of HBFC into a self-sustaining commercially viable housing finance institution in Pakistan will be dealt with in the final chapter.

CHAPTER FIVE

CONCLUSION AND POLICY RECOMMENDATIONS

Given the major problem areas in the present functioning of HBFC as noted in chapter 3, the potential scope for several types of institutions operating alongside each other in the housing market of the future, and the lessons learnt from the successful experience of HDFC in India, the question arises as to which type of role or combination of roles should be undertaken by HBFC? The alternatives are that HBFC:

* becomes the "apex"[38] institution.
* converts into a mortgage bank.
* remains an institution solely to implement financial aspects of government housing policy.
* becomes a mixture of mortgage bank and special government agency.

To assign the role of "apex" institution to HBFC would be a doubtful step for several reasons. HBFC's past performance, present accounting problems and qualified balance sheet hardly give it a suitable image to become a credit leader of the housing market. The conversion of HBFC into a viable institution is bound to take at least several years while the need for an "apex" institution is urgent.

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[38]The apex housing finance institution is conceived to be the National Housing Bank, with a regulatory, promotional and re-finance role for other institutions.

HBFC does not possess many of the skills required to act as market leader. The problem of what to do with the current non-viable portfolio and unrecovered loans of HBFC would arise as these could not be retained in the "apex" institution. Finally conversion to an apex institution would jettison one of the main strengths of HBFC - that it has a countrywide network of branches and staff who understand local conditions.

The possibility of HBFC becoming solely a commercially operated mortgage bank can also be eliminated. The government is certain to continue to need the services of an organization which can implement its special financing schemes in the housing sector. HBFC has carried out this function for over thirty nine years, building up considerable experience (both good and bad) in the process. It therefore makes little sense for HBFC to move entirely away from this role, as this would require government to form yet another institution to take its place.

The choice, therefore, lies between HBFC acting solely as a distributor of special government finance and HBFC combining the roles of a commercially oriented institution like a mortgage bank and that of government agent. Learning from the successful experience of the Indian financial institution, from these alternatives I unhesitatingly recommend the latter because this is the most likely way to ensure the future efficiency and viability of HBFC. The prime issue is not whether HBFC should or should not concentrate its activities in assisting the less well off, although this is important. The fundamental consideration concerns how HBFC can optimize its contribution to the development of housing in Pakistan; optimization implies that whatever HBFC chooses to do, it should do efficiently.

No doubt HBFC's efficiency could be improved by the introduction of better management techniques, accounting procedures, management information systems and so on, but all these need some compelling force to make them effective and some basis on which to measure the results. The solution, in my view, is to expose HBFC management as much as is practical to the challenges of the market place. The need to ensure commercial viability is one of the most effective motivating forces available. It establishes an atmosphere/environment against which realistic yardsticks can be established for setting management goals and for measuring management effectiveness in the achievement of those goals.

If the proposal of HBFC adopting a dual function is accepted, then two alternative organization structures are suggested by which HBFC can implement this role. These are:

a) to set up an HBFC holding company with two subsidiary companies; one operating on commercial lines the other concentrating on government schemes.

b) to develop under a "unitary" management structure with one board of directors and one top management team guiding both the commercial and the government operation.

I recommend a "unitary" structure primarily for the same reasons underlying my choice of dual function. The objective is to create a situation where management have to develop market oriented skills which can be applied not only to the commercial operation but also to the implementation of government programs. If the "commercial" and "government" operations were divorced from one another, this cross fertilization of skills would be less likely, and there would be a strong possibility that the part of HBFC left solely with government business would suffer from lack of motivation, declining management and staff morale and a further deterioration in its efficiency. But there are some other reasons as well.

a) HBFC's annual disbursements are currently running at an annual level of Rs.1.9 billion, but the estimated total financing requirements of the poverty income sector alone are around Rs. 3 billion annually. Despite the great need for low income housing, concentration on this sector alone would inevitably mean a substantial contraction in HBFC activity because HBFC would be unable to raise sufficient funds and establish a sustainable revolving credit scheme.

b) Government schemes might not produce a steady flow of business for HBFC nor be distributed over the whole country: thus HBFC would not be able to utilize its main strength - its existing branch network.

As other privately or jointly owned mortgage banks enter into housing finance, it is likely that they will be attracted to the "cream" of the market and concentrate at least initially on larger size loans to upper income groups so as to minimize their operating costs. HBFC in its role as a mortgage bank, should therefore continue to have a special regard for the lower income end of the commercial market although it will need to balance this with at least some of the "cream". In essence the larger borrowers would be cross-subsidizing the smaller borrowers.

It is therefore recommended that HBFC should aim in future to become a financially self-sustaining institution, eventually earning the right to a license as a mortgage bank with particular focus on the lower income sector of the commercial housing finance market. It should also continue to undertake special schemes on behalf of the government on an agency basis. In recommending this alternative, I have taken into account:

* Government's intention that HBFC develops alternative sources of finance so as to reduce the pressure of housing finance on the budget.[39]
* the need to remove the barrier that subsidized financing places in front of other possible entrants into the housing finance market;
* that in the interest of overall efficiency, on government programs as well as normal housing finance, all management need to be exposed to the discipline of the market place.[40]
* the successful experience of HDFC in India, which has shown a great deal of creativity in exploiting the opportunities and demonstrated that funds can be effectively mobilized for housing finance by reliance on private sector initiatives.

POLICY RECOMMENDATIONS

In order to convert HBFC from being an administered department of government, which it now is, into the managed commercially viable operation that it ought to be, a wide range of changes will be needed to HBFC's policy,

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[39]See Seventh Five Year Plan, op cited.

[40]**Renaud, Bertrand** 1989. The Role of Housing Finance in Development: Issues and Policies, Washington, DC: The World Bank. Infrastructure and Urban Development Department

organization and systems. Above all, there is need for a fundamental change in the attitudes of the management and staff away from an "administrative" way of thinking towards a commercial "management" style. Instead of procedural changes, I will concentrate on the major policy changes which need to be implemented in order to create an environment which will enable the value of subsequent procedural changes to be maximized. The policy recommendations are aimed at converting HBFC into an institution which is able to attract funds from sources other than the government. For this, HBFC needs to improve its financial image; increase the earnings on its loans; tighten control over its accounting and improve loan recoveries; broaden the range of its management skills and enhance management calibre and staff morale generally; and make the company more manageable.

The proposed policy changes fall under five headings:

* organization and management
* financial restructuring
* fund raising
* loans and investments
* loan recoveries

Organization and Management

Here I will discuss only the top-level organization and management issues. The first need is to achieve a wider day-to-day management separation between HBFC and the Ministry of Finance.

This management separation can be achieved either by introducing changes to the HBFC act or by incorporating HBFC as a limited liability company. Initially, the equity would be held solely by government but there would also be scope for private capital at a later stage. It is suggested that experienced people from the financial community should be more strongly represented, including one or two from the private sector. There is also a need to strengthen top management by making the top positions of managing director, the deputy managing director, and the chief internal auditor "permanent" appointments. The present three year rotation does not give top executives sufficient time to understand and have a lasting impact on the conduct of the business.

Financial Restructuring

If HBFC is to have the ability to approach the market-- either in Pakistan or abroad-- for funds or to have any appeal to private savers, capital restructuring is an urgent necessity. The balance sheet needs to be "cleaned" by the write-off of long-term non-performing items like the "net assets in Bangladesh",[41] and there needs to be an increase in equity so as to restore the debt/equity ratio to an acceptable level of, say, 15:1. After restructuring, the improved image will need to be maintained through a conservative dividend policy which would enable the steady build-up of reserves: moreover, a sound debt/equity ratio should be maintained along with an increase in borrowing and lending activity.

In a sense, the restructuring can be seen as a bargain between HBFC and government, where HBFC agrees to give up its access to subsidized government funds in support of its future normal operations in return for a conversion of some SBP loans into equity and the write-off of other loans and commitments. As the enhanced equity is by nature a risk cover, it is important that this portion of HBFC's total capital is not invested in long-term housing loans. Instead, it should be placed in more realizable assets, including at least part in the ownership of HBFC's own head and branch offices, which would have the secondary effect

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[41]Net assets in Bangladesh aggregate to Rs. 271.2 million. The financial statements of HBFC reveal that although it has had no control over its Bangladesh dealings for over a decade now, these balances continued to be reflected as assets year after year, pending settlement of any possible compensation from Bangladesh. I am skeptical about the claims of compensation and recommend that the assets be written off. It is understood that other corporate enterprises in Pakistan took this action long time ago.

of helping to improve HBFC's image as a sound financial institution.

Fund Raising

The intention is that HBFC should be required in the future to mobilize its working funds from whatever source is sensible. This could include:

* loans from institutions abroad
* loans (at market rates) from government
* loans from other institutions (e.g., State Life Insurance Corporation) in Pakistan
* investments from corporate pension funds
* the issue of bearer and other bonds to the general public
* the acceptance of time and savings deposits from the general public

Clearly the move towards a full commercial operation will have to be phased. Until HBFC has improved its credibility in the eyes of the general public and the financial community, few sources of funds will be available to it. Moreover, the most welcome source, in the sense that it will be tapping new funds, is the development of savings and other borrowing from the general public and this will need to be delayed until HBFC has developed facilities and staff which are capable of handling cash.

There is indeed a natural sequence by which HBFC can move to the position of being a fully self sustaining institution, each step in the sequence being subject to preconditions. There are four steps in the sequence: these with their preconditions are as follows:

<u>Step 1</u>: Increase in equity by Government/SBP.

<u>Preconditions</u>

i) Restructuring of balance sheet including provision to cover doubtful recoveries.

ii) Discontinuation of future soft loans from SBP except to support the exiting portfolio (or new subsidization schemes of government)

<u>Step 2</u>: Obtaining loans/equity from multinational or other foreign financing agencies.

<u>Preconditions</u>

i) Increase in equity by Government/SBP.

ii) Implementation of commercial lending policies.

<u>Step 3</u>: Raising of large scale finance from the financial community or the public (formal and informal) through instruments such as floating of bearer bonds, issue of preference or ordinary shares, investment by pension funds and insurance funds.

Preconditions[42]

i) Increase in equity by government.

ii) Implementing commercial lending policies.

iii) Development of ability to forecast financial requirements by HBFC.

iv) Production of unqualified audited accounts.

v) General improvement of image of HBFC.

vi) Development of a funds management department within HBFC.

Step 4: Raising of savings directly from the public by way of term deposits and savings accounts.

Preconditions

i) All preconditions in step 3, plus.

ii) An improved branch network.

iii) The development of cash handling facilities and procedures.

iv) The training of staff to handle cash.

In addition to the above will be the funds which HBFC will manage "in trust" for undertaking special schemes on behalf of the government. This entire operation will, of

[42] It may be possible to float bearer bonds under government guarantee without meeting conditions iv and v, although the chances of success would be less and the failure of a premature issue could prejudice the chances of success of a later issue.

course, require the introduction of fund raising and managing skills within HBFC and the development of the ability to forecast funding needs.

Loans and Investments

There are some fundamental guide lines which could be used to develop future loan and investment policy.

i) Average rates of return on loans and investments should be sufficient to cover the average cost of borrowing plus the operating costs of HBFC plus a reasonable surplus from which to build up reserves and reward the equity holders. From the experience of HDFC in India, it seems that a spread of some 2.5 percentage points between borrowing and lending rates will be necessary. It is estimated that the average borrowing costs are around 12-13% at present, which would suggest lending rates in the range of 14.5 to 15.5%, but this is based on current market circumstances. Raising funds on the scale eventually required by HBFC could change this picture as could a change in the future rate of inflation.

ii) The rate of return on the instruments used to lend or invest funds must be based on the cost and profit of HBFC and not that of the borrower. Thus lending on a "Profit and loss basis" as currently understood would seem to be ruled out. The systems of "mark-up" or even leasing are preferable and acceptable under the Islamic system.

iii) Provision must be made in the loan or investment contract to permit an upward or downward adjustment in the rate of return from time to time. This does not mean that lending rates will be subject to frequent fluctuation, but simply emphasizes the point that no institution that bases its operation on long-term lending and shorter term borrowing can afford to allow its lending rates to get out of line with its borrowing rates for any lengthy period.

Given these guidelines other policy issues suggested are classified into three groups:

* Normal housing loans
* Other commercial loan activity
* Government schemes

a) **Normal housing loans:** Although the return on housing loans should be at one standard rate, HBFC should build up over a period of years to be able to offer a varied range of other loan conditions.

- loans to individuals should be for existing houses as well as houses under construction and for housing improvements.
- loan periods should be varied to fit the needs of the borrower from 10 to, say, 25 years subject to the applicants age and ability to repay.
- the method of repayment can be on a flat rate instalment, declining balance or life insurance linked basis to suit the requirement of the borrower.
- the size of loan should not exceed 80% of the corporation's evaluation of the property, including land.
- the assessment of the borrowers ability to repay should be rigorous and should ensure that
    - the applicant's total standing commitments (including property taxes and other loan repayments) will not exceed an agreed portion of his/her monthly income. The portion will vary according to size of income and be based on interpolated household expenditure estimates.

- there is sufficient third party evidence (reference from bank, employer, trade association) to support the applicant's income claim.

- in the event of a contract being terminated by the borrower prior to repayment installments being due, mark-up for the period the partner has had use of the corporation's funds must be claimed from the borrower at the corporation's maximum rate of return.

b) **Other commercial loan activity**

This can include the granting of second mortgages provided repayment assessment of applicant supports this. Other activities include entering into special loan arrangements with:

i) public or private corporations i.e., housing loans to staff coupled with repayment by deduction from the salary. Any subsidization should be left to the corporation and not HBFC, although HBFC could consider offering a discount on its base lending rate if circumstances (bulk repayment, security of repayment) justify.

ii) house building contractors for bridging finance or housing co-operatives, providing the applicants are financially sound and have a good track record. The amount of funds for this purpose should be limited to an agreed percentage of HBFC's total portfolio. Term of years should be 1 to 3 with a rate of return higher than the base lending rate.

c) **<u>Government schemes</u>**

The proposal is that these should be organized on a contractual basis.

i) The central or provincial government should specify the

- term, type and amount of individual loans or grants
- the rate of return, if any, to be charged to the individual borrower on a mark-up basis by HBFC
- the target borrower and how he is to be identified i.e., the procedure for assessing eligibility for the scheme
- the proposed number of beneficiaries
- procedure to be adopted in case of default

ii) HBFC should estimate cost of administering the scheme, including cost of estimated late recoveries, amount of subsidy and propose a contract "price' to be paid by the government to HBFC either in lump sum or in installments as appropriate.

iii) HBFC should maintain separate accounting for each such scheme.

Loan Recoveries

A complex of reasons for the poor recoveries outlined in chapter 3 calls for an integrated approach in seeking improvement. Part of the approach -- the charging of commercial rates of return and the increasing of loan sizes -- have already been suggested above. In addition, the first priority must be to ensure that HBFC does not continue to suffer from a large number of new defaulters in the future and that the future organization should be geared to preventing new default. Emphasis should be placed on the thoroughness of the loan approval procedure and not its speed. The key features of the reformed procedures could be:

- the setting up of an early warning system to identify potential new defaulters.
- rapid follow-up by the district offices.
- regular support to the district office from Computer Department with accurate account and default information.
- the development of meaningful and speedy information to management at the head office, zone and district level to identify where problems are arising.

- the establishment and keeping close contact with the borrower and reducing to a manageable level the number of accounts for which each district office is responsible.

By the reorganization of HBFC according to the above policy guidelines and with the implementation of many other procedural changes in respect of introduction of computerized accounting, stronger efforts to improve recoveries, steps to improve officer training, etc., the country can hope to find a commercially viable, self-sustaining institution, cross-subsidizing the small borrowers and maximizing its efforts to ease the housing problems of the less better-off section of the population. However, the proposals outlined in this chapter are not fully developed and it is considered necessary to pursue further research on the routine working of HBFC in order to arrive at a more detailed reform plan.

In view of the massive housing shortages enumerated in the earlier chapters, government shall also have to initiate measures to encourage resources to fund the housing finance requirements of the better-off also. There is a need for some initial direct support by government to new institutions in the housing finance sector, by way of providing equity for a new apex institution and through this medium also a share in the equity of one or two new mortgage banks. The potential market for private housing finance institutions in Pakistan is huge. The need for an effectively functioning government supplement to private housing finance for the lowest income groups is also great. The reformed HBFC would set an example by demonstrating to private investors that the provision of long-term housing finance is a viable financial market, i.e., that the loans provid a reasonably safe investment and a sufficient return to attract private investors to move into the creation of private housing finance institutions. It is hoped that HBFC together with an expanded institutional support framework, would help significantly to meet the continually growing housing needs of Pakistan.

HBFC RENTAL SHARING SCHEME

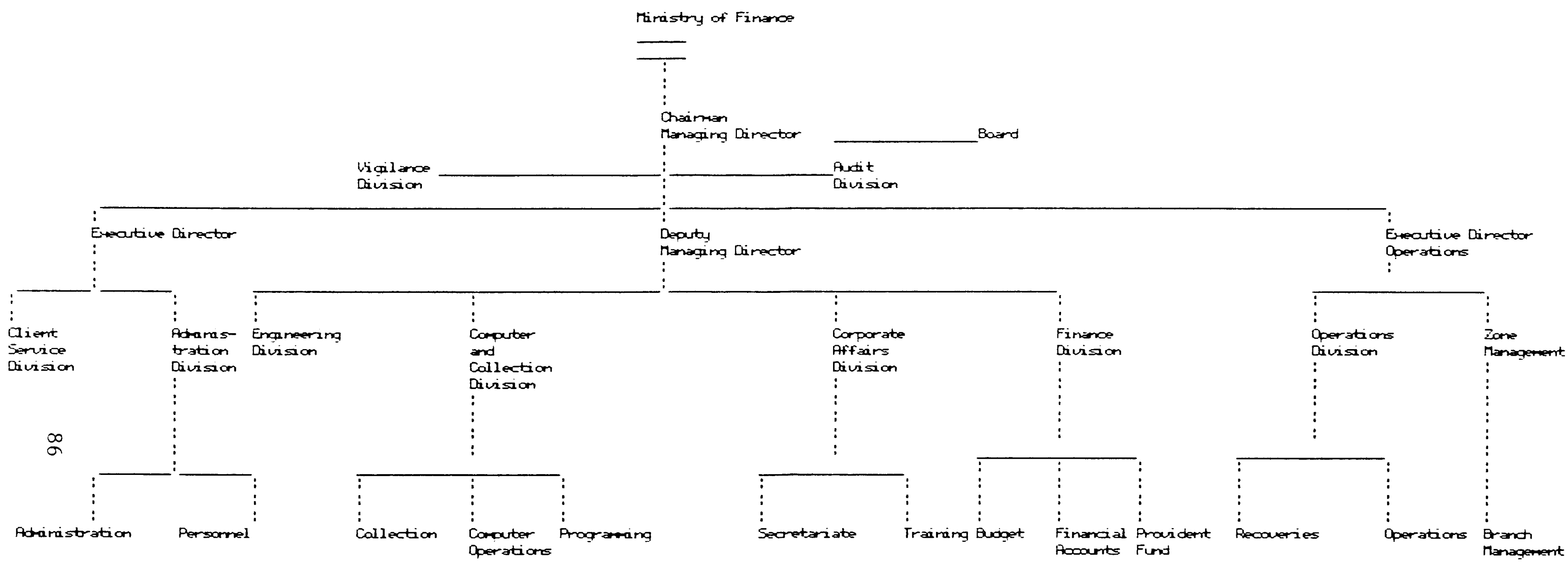
The Corporation introduced the first interest-free scheme of financing in Pakistan on 1 July, 1979. Under this scheme, the Corporation shares the rental income of the house which is determined in advance for a period of three years. Five cycles of three years each to determine rental shares and monthly installments have been fixed to allow for variations in the income of the Corporation derived from sharing the net rental value of the house. To determine the cost of land, cost of construction and anticipated gross rental value, a sample survey is conducted each year throughout the country and the rates so obtained are made applicable to the locality concerned. The cost of land of a locality is obtained by multiplying the area by the per sq. yd. price obtained through the sample survey. The cost of construction and gross annual rental value are obtained by multiplying the covered area of the proposed house by the respective rates per sq. foot obtained through the sample survey. To arrive at the anticipated net annual rental value, deductions to the extent of one-twelfth of gross rent and property tax payable to the provincial government or a local authority, as determined by the Corporation, are made from the anticipated gross rent. After arriving at the cost of land, cost of construction and net annual rental value of the house, the share of the corporation for the first cycle of 3 years is determined by applying the following formula.

$$\frac{\text{Investment of the corpor.} \times \text{Anticipated net rental value}}{\begin{array}{c}\text{Cost of the house}\\ \text{(Cost of land + cost of construction)}\end{array}}$$

The anticipated net rental value is divided by 12 to arrive at the monthly share in the net rent. The share of the Corporation in the monthly anticipated net rent plus monthly recovery from the principal fixed for a cycle is the monthly installment for a cycle.

Source: HBFC

ORGANIZATION OF HBFC (Head Office)



SOURCE: HBFC

HOUSE BUILDING FINANCE CORPORATION
1987-88 APPROVED INVESTMENT BUDGET
(Thousands of Rupees)

FUNDS AVAILABILITY	
Carryover from last year	52,341
State Bank of Pakistan credit line	1,450,000
Recovery of Principal from borrower/partners	743,600
Flood subsidy from Government of Pakistan	1,500
Faisal Town[43] installments from house purchase	67,000
Staff loans recovery of principal	600
Brought forward from Administrative Budget	471,760
Sale proceeds of HBFC House Islamabad[44]	165,000
TOTAL	2,951,801

UTILIZATION OF BUDGET	
Disbursement under Rent Sharing Scheme (RSS)	1,943,000
Payment of principal to SBP	400,000
Payment of interest of interest bearing scheme to SBP	52,545
Payment of principal to Government of Pakistan	35,000
Payment of interest to Government of Pakistan	12,304
Payment of RSS sharing of profit to SBP	33,400
Insurance Fund	500
Carryover to next budget	75,052
TOTAL	2,951,801

SOURCE: HBFC

[43] A development scheme undertaken in Lahore by the Lahore Development Authority.

[44] Building constructed by HBFC for its headquarter in Islamabad but subsequently sold.

"Investment" Rates of HBFC's PLS Scheme

"Investment" Amounts Rs	Level Payment Amount Rs	"Rental" return rate Year 1 %	"Rental" return rate Year 15 %	"Effective" return rate (Loan period) %
1. Lower Income				
60,000	583	6.75	14.03	8.28
100,000	1007	7.25	15.07	8.88
150,000	563	7.75	16.11	9.46
200,000	2120	8.00	16.63	9.76
2. Lower Middle Income				
60,000	583	6.75	14.03	8.38
100,000	1060	8.00	16.63	9.76
150,000	1698	9.00	18.71	10.93
200,000	2337	9.50	19.75	11.50
3. Middle Income				
60,000	636	8.00	16.63	9.76
100,000	1114	8.75	18.19	10.64
150,000	1753	9.50	19.75	11.51
200,000	2485	10.50	21.83	12.65
4. Upper Income				
60,000	837	12.50	25.99	14.93
100,000	1395	12.50	25.99	14.93
150,000	2120	12.75	26.51	15.20
200,000	2827	12.75	26.51	15.20
5. Non - RCC roofed houses in Rural Areas				
60,000	556	6.10	12.68	7.49
100,000	961	6.60	13.72	8.09

SOURCE: Analysis of HBFC documents.

ANNEX 5

NUMBER OF LOANS AND DISBURSEMENTS (CATEGORY-WISE)

(RS. IN MILLION)

YEAR	UPTO RS. 60,000		RS 61,000 TO RS 100,000		RS 101,000 TO 150,000		TOTAL	
	NO	AMOUNT	NO	AMOUNT	NO	AMOUNT	NO	AMOUNT
1982-83	8032	360.70	6791	559.70	2936	345.20	17759	1265.60
1983-84	10032	481.60	10825	899.60	2499	304.20	23356	1685.40
1984-85	7854	385.52	8982	735.37	2452	335.48	19288	1456.37
1985-86	9689	454.52	8256	685.63	3024	403.96	20969	1544.11
1986-87	6119	283.13	6029	504.46	3000	381.08	15148	1168.63
TOTAL	41726	1965.47	40883	3384.76	13911	1769.88	96520	7120.11

SOURCE: HBFC HEAD OFFICE

HOUSING DEVELOPMENT FINANCE CORPORATION OF INDIA
Income Statements and Selected Ratios

	1979-80	1980-81	1981-82	1982-83	1983-84	1984-85 6 Months
Income Statements (Rs. millions)						
Interest on Housing Loans	5.7	21.5	53.6	104.2	176.2	122.2
Fees and Other Charges	4.2	7.2	9.5	15.6	20.4	12.2
Income from Investments	5.2	6.1	21.4	24.8	58.1	34.9
Total Income	15.1	34.8	84.5	144.6	254.7	169.6
Interest Expense and Other Charges	1.8	11.2	47.9	87.1	174.4	119.2
Operating Income	13.3	23.6	36.6	57.5	80.3	50.4
Operating Expenses	4.0	6.7	9.5	14.2	21.1	14.4
Profit before Tax	9.3	16.9	27.1	43.3	59.2	36.0
Tax Provision	3.1	5.4	8.9	14.4	20.5	10.5
Profit after Tax	6.2	11.5	18.2	28.9	38.7	25.5
Legal Reserve	3.7	6.7	10.8	17.8	24.6	15.1
Divident	--	5.0	7.5	10.0	12.0	--
Previous Year's Profit (Loss) B/F	(0.1)	2.4	2.2	2.0	2.1	--
C/F to Balance Sheet	2.4	2.2	2.1	2.1	--	10.4
Ratios (% p.a)						
Profit after Tax/Average Net Worth	6.1	10.5	15.4	21.7	24.9	
Interest and Fees Earned/ Average Housing Loans	17.4	14.4	14.6	15.5	15.2	
Interest Expense and Other Charges/Average Total Debt	6.8	6.2	10.9	10.6	11.4	
Operating Income/Average Total Assets	10.3	8.1	6.6	6.0	4.8	
Interest Coverage Ratio	6.2	2.5	1.6	1.5	1.3	

SOURCE: "The Housing Development Finance Corporation of India: Evaluation of the Housing Guaranty Loan", A Report Prepared for The Agency of International Development. (June,1985)

HOUSING DEVELOPMENT FINANCE CORPORATION OF INDIA
Balance Sheets

(Rs.million)

	1979-80	1980-81	1981-82	1982-83	1983-84	1984-85 6 Months
ASSETS						
Net Current Assets	28	104	85	183	410	286
Investments	19	13	29	31	122	95
Housing Loans	101	298	594	985	1,611	1,944
Fixed and Other Assets	8	9	13	14	20	27
Total Assets	156	424	691	1,213	2,163	2,352
LIABILITIES						
Deposits	39	178	399	671	1,198	1,249
Borrowings	11	133	168	400	796	908
Total Debt	50	311	567	1,071	1,994	2,157
Paid-in Capital	100	100	100	100	100	100
Reserve and Surplus	6	13	24	42	69	95
Net Worth	106	113	124	142	169	195
Total Liabilities and Net Worth	156	424	691	1,213	2,163	2,352
Debit/Equity Ratio	0.5	2.8	4.6	7.5	11.8	11.1

SOURCE: "The Housing Development Finance Corporation of India: Evaluation of the Housing Guaranty Loan", A Report Prepared for Agency of International Development.(June, 1985)

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