Emerging Trends and Needs in Mortgage Finance in Pakistan

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Global Mortgages meltdown, and subsequent emerging situation in US , Europe and Pakistan

- Last year, we saw how the entire world financial system was affected by the mortgage meltdown in USA & Europe. If truth be told, then one of the contributory factors was the heavy reliance of banks and borrowers on opting for ARM (Adjustable Rate Mortgages). In Pakistan too, the reliance is most singularly tilted towards ARMs, and that has exposed the vulnerability of the borrowers who have witnessed the interest rates on their mortgages rise from 8% about 4 years ago to 16.50% currently.

- People in not even the most richest countries can afford this sort of rise in mortgage payments. So to expect Pakistan’s heavily stretched borrowers not to default in such circumstances is wishful thinking. And it is showing in the shape of mortgage NPLs that exceed 14.10% of the total outstanding mortgage portfolios of all banks.

- The answer lies in moving towards Longer Fixed Rate Mortgages, just like South Korea did, after their economic meltdown in 1997. While the economies in USA & Europe were dragged down by the mortgage crisis, the irony is that their revival is also being measured against the number of mortgages written every month! That shows the never diminishing nature of Mortgage Finance across the world.

Pakistan's severe need for housing seen through the mirror of high interest rates.

- From the Government to the Financial experts, everybody is keenly aware of the urgent need to focus on the problem of housing in Pakistan, principally because of the Rural to Urban migration taking place, but also because when people move into the middle class income groups, they tend to want to switch from rented accommodation to the owned one. However, no factor is hindering this switch for the average middle class Pakistani, than the incidence of exorbitantly high interest rates.

- The situation where this switch takes place conveniently and automatically is when the rental payments are equal to or just slightly lower than the mortgage payments. If we look at the US market today, one can obtain a 30 years fixed rate mortgage at 5.50%, while in Pakistan, one has to pay 16.50 % for a 1 year adjustable rate mortgage. This is precisely the reason that the product is simply out of the reach of the vast population that earns between Rs: 15,000 to Rs: 30,000 per month (which by the way forms the majority of earners in Pakistan’s work force).

High transactional costs

- The costs associated with undertaking a mortgage loan are very high, that include title transfer fees, lawyers fees, dealers commissions, stamp duties, and local taxes. These inhibit the prospective borrowers

Early stages of Regulatory Facilitation

- The Central Bank in Pakistan has started taking an active interest in the revival of the Mortgage Finance in Pakistan. This is not only very necessary, but is also very encouraging for those banks that have not stopped lending to this very important segment even after the recent economic crisis facing Pakistan's economic. Prominent among these active players are Bank Alfalah, Askari Bank, Faysal Bank, DIB etc. But to enable more players to enter the market, it will be necessary for the SBP to lay down a mandatory criteria for the banks to allocate for mortgage financing, like say 10% of the total credit portfolio. In the early days, Malaysia did this through CAGAMAS, and the result is that now Malaysia and Singapore are much ahead of the rest of Asia in financing mortgages.

- It is proposed that SBP may partner with specialized platforms like the Association of Mortgage Bankers for the enhancement and improvement in understanding of the Mortgage products among banks, for carrying out changes in regulations for Mortgage Financing, a well as bringing to Pakistan the wealth of experience available in the South Asian and East Asian developed countries in the field. India has already taken the lead in this field, and the existence of the SAHF (South Asian Housing Forum) that is now based in India is becoming a major mover in the industry. Likewise, the Housing Finance Bank is responsible for developing regulations for managing Mortgage Finance across the country, and has been assigned the role of a semi-Regulator, responsible only to the Central Bank. AMB can be developed to assume that role in 5-8 years, once the ground work has been developed to an advanced stage.

Separation of Mortgage Finance from Consumer Finance

- Serious thought needs to be focused on the need to separate Mortgage Finance from ordinary Consumer Finance. This is the most important point of my presentation today, as there is simply no comparison between clean loans, or even Auto Loans with Mortgage Loans. Let’s look at the numbers.

- While the banks can lend upto Rs: 2.00 million for Credit Cards and Personal Loans, the Auto Loans are also mostly capped at Rs: 2.00 million. However, the statistics available with SBP also show that the average size of the Mortgage loan in Pakistan is Rs: 2.50 million. And the highest cap (although removed by the SBP) among most of the banks is now set at Rs: 50 million. Now a Rs: 50 million loan is by no stretch of imagination, a consumer loan. It is processed like a semi-commercial loan. But let me say that the differences between a Mortgage Loan and a SME loan are almost minimal. There is nothing to consume in a Mortgage loan, rather it is a life-time investment, which, a credit card, or a car is not !

Let us also further look at the similarities between the 2 products.

Category	Mortgage Loans	SME Loans
Sales target market	Salaried, Businessmen, Self-employed Individuals	Businessmen, Self-employed individuals
Debt: Equity Ratios	70:30 mostly	70:30 mostly
Nature	Need based	Need based
Processing Requirements	Structured, based on verifiable income steams, external income verification involved	Structured, based on cash flows, and verifiable income streams, external income estimation involved
Documentation	Equitable/ Registered mortgage of residential property	Equitable/ Registered mortgage of commercial or residential property
Operations	Monthly installments	Flexible, or monthly installments
Foreclosure Process	Court derived, or under section 15	Court Derived or under section 15

- The above table clearly shows that the time has come to segregate Mortgage Finance as a stand-alone product category, to give it the boost and focus which is currently missing with commercial banks that treat it as just another component of their consumer banking product range.

- There is now an urgent need to revisit the Prudential Regulations relating to Mortgage Financing, and have a separate set of Prudentials exclusively for Mortgages. There is also an urgent need to revisit the existing Foreclosure laws in Pakistan, first between the SBP and the Banks, and then between the SBP, IFC, AMB, PBA and Ministry of Law and Justice, so that the weaknesses in the existing laws can be plugged, and the current examples of Dubai property foreclosures can be made a benchmark, so that the pile of NPL-related litigation cases pending with courts can be speeded up, and funds locked in Specific Provision as well as Suspended incomes in Banks’ balance sheets can be freed up and utilized for productive lending again.

Non-availability of state land for Supervised Construction and Lack of Developer Financing

- The issue of Developer Financing , or the lack of it will not go away, primarily because individual financing of housing units, especially concentrated in posh localities of Pakistani cities will not resolve the acute housing shortage.
- Just as the East Asian economies and now Indian market has witnessed growth in housing stock with the participation of private developers, so is this required in Pakistan as well.

- However, for the Pakistani banks to make meaningful contribution to this segment, it is essential that the private developers recognize the need to have audited accounts, clean borrowing records, transparent record of past completed, and <u>HABITABLE</u> projects free of any municipal or regulatory entanglements, and offering all essential civic amenities. Banks look at continuity of the Developer’s business entity. If a developer structures a company for a single project only, and winds it up after the completion, only to form another company for tax reasons, then the comfort of the banks will not be there.

- Furthermore the time has come for the Developers to have their entities rated, both for Project Risk, as well as Financial Risk, by reputable organizations like PACRA or others, so that banks can derive some comfort from that, while considering their financing proposals.

- Moreover, the Provincial governments have to free up state land, and a legal framework has to be created whereby, Banks can supervise completion of the projects with their financing, so as to ensure that the developers only charge for the constructed units/ flats/ houses, whose unit prices do not include the cost of land. This way, affordable housing can be made available to the middle class income segment, with availability of Bank financing.