**Indonesia 2011 Housing Reports. Housing finance chapter**

**INTRODUCTION**

The purpose of this paper is to assist the Government of Indonesia (GoI) in utilizing housing finance to create housing opportunities in the country. In short, it notes that while progress has been made in Indonesia, there are still obstacles to a vibrant mortgage finance sector, particularly for families of low and moderate means and /or active in the informal economic sector.

 It will make the following main recommendations:

* Develop voluntary savings for housing schemes
* Enhance PT-SMF ‘s role: better support alternative lenders, provide short term collateralized liquidity support, act as a quality standard setter for securitization structures and market
* Strengthen alternative lenders’ capacities
* Consider a risk sharing scheme for housing loans to low income, informal sector borrowers
* Use the new “liquidity facility” FLPP to improve the economic and social efficiency of lending within government assistance programs

**MARKET OVERVIEW AND EVALUATION**

1. **The market size still lags the overall economic development**

Residential mortgage loans have been increasing very fast in Indonesia –between 20% and 40% per annum. between 2005 and 2010, outpacing the already strong growth of the overall credit supply, and reaching close to 9% of total bank portfolios in 2010.. Relatively to the size of the economy, however, the volume of housing loans outstanding, estimated to amount to IDR 150 trillion in September 2010, still represents a low 2.3% of GDP, below the pre- 1997 crisis level (3.1%)..

1. **A costly financial service, inaccessible to large segments of the population**

Most of the commercial banks now offer housing finance products, and in the middle and upper segments of the market, the degree of competition is high It is however more evidenced by the struggle to control distribution channels, such as developers, than by a decrease of intermediation margins, which remain at the high level. Given that lenders charge moreover high up-front origination fees and origination fees and require flat insurance premiums (life and property), the cost of housing loans is high for consumers[[1]](#footnote-1).

In the low middle-income segment, the traditional – but partially privatized- state housing institution, Bank Tabungan Negara (BTN), has a near monopoly. After a significant loss of market share in the early 2000s, BTN has been experiencing a strong surge of activity since 2007, and with 27% market share nearly regained in 2010 its 2003 relative position. This results from dominance in the distribution of subsidized housing loans, 97% of which are made by BTN – only 2 other banks having some presence in this sector.

All these institutions only serve salaried population – tax returns are required even to benefit from subsidized loans[[2]](#footnote-2)- whereas a majority of the population is active in the informal sector of the economy (around 70% of the Indonesian employment).

Categories of institutions outside the mainstream financial system serve these segments, but their supply of housing loans is limited. Regional banks, which have the opportunity to reach out to lower income households in their communities, did develop ’ mortgage portfolios, but the volumes involved have not been growing nowhere near as commercial banks nor do they start with as large of a base. A mortgage business line was developed by some credit cooperatives. However, problems have been reported in the extension of low-income housing loans in this sector.

Despite sporadic developments, e.g. by the members of the Sharia based Baitu Maal wat Tamwil (BMT) network or BTN itself, Shariah lending is not widely offered.

1. **Financial, and especially interest rate, risks are constraining the development of housing finance**

Mortgage loans are extended for maturities of up to 20 years, but often last actually much less, as it is a common practice for borrowers to prepay. Because of funding constraints, interest rates are generally adjustable[[3]](#footnote-3) according to the lenders’ cost of funds, which can translate in a credit risk in stressed financial market conditions. Subsidized loan programs require fixed interest rates –during the first 5 to 8 years for the hitherto prevalent buy-down subsidy scheme, during the whole life of the loans with the new scheme (see below)-, which, in the absence of hedging instruments, can deter lenders from participating to them.

Securing long term liquidity is also a structural concern. Loans-to-deposits ratios are high in Indonesia - a success for the BI policy to induce the full mobilization of banking resources to develop credit. However, in the case of long term lending, using deposits as the source of funding beyond core deposit bases - considered as permanent resources for banks- generates a liquidity risk, which constrains the further growth of credit. This is particularly the case for BTN, which recurrently has a very high loan-to-deposit ratio (110% at the end of 2010, a ratio that is in fact higher if the volatile share of deposits is excluded from its calculation).

1. **The mortgage market infrastructure has benefited from significant progress, but some issues remain**

 The market infrastructure has been noticeably improved in the past few years, and many of the necessary components have been put in place. Challenges still remain due to factors such as a high level of transaction costs, questions about titling and registration, and certain debtor information.

* **Property rights and the titling administration** have gone through some degree of being rationalized and strengthened[[4]](#footnote-4).There is a relatively wide array of possession rightsin Indonesia, with widespread leaseholds or land usage rights, beside freehold titles. The rights attached to each category of title are clearly defined by law. However, this creates a relative complexity of the legal background, limits the categories of properties that can be mortgaged, and may constrain the future securitization market. .

The BPN registration system now covers the vast majority of the country, including the totality of urban areas and is largely computerized. . However, in practice lenders note that there are long delays, , due to operational bottlenecks. The same issues result in “hidden cost”, which may represent a widespread practice where land is being converted to urban usage.

Land aggregation and sub-division pose problems, which hinders large scale housing developments that could better achieve affordable prices. Another major issue is

the high level of transaction costs, which are in the range of 12%. It is detrimental to the liquidity and the transparency of the real estate market, induces legally unsecured practices, and is an incentive to informalities. . This, though, lowers the maximum amount that can be loaned on the property.

* **Mortgage rights have gotten stronger.** A 1996 law provides in theory the required legal security to lenders. Thanks to the legally strong creation principle- equivalent to a judicial decision-, their enforcement is in principle efficient, since mortgagees has the right of direct power of sale in case of default. Debtors’ rights are in the same time safeguarded by the obligation to sell repossessed properties by public auction. In practice, however, lenders continue to often choose a judicial route to circumvent debtors’ resistance. In addition, because of the cost of registering mortgages, financial institutions tend to accept simple powers of attorney that allow them to only formalize a security right when it needs to be enforced. Banks will generally try many alternatives to foreclosure such as alternative mortgage payment collection and social pressure on the homeowner. This contributes to relatively low delinquency and default rates
* **A partial debtor information system is now in place.** Bank of Indonesia established in 2006 a credit information bureau – BIK: Biro Informasi Kredit-, the cornerstone of Debtor Information System (SID) network. All commercial banks and some large finance companies are expected to participate in the scheme. All loans must be reported to it, without any declarative threshold. BIK collects and provides both positive and negative information, as well as repayment history. On line access is available. Two main shortcomings limit however the system efficiency: (i) it does not include multifinance companies and micro finance institutions;[[5]](#footnote-5) (ii) its operational capacity is insufficient. The extension of the system to non-bank financial institutions is being contemplated.
* **The appraisal industry organization supports its credibility.** Either as a result of formal regulation [[6]](#footnote-6)or self-regulation, licensed appraisers must comply with professional standards, selective certification processes, and ethics rules. The main challenge to the accuracy of valuations is the access to market information. However, appraisers noted that, at times, banks use internal appraisers on properties where the bank has a relationship with the developer, causing a potential skewing of prices.
1. **Credit risk management is fairly sound overall**

Credit policies are generally prudent, although the types of loans originated adds a layer of risk:

* Banks demonstrate caution in their risk management policies. Loans are mostly granted to holders of freehold titles. Ability to repay is a key criterion, and is not only assessed through debt-to –income ratios, but through budgetary estimates. Interestingly, banks preventively increased loan loss provisions in 2008, without deterioration of the performance of their portfolios[[7]](#footnote-7). One aspect of this cautiousness is to focus lending to salaried categories, an obstacle to the expansion of access to housing credit for those whose income is informal. However, debt payment to income ratios can be very high in government programs, a cause of concern and an obstacle to the expansion of finance in low income categories.
* The main weakness probably lies in the use of powers of attorney to create mortgages rather than actually registering the mortgages, a source of legal uncertainty. Furthermore, there does not seem to be much attempt to develop an expertise in assessing the risk of informal sector borrowers, starting with a capacity to indirectly measure undocumented incomes, and as a result, a large part of households do not have access to housing finance.
* The fact that variable rate mortgages are the predominant form of housing loans adds an element of risk, particularly in times of lower interest rates. Financial institutions qualify borrowers based on their current income and the debt service coverage needed to service the mortgage debt.. It is not common practice for financial institutions to look at sensitivity analyses to note the effect on increases on a borrower’s ability to service the debt.
* Indonesia’s Central Bank, Bank Indonesia (BI), developed a risk based prudential approach relying on supervision. It provides a better capacity to adjust to evolving contexts than set regulations. An example was recently provided with a guideline to limit Loan-to-Value- Ratios to 70% as against up to 90% in a recent past, a move that reflects an adjustment due to concerns about the evolution of real estate values and the increase of interest rates Also, BI initiated the construction of the main housing price index in Indonesia, a necessary real estate market monitoring tool.

As a result mortgage NPL ratios have been stable in a 3%-4% range since 2002 . Even in the case of BTN that serves lower income segments than the industry average, delinquencies stand at a reasonable 4% rate (end 2010).

1. **Adequate funding is insufficiently available**

Lending for housing essentially uses bank deposits as source of funds. The practice of adjusting interest rates according to the evolution of the lender’s own cost of fund mitigates the interest rate risks borne by financial institutions, but by transferring it to borrowers as mentioned. Overall, this does not seem to pose a systemic risk to the financial sector: loan to deposit ratios for commercial banks have been stable in a 70%-75% range in the past few years, and their net stable funding ratio, as established by BI following the Basle III concept, stands at the comfortable level of 2 (2010), and the volume of liquid assets is high. However, this is being achieved at the expense of the development of long term finance, starting with lending for housing. The use of capital market has been limited until now[[8]](#footnote-8), but two instruments are now available to mobilize long term resources:

* The Secondary Market Facility PT Sarana Multigriya Finansial (PT-SMF), established by the government in 2005. After a slow start due to regulatory constraints – initial limitation of the maturity of refinance loans, waiting period of 3 fiscal years before tapping the bond market- SMF is progressively developing its activity. Long term refinance loans outstanding amounted to IRP 1.6 trillion in the middle of 2011, while it has been involved in the securitization deals for BTN (see below). Its intervention mostly targets below median housing loans (IDR 150 million limit). As a market developer, SMF is working on a housing buyer education program and has also developed training materials for lenders that emphasize critical underwriting and documentation processes.
* A securitization framework has been developed and has been now tested 4 times by BTN , the institution most constraint by funding issues. PT-SMF has played a significant role in promoting the instrument, by acting as arranger, credit enhancer and standby investor.
1. **The mobilization of market resources for lower income groups remains a policy challenge**

a) A diversified set of loan linked assistance programs have been developed by the government: primarily in the formal lower/middle market for single and multifamily houses (KPR- RS and Rusunami), but also for self-construction and home-improvement by lower-income or informally employed households[[9]](#footnote-9). The assistance can benefit to households earning up to IRP 4.5 million per month (USD 500)- probably the median income in the capital region now-, for investments up to IRP 144,million.

The outcomes of these programs have been below expectations, for reasons linked to the supply side -insufficient attractiveness or land price constraints of low priced housing for developers[[10]](#footnote-10)- as well as to the financial side: disinterest of private banks for small loans – IRP 150 million seems to be a minimum threshold, which requires monthly income of at least 4 millions; asset liabilities constraints as explained above; insufficient capacities, especially in risk management, of multi-finance companies and regional banks, which would be more appropriate channels to serve informal sector households. In addition, the disbursement of subsidies has been affected by budgetary constraints in terms of volume and regularity.

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b) To remedy some of these obstacles, a new subsidy scheme and management system has been developed at the end of 2010.

The government provides long term funding at very low cost – 0.5%- to financial institutions in a proportion of 40% of lending. Loans interest rates are set at fixed levels, increasing with the amount borrowed and ranging from 8.15% to 9.80% p.a..

The eligibility criteria are (i) a first time purchase/construction; (ii) income ceilings: IRP 2.5 million (house) or 4.5 million (apartment); (iii) evidence of income tax.

The funding will be housed in a generic accounting structure, BLU – in this specific case BLU Pembiayaan Perumahan (BLU- PP)- designed as a revolving mechanism aimed at ensuring the continuity of the flow of resources throughout fiscal years, and combining various sources of funds. It is described as a liquidity facility, FLPP . FLPP will be funded from the government budget – IRP 5 trillion have been mentioned- , but also by institutional investors such as the Social Security fund Jamsostek and other social safety net entities.

The new systems raises several issues:

* It is not financially efficient to fund loans on fiscal resources: this scarce source of finance should be used to leverage market resources, and not be invested in houses. Experience shows that revolving schemes are quickly depleted due to price increases
* The fixity of interest rates may very well put off many institutions from participating in the scheme
* In fact, the only actual user is currently BTN, and the system reinforces its monopolistic situation, while securing a high level of intermediation margin[[11]](#footnote-11) - which, however, is partially justified by the increased exposure to interest rate risk for the 60% share of lending funded by the bank. The system is theoretically open to any lender, but does not address any of the issues that deter private sector institutions from developing products for lower income groups. Incentivizing new participants appear all the more important that BTN faces more funding constraints than other banks.

 c) The limits of Micro Finance for Housing are a strong constraint for the deployment of self-construction loans and lending to the informal sector. The Indonesian micro-finance market is large, but housing does not seem to be often an explicit credit purpose. Even the major market player, BRI does not offer a micro finance product specific to housing. This gap is detrimental to the government strategy: MFH is a cornerstone of the self-help programs, it could provide useful complements to assisted basic signal family houses or help an upwards mobility to wards formal housing in need of renovation.

**MAIN RECOMMENDATIONS**

1. **Develop Savings-for –housing systems**

The development of capital market is very much needed to comfort the expansion of housing finance in Indonesia. It will however take time, especially if the resources of some large institutional investors are directly allocated to housing through the new FLPP.

One route that GoI may want to consider is the stimulation of private savings prior to investing. Such schemes can be useful in supplementing the long term resources available for housing, and providing comfort to the financial system. There are various ways to design these schemes. A major differentiation is between mandatory and voluntary schemes. The first category - provident funds for housing- works well only in countries where the formal sector is largely predominant, like in Singapore. Where it is not the case, they can generate inefficiencies (e.g. Nigeria) or market distortions (e.g. Mexico). Voluntary schemes bring in the major benefit of facilitating the inclusion of informal sector population – by being disconnected from employers and by providing means to assess credit risks in the absence of documented income. Caution must be exercised however if tax incentives are provided to maintain the liquidity balance of these systems.

1. **Re-evalue PT- SMF’s value added and strategy**. Assisting BTN’s securitization deals is not necessarily the highest benefit that SMF can bring to the market as a whole. , The development of a bond issuance program would be important by providing investors with a new class of secured asset . Subject to adequate operational capacity, SMF’s added value would be enhanced by focusing on the stimulation of the overall finance supply by better helping lenders beside BTN, and by playing a central role in developing mortgage securitization globally. Possible options to consider are:
* Create a short term refinance window. Beside long term refinance, SMF could help primary lenders, and before all commercial banks, to manage their short term liquidity position. This could be done through a repo type of window, using mortgage portfolios as collaterals
* Emphasize the support to alternative lenders. Funding is a major obstacle for smaller institutions to develop long term lending. A larger access to SMF would stimulate the involvement of these institutions and given their commercial target, de facto support the public low income housing programs. SMF as a refinancier could also have a major impact on the sustainability of this market development by promoting safety and soundness standards in selecting and assisting eligible institutions
* Take the lead in developing market standards for mortgage securitization, and ensure the conditions of investors’ confidence by providing due diligence services, oversight functions such as master servicing , organizing the flow of information of portfolios and market transactions, etc.
1. **Consider developing a new credit enhancement scheme specifically targeting low income and informal sector borrower.**  One major obstacle to the deepening of the market, including in the case of BTN, is probably the fear of credit risk generated by the currently underserved population. A risk sharing scheme, supported by the government but still established on actuarially sound bases and promoting prudent lending standards[[12]](#footnote-12) , could act as an important lever in this respect. The participation to the SID network would be to include in the requirements of the scheme.
2. **Build the capacities of regional banks and micro-finance/cooperative institutions.** Beside an easier access to PT-SMF,, many non-mainstream institutions would benefit from large capacity building programs (dissemination of expertise, internal organization, product development, business plans, etc.)[[13]](#footnote-13). Technical assistance to reengineer business processes with the view of lowering the cost of small loans[[14]](#footnote-14) would be of utmost importance
3. **Enhance the impact of FLPP on the economic and social efficiency of low income housing finance.** The introduction of the liquidity facility, in principle accessible to any lender, should be an opportunity to improve the efficiency of the lending mechanism towards underserved categories. In particular, a significant enhancement of FLPP’s role could result from:
* Switching to a tender process for the allocation of subsidized credit lines. Each year, the recipients could be selected based on the lending conditions they would commit themselves to offer. This could have a beneficial effect on the currently very wide intermediation margins and contribute to reduce the borrowing cost incurred by low income households
* Creating an oversight capacity to regularly monitor the compliance of lending with the criteria set by the policy makers to benefit from the subsidy programs

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1. Closing costs range from 3.5% to 5% of the property value [↑](#footnote-ref-1)
2. BTN granted a waiver in the case of the smallest housing investment, but our understanding is that tax slips are required in the new assistance program that started at the end of 2010 [↑](#footnote-ref-2)
3. Loans with a first fixed rate period also exist, at a higher rate. According to a recent survey (NORC ,July 2008), a large majority of households would prefer fixed rate loans [↑](#footnote-ref-3)
4. See notes on land issues for more detailed analyses, and illustrative case studies [↑](#footnote-ref-4)
5. These institutions have the ability to participate but on a mere voluntary basis [↑](#footnote-ref-5)
6. BI regulation of independent valuations for secured loans above a certain threshold, BAPEAPM requirement of code of conduct, MOF requirements [↑](#footnote-ref-6)
7. BI Financial stability Review Sept 08 [↑](#footnote-ref-7)
8. BTN issued a few corporate bonds, lastly in 2004-2005 [↑](#footnote-ref-8)
9. See Marja Hoek-Smit 2008 report for a detailed description and evaluation [↑](#footnote-ref-9)
10. Despite the “1-3-6” rule aimed at socially diversified projects [↑](#footnote-ref-10)
11. From 4.25% to 5.90% [↑](#footnote-ref-11)
12. giving for instance the priority to affordability metrics and prior savings requirements over loan to value considerations [↑](#footnote-ref-12)
13. the various initiatives undertaken in the last few years to integrate micro-finance institutions in federations toped with apex entities could offer opportunities to strengthen MFIS’ financial and operational capacities [↑](#footnote-ref-13)
14. For instance: demand aggregation, borrowers pre-qualification, new technology solutions to handle payments [↑](#footnote-ref-14)