Financing 10 million new houses for Pakistanis: What is the State Bank doing?

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- The latest State Bank of Pakistan (SBP) guidelines for housing finance retain provisions for banks to provide housing and construction finance to under-construction projects, with a key amendment — housing finance providers are no longer required to mitigate their risk by lending only to projects where they are already offering construction finance.
- While the motivations behind the policy are commendable, it is unlikely that the current iteration will significantly increase the supply of housing units, since the new requirements raise a host of new potential complications for builders and developers in the form of inter-bank coordination, documentation, ranking of charges etc.
- Since the SBP guidelines for housing finance consistently impose substantial costs and conditions on builders and developers, to facilitate access to housing finance through their under-construction projects, any effective policy response to the nationwide housing shortage must take their practices and concerns into consideration as well as those of the banks.

Background and context

Since July 2020, the State Bank of Pakistan (SBP) has taken a series of steps to accelerate the construction of new houses to meet the widely-reported shortfall of ten million housing units across the country. These measures compelled banks to increase lending to the construction and housing sector as an augmentation to other steps taken by the Government of Pakistan to make it easy for citizens to buy housing units through mortgage financing.

While these decisions appear to be motivated by the right policy instincts and are aligned with the construction finance policy, there are several caveats to how these past measures are expected to play out. These implications were discussed in the Tabadlab First Response published in September 2021 – **Central Bank as Real Estate Regulator: Can the SBP's Latest Guidelines Help Meet the Housing Shortfall?** A summary of past developments in this series is presented below:

July 2020: SBP set lending targets for all banks to extend credit to construction and housing finance. Construction finance covers lending to builders and developers of various projects, while housing finance entails lending to end-users to purchase, construct, or renovate a home – whether a house or an apartment. SBP required banks to lend at least 5% of their total domestic private sector credit to construction or housing finance, by December 2021.

October 2020: SBP took up the role of monitoring and disbursing the mark-up subsidy programme announced by the Government of Pakistan for buyers of housing units costing up to PKR 6 million (circular issued on October 12, 2020).[1]

November 2020: SBP relaxed the prudential regulation of accepting another liquid security or residential property to meet the prescribed 15% equity contribution of the borrower for units being financed.

April 2021: SBP expanded the type of transactions that can be counted towards meeting the construction and housing finance target whereby banks could invest in or lend to Real Estate Investment Trust (REIT) management companies, invest in Sukuks and bonds issued by the Pakistan

Mortgage Refinance Company, or lend to borrowers indirectly via microfinance banks. While this step would have helped banks meet the construction and housing finance target, the impact on housing stock was uncertain.

As a result of these steps taken by the regulator, new construction and housing lending in FY 2021 totalled PKR 259 billion, an increase of 75% over FY 2020.[2]

September 2021: SBP made a significant change to the regulatory landscape by allowing banks to provide housing finance to buyers in under-construction projects. While the circular referred to both low-rise and high-rise under-construction projects, it was mainly relevant to high-rise projects. The purpose of the housing finance during the construction phase, as envisaged by the SBP circular, was to enable the end-user to make periodic instalment payments to the builder while the project remained under construction.

The latest move

In the announcement made on February 25, 2022, SBP has removed the central pillar of the September 2021 guidelines – that housing finance providers hedge their risk by lending only to projects where they are already offering construction finance. Under the latest circular:

1. A bank can provide housing finance to purchasers in projects where builders and developers are not availing construction finance.
2. To mitigate the risk to the bank offering housing finance to purchasers in these projects, the builder must pledge the underlying land to the housing finance provider.
3. Later if another purchaser, or a group of purchasers, obtain housing finance from another bank – different than the bank providing housing financing to the initial purchasers – to secure its risk, the second bank should arrange an NOC from the first bank and enter a bilateral arrangement for collateral against land.
4. The builder, even when not availing construction finance, must also comply with those requirements of the SBP guidelines for construction financing applicable to builders who have availed construction finance.
5. Builders are required to obtain written consent from those purchasers that are not availing housing finance and submit the original copies such letters to housing finance providers. This requirement existed in the previous guidelines, but has been re-emphasized in the latest circular.

Implications of the revised SBP Construction Financing Guidelines

SBP expected that the guidelines laid out for construction financing in September 2021 would have made construction financing more accessible for builders and developers who were previously unable to secure such financing. While analysing this previously, it was cautioned that the changes instituted were unlikely to result in the desired increase in housing unit supply.

> The assumption underlying SBP's guidelines is that the availability of construction financing will entice the builder to comply with real estate regulations, bring additional transparency into the project and pay their fair share of taxes. Time will tell, but there is a chance that this overreach of SBP into real estate regulation will discourage the majority of the builders from approaching the banks for construction financing. [...] The SBP's noble intentions in this instance will not be enough to level the playing field amongst the builders, and they will do little to incentivize better treatment of consumers at large.
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> It is likely that the new guidelines to promote the financing of housing units in under-construction projects will end up encouraging the construction of high-end apartments by renowned builders. Though this will help SBP inch closer toward its targets for construction financing, it will fall short of generating more affordable housing units in the country, ostensibly the very policy goal of the push for easier construction financing. It will also not help in substantially contributing to the reduction of the ten million housing units' gap in Pakistan.[3]

SBP issued a statement clarifying their intent:

> The SBP guidelines in no way benefit "influential builders only". Actually, these are designed to promote housing and construction finance for all categories of projects including affordable and low-cost housing. The objective of these guidelines is to facilitate both potential home owners and builders who are currently unable to access bank finance for under construction projects. Under these guidelines, financing will also be available for small projects of two to three apartments with area as small as 5 Marla or less.
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> The objective of the SBP guidelines issued is not to micro manage the banks. On the contrary, these guidelines, prepared after detailed consultations with banks, provide an enabling framework that will help banks to venture into this new segment of financing. It is entirely up to the banks to decide which project and builder are credit worthy in accordance with their internal credit policies and due diligence.[4]

Given that the latest circular removes the conditions previously imposed on builders availing construction financing, it appears our concerns about minimal impact on increased construction financing were well placed. The new guidelines, we believe, can further create potential issues and challenges, and will not address fundamental drivers that can increase housing supply.

The SBP's intent to facilitate builders, developers and purchasers is commendable. However, the following challenges can potentially limit the effectiveness of revised guidelines:

1. Builders and developers who have not availed construction financing for a given project will be required to create a mortgage charge over the land and the project. Builders who are constructing an apartment building – for instance, of 100 apartments – on free and clear land, from their own resources without taking any construction financing from the bank, will not find it viable to give a mortgage over the land to a bank simply because one apartment buyer is getting housing finance.
2. Builders who are not availing construction financing will nevertheless have to comply with the SBP guidelines for construction financing, incurring all the costs of compliance without any particular benefit – something they are unlikely to do. Given the slow adoption of this facility since the September circular, the new guidelines – which retain these compliance costs – will probably inhibit uptake in the future as well.
3. Purchasers are not restricted to any lender in their search for housing finance. This means that, in the few cases where a builder might be willing to facilitate purchasers, the project could have several banks and DFIs trying to create mortgage charges over the land and project. This would likely raise previously unforeseen complexities of inter-bank coordination, documentation, ranking of charges etc.
4. Housing finance providers will not only have to assess purchasers' capability to service their mortgage, but as the project is under construction, they will have to undertake the same credit assessment that construction finance lenders do. This means estimating the project completion risk. Mortgage finance providers in developed markets only finance completed projects for a specific reason – it limits their responsibility to assessing only the mortgage servicing capability of the purchaser and not the builder/developer. To estimate project completion risk, housing finance providers will require information from builders (cashflows, feasibility, bank balance, track record, cost reports etc.) to assess if the project can be completed on time. If builders are not utilizing construction financing in order to avoid disclosing this information to construction financing lenders, there is a very low probability that they will disclose this information to a purchaser and/or a purchaser's bank. Similarly, if multiple purchasers obtain housing finance from multiple lenders, the builder will have to disclose this information to each lender.
5. Many of these projects are under construction and may have been under construction for extended multi-year cycles. Several of the purchasers who aren't availing housing finance and have been making their payments regularly, will be taken aback when the builder reaches out to obtain their consent to subordinate their rights to a bank just because one of the other purchasers is availing housing finance. It is not clear if consent is required from all

owners in a project, though this is expected to be the case. If so, a purchaser refusing to grant consent will create further complexities.

Conclusion

It is important to view housing from a holistic lens that accounts for views, considerations, practices and concerns from all stakeholders that will be essential to increase housing supply especially affordable housing. While the latest guidelines do refer to a consultative process with banks,[5] it is unclear if developers and builders have been consulted. Since these guidelines impose significant costs on them in the form of compliance, reporting, and transparency, builders and developers must be aligned and fully on-board to enable access to housing finance through their under-construction projects. This will be essential to enabling a functioning housing ecosystem for improving asset ownership for Pakistanis.

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Endnotes

[1] State Bank of Pakistan. (2020, October 12). *Markup Subsidy for Housing Finance* https://www.sbp.org.pk/smefd/circulars/2020/C11.htm

[2] Iqbal, Shahid. (2021, July 16). *Housing, Construction Finance up 75pc in FY21: SBP*. Dawn. https://www.dawn.com/news/1635289

[3] Khalil, Ibrahim. (2021, September 10). *Central Bank as Real Estate Regulator: Can the SBP's Latest Guidelines Help Meet the Housing Shortfall?* Tabadlab. https://tabadlab.com/central-bank-as-real-estate-regulator-can-the-sbps-latest-guidelines-help-meet-the-housing-shortfall/

[4] State Bank of Pakistan. (2021, September 11). *Clarification*. https://www.sbp.org.pk/Media/Clari/2021/Clarification-11-Sep-21.pdf

[5] State Bank of Pakistan. (2022, February 25). *Guidelines for Financing of Housing Units in Under-Construction Projects*. https://www.sbp.org.pk/smefd/circulars/2022/CL5.htm