# Housing Finance in Bangladesh

## Improving Access to Housing Finance by Middle and Lower Income Groups

by

**Marja C. Hoek-Smit**

Prepared for
The Government of Bangladesh
Ministry of Local Government, Rural Development and Co-operatives)
and
UNDP/UNCHS (Habitat)

December 1998

The author wishes to thank Dr. Shahnaz Huq-Hussein of the University of Dhaka for her unstinting support in the process of conducting the fieldwork for this review. The views contained in the report are those of the author and not necessarily those of UNDP/ Habitat.

# I BACKGROUND AND CONTEXT

The lack of available and accessible housing finance has been identified by the Government of Bangladesh (GOB) as one of the important hurdles in improving the housing conditions for middle and lower income households. In that connection, the Ministry of Local Government and Rural Development, and Cooperatives, recently requested UNCHS to provide policy advice on the housing finance sector, with a particular focus on policies to increase access to housing finance by middle and lower income households. UNDP agreed to provide funding for the study. The housing finance consultancy is to a) provide a brief overview of existing housing finance systems in Bangladesh, including those available to the urban and rural low-income households, and, b) to make suggestions for the improvement of housing finance mechanisms for lower-middle and lower income groups suitable to the conditions in Bangladesh. The consultancy took place from November 11 through 23, 1998 in Bangladesh.

UNCHS has been involved in the shelter and urban sector of Bangladesh since 1979. It conducted an Urban and Shelter Sector Review in 1993, and has recently formulated an Urban Poverty Alleviation Project which is awaiting final approval by the GOB. In addition, UNCHS has completed a Shelter Rehabilitation Assessment Study after the recent floods. A housing finance component that would increase access to housing credit for lower income groups, would complement projects by the GOB and International Agencies that already include micro-credit, infrastructure and services provision.

The need for improvements in the housing finance system has been expressed in several studies and by different government and international agencies. The Asian Development Bank prepared a comprehensive urban institutional improvement project in 1993, of which an analysis of the housing finance sector was a part. Detailed recommendations for action were made. However, the project was not approved and government did not take up the proposed actions. The World Bank is presently assisting Bangladesh in the formulation of an Urban Strategy. The draft report also identifies housing finance as one of the constraints in improving housing in urban areas, but it does not include an analysis of the sector. The present study builds on these efforts and attempts to formulate recommendations for improving access to housing credit for various groups of presently underserved urban and rural households.

The analysis and related recommendations fall into four categories: 1) the macro-economy and the efficiency of capital markets generally as these relate to the functioning of the formal housing finance market, 2) the way housing is supplied in urban and rural areas, 3) the structure and efficiency of the housing finance system, and, 4) micro-finance mechanisms for housing accessible to households that are unable to be served by the formal finance system. This brief consultancy cannot do justice to the complexity of these four different areas, but attempts to provide a coherent picture of present practices and potential improvements that might be explored in both the formal mortgage market and the alternative housing credit programs offered by micro-finance providers.

## II CURRENT TRENDS IN HOUSING FINANCE

Over the last few decades, comprehensive studies of housing markets and housing finance systems across the world have created a shared body of knowledge on what constitute effective and non-effective housing policies and housing market regulations. In particular, programs to finance social housing are perceived differently today than a few decades ago, both in developing countries and advanced economies. The focus is on creating well- functioning housing markets and the expansion of a safe and sound housing finance system.

Housing finance systems in many developing and emerging economies share several characteristics. First, most housing finance systems are, in Renaud's words, "institutional patchworks" that comprise private sector lenders as well as several government-managed housing finance institutions or programs (Renaud, 1997), in the form of special government housing "banks" or special housing funds capitalized by payroll taxes. These institutions stifle competition in the financial system because of their access to low-cost government funds and prevent innovations in the way housing finance is provided. In most countries these programs are dominated by special interests, and allocation of funds to either private borrowers or construction firms no longer focuses on disadvantaged groups. The private banks do not consider long-term lending for housing a priority because of the associated risks in non- integrated financial systems and the predominance of government finance programs catering to the same professional middle class to which the financial sector might want to extend their services.

Second, many government programs use interest-rate subsidies on fixed-rate long-term mortgages which have some negative characteristics: 1) the funding and cost of special government lending programs to the economy is non-transparent, i.e., it is not on the budget and increases with inflation; 2) the subsidized interest-rate programs stimulate debt acquisition rather than savings, in other words the more one borrows, the higher one's subsidy (see Renaud, 1984, 1997; Diamond, 1997; Hoek-Smit, Diamond and Bovet, 1997; Hoek-Smit, 1998 for analyses of housing finance systems in Latin America, Asia and Africa).

As a consequence, the formal housing finance system only provides mortgage loans for a small proportion of newly constructed houses and home purchases. A much larger proportion of households than necessary have to finance housing from savings or build incrementally and at a low standard because upfront finance that would allow them to purchase a higher quality home and pay for it over a longer period is not affordable or inaccessible. Of course, formal finance is inaccessible for many households in developing countries for other reasons. These include insecure and undocumented incomes, a lack of land and housing options for middle and low income households that are acceptable as collateral to banks, and the high costs and related lack of interest by the banks to work with small clients, to name just a few.

Increasingly, developing countries move towards a more integrated modern housing finance system. First, there is a trend to increasingly rely on capital markets as sources of funds for primary housing finance lenders rather than on depository institutions alone. Second, it has been shown that, if assistance to low and moderate income households is necessary, subsidy programs are best designed to allow households to participate in the housing market, rather than provide public housing. Third, support to moderate income borrowers to acquire loans through the private financial sector has proven to be most efficient if it is provided as a direct demand subsidy in combination with other facilitating measures and incentives to the banks rather than as interest-rate subsidies through segregated government lending programs and institutions. This way, mixing subsidized finance with market-based lending is avoided in order not to distort prices and create disincentives for expansion of the private finance sector (e.g., preventing access to capital markets). Fourth, for those households who cannot use the private sector for their housing finance needs, even with incentive programs, special social housing funds or lending mechanisms are used that provide shorter-term and smaller loans, at concessionary rates if necessary, but which are clearly separated from the rest of the housing finance system. Both types of finance subsidies are set up to be efficient, transparent and well targeted to those who cannot participate in the formal housing finance sector without such support.

Many Latin American countries (e.g. Chili, Costa Rica) and several South Asian countries (e.g. Malaysia, Thailand, India) have initiated a fundamental restructuring of their housing finance systems according to these principles. Even though all countries have a different history in the development of their housing and housing finance system, it is important to make use of the experiences of other countries with a similar economic and financial background. The analysis of the Bangladesh housing finance system is undertaken against the background of these international developments.

# III THE ECONOMIC CONTEXT

Bangladesh is one of the poorest countries in the world with a per capita GNP of $260. It faces continuous challenges in maintaining economic stability, improving public sector efficiency and inducing economic growth sufficient to alleviate the desperate poverty of a large segment of the population. This section briefly reviews current trends in the economic and financial environment with a particular view to the housing sector.

## A. Structure and Growth of the Economy

Since the 1980's Bangladesh has moved towards establishing a liberal market-based and private sector driven economy. Prudent macro-economic and fiscal policies have resulted in the highest foreign reserve in decades, increased contribution in GDP and a boost to the value of the Taka compared to other currencies in the region. It appears as if the economic turmoil in East Asia has had only a small impact on Bangladesh.

The economy has been diversifying. The agricultural sector, which provided 62 percent of GDP in 1975 accounts presently for roughly 30 percent of GDP. The services sector is the largest and fastest growing, contributing 50 percent of GDP and growing at a rate of at 6.5 percent during 1996. Housing services have remained at 7 percent of GDP in constant prices. By far the largest export product are garments. The garment industry has seen an unprecedented increase during the last decade, employing an increasing proportion of the labor force of which the majority are female workers.

Inflation has increased in recent years, but remained modest. However, in February 1998, the year-on-year rate was 8.1 percent, while in previous years it had declined steadily to below 5 percent. Housing costs have risen faster than the overall CPI. Several factors contributed to this rise in inflation according to the World Bank and Asian Development Bank; monetary expansion, a poor aman crop, and political instability (1998, p.7). Foreign exchange levels have stabilized and government's deficit has decreased gradually to a present low of 5.3 percent of GDP for FY97.

The GOB has contained spending by downwards adjustment of its Annual Development Program (ADP) (an 11.5 percent decrease between FY97 and 98 in Taka amount). Unfortunately, the efficiency and cost effectiveness of programming and implementation of the ADP is considered inadequate across sectors, including the housing sector (World Bank, 1996). For example, an increasing proportion of the public expenditure program for housing is allocated to "quick fix" supply-side programs that do not improve the long-term functioning of housing delivery to moderate and low-income households and lack an institutional "home" in which housing policies can be assessed. Allocation to the housing sector are approximately 5 to 6 percent of the ADP.

The ADP is increasingly dependent on foreign funds. The debt-GDP ratio in F97 was over 50 percent. However, most of the debt is official multi- and bilateral long-term debt provided on concessionary terms. Debt servicing is therefore low relative to the size of the debt and amounted to close to 11 percent of export earnings in FY97. These concessionary loans have, however, had a distortionary influence on interest rates in the country. Foreign lending for the housing sector directly is negligible.

The domestic savings rate has increased over the last few years, but is low compared to neighboring countries. It is estimated at 15 to 16 percent of GDP. When net factor income and transfers are included the national savings rate rises to approximately 20 percent.

## B. Employment and Household Income Distribution

Bangladesh has a population of approximately 124 million people. Population growth decreased over the past decades and was 1.6 percent per year during the 1990 -1996 period. The labor force grew with an average of 2.1 percent during that time, due to an increasing number of female participants. Over that same period, GNP at constant market prices increased at an average rate of 4.8 percent and economic growth for 1998 was estimated at 5.5 percent. However, the devastating floods, politically induced strikes or hartels, the poorly performing financial sector and losses in state-owned enterprises (SOE) have had a negative impact on the economic situation. There is a broad agreement that Bangladesh's economy could and needs to perform better than it does presently in order to address the severe poverty problem (World Bank and Asian Development Bank, 1998, p.1). Indeed, these economic growth figures have had only a modest influence on the proportion of people living in poverty. While poverty is down from 42.6 percent of the population in 1991/92, it was still 35.6 percent in 1995/96. The World Bank estimates that close to half of the urban population (11 million people) falls under the poverty line with incomes of Tk.3500 ($75) or less per month.

The shift to a less agricultural economy is reflected in the increasing proportion of the population residing in urban areas. Urban growth rates are around 5 percent per year, compared to overall population growth rates of 1.6 percent and rural to urban migration is high. Still, approximately 80 per cent of the population lives in rural areas. Rural immigrants are increasingly comprised of young women who are attracted by the opportunities in the growing garment industry. However, urban formal sector employment has not kept up with urban population increase and the majority of the urban labor force is dependent on informal sector employment. [1]

The 1990 census showed the proportion of household income derived from the different sectors in the economy.

**Table IIIa Sources of Income (%) By Urban and Rural Sector, 1991-92**

[1] A planning study for Dhaka in 1980 found that close to two-thirds of total employment is in the informal sector, particularly in retailing, construction and transportation. This figure explains the low unemployment figures of approximately 4 percent of the labor force. The same study showed that close to 16 percent of total employment is in the government sector, which would include almost half of all formal sector employment (Islam, 1998).

| *Source of income* | *National* | *Rural* | *Urban* |
|---|---|---|---|
| Agriculture | 33.4 | 38.3 | 5.9 |
| Business & Commerce | 14.8 | 15.0 | 24.7 |
| Professional, wages, salaries | 24.3 | 7.1 | 37.9 |
| Housing sources ( income from house rents including computed rent of owner-occupied and rent free) | 9.4 | 9.6 | 11.0 |
| Gifts and remittances | 10.3 | 6.8 | 9.1 |
| Other sources | 7.8 | 23.1 | 11.4 |
| Total | 100.0 | 100.0 | 100.0 |

Source: Household Expenditure Survey, Bureau of statistics (BBS) 1991-92, p. 13

Data on household incomes are notoriously difficult to compile since most households and individuals have several sources of income, both formal and informal. Remittances from relatives overseas are part of many households' income, but are difficult to trace. Therefore all household data are approximations. Below we show the income distribution projections from the 1993 ADB Institutional Strengthening study. These figures are in line with those used in the GOB Housing Indicators Report of 1995; median monthly income figures for Greater Dhaka were estimated at Tk.4000, slightly higher in Chittagong and less than that in the other cities and towns.

**Table IIIb: Projected household income distributions, 1992/93**

| | **Monthly Household Income (Taka)** | | | |
|---|---|---|---|---|
| **Percentile** | **Greater Dhaka** | **Dhaka Built Up** | **Urban Areas** | **Rural Areas** |
| 10th | 1,600 | 1,650 | 2,100 | 1,200 |
| 25th | 2,300 | 2,600 | 2,800 | 1,700 |
| 50th | 3,800 | 4,750 | 4,400 | 2,500 |
| 75th | 8,000 | 9,500 | 6,800 | 3,800 |
| 90th | 20,000 | 25,000 | 11,200 | 6,100 |

Source: Consultants estimates from data in the Reports on the Household Expenditure Surveys and the Greater Dhaka Land-Use Transportation Study, 1993.

Recent poverty level estimates (see above) are an indication that incomes have not kept up with inflation over recent years. Therefore, while nominal income figures will be higher than those calculated in 1993/1995, it is unlikely that the full CPI increase over the years can be applied to calculate present income figures. Micro-finance lenders estimated urban median incomes at approximately Tk.5000 to 5500 and rural median incomes at Tk.3000 to Tk.3500.

# IV THE FINANCIAL SECTOR

## A. Overview

The overall size of the financial sector relative to GDP remains smaller than that for other countries in the region (see Table IVa). However, the overall macro-economic environment has provided a favorable climate for financial sector development. The financial system is comprised of:

- the central bank- The Bangladesh Bank (BB)
- four nationalized commercial banks (NCBs)[2], with total bank assets at Tk.1670.6 billion
- four government-owned specialized development banks[3], with total bank assets of Tk.119.1 billion (DFIs)
- 18 private domestic banks, with total assets of Tk.1449,4 billion
- 12 foreign banks, with total assets of Tk.82.5 billion. The number of foreign banks entering Bangladesh is increasing. Although these provide much needed competition because of their much higher efficiency as measured by their profits per employee, the playing field is far from level, particularly compared to the NCBs with their advantage in accessing lower cost funds.
- the Grameen Bank, governed under a special Act, which has Tk.10,45 billion in outstanding loans (12/97), predominantly in the form of micro-credit to women in rural areas.
- several non-monetary financial institutions, including the Bangladesh House Building Finance Corporation (BHBFC), Investment Corporation of Bangladesh, Bank of Small Industries and Commerce (BASIC)
- 14 private non-bank financial institutions, including the recently established Delta Brac Housing Company.
- the Post Office Savings Bank.
- the Stock Exchange, with a market capitalization of Tk.70 billion in 1996/97 (only 5 percent of GDP).
- the State Provident Fund, several smaller state and private pension funds, most of which are undercapitalized.
- 21 general and 6 life insurance companies, dominated by two public sector corporations for life insurance and general insurance
- the cooperative and credit union sector, with the Bangladesh Samabya Bank Ltd as the apex institution.
- several large non-governmental and non-profit micro-finance institutions
- non-institutional credit agents such as money lenders.

Table IVa summarizes some of the main macro-economic and financial indicators.

---

[2] Sonali Bank, Janata Bank, Agrani Bank, Rupali Bank

[3] Bangladesh Krishi Bank (Agriculture), Rajshahi Krishi Unnayan Bank (Agricultural Development, Bangladesh Shilpa Bank (Industrial).

**Table IVa: Overview of the Macro-Financial System, 1993/94-1997/98**

| | 1993/94 | 1994/95 | 1995/96 | 1996/97 | 1997/98 |
|---|---|---|---|---|---|
| Real GDP growth (percent change) | 3.8 | 5.5 | 5.0 | 5.9 | 5.6 |
| Inflation (percent change) | 3.3 | 8.9 | 6.6 | 2.6 | 7.0 |
| Budget Deficit/GDP (percent) | -4.6 | -5.3 | -4.5 | -4.4 | -4.2 |
| M2/GDP (percent) | 27.1 | 27.9 | 27.7 | 28.5 | 28.6 |
| Deposit Growth (percent change) | 11.6 | 15.0 | 8.2 | 10.5 | 10.0 |
| Credit Growth (percent change) | 3.0 | 23.2 | 20.4 | 13.2 | 11.3 |
| Credit to private sector (percent change) | 5.1 | 23.6 | 22.6 | 13.7 | 10.1 |
| Private Credit/Total Credit ( percent) | 71.6 | 71.8 | 73.1 | 73.4 | 72.7 |

Source: various Bangladesh Bank publications

Below we highlight the main financial sector characteristics relevant to an understanding of the housing finance system.

## B. The Banking Sector[4]

The financial sector in Bangladesh is dominated by the banking sector, which accounted for 96 percent of the system's total assets at the end of 1997[5]. However, the banking sector has major weaknesses, that impact the availability of housing finance. Some important features of the banking sector are briefly discussed below:

*Non-performing loans.* The banking system has a long-standing problem with non-performing assets, concentrated in a relatively small number of private borrowers, and estimated at more than one third of the loan portfolio of both the Nationalized Commercial Banks and domestic private banks. Sectors with the highest percentage of total overdue loans are the agricultural and commercial credit sectors. Only in 1990 were loan classification guidelines implemented and, although recently tightened, these are lenient by international standards.

*Interest rate structure.* Savings and lending volumes have been affected by high spreads between bank lending and deposit interest rates (see Appendix 1 for interest rate structure of the banks), resulting from the high volume of non-performing loans. Real lending rates have remained high (9 to 12 percent) and bank deposits appear to be affected by the

[4] The banking sector's activities include, apart from the conventional activities, a micro-lending component. It disbursed more than Tk.2100 million in micro-credit during 1996/97.

[5] Domestic banks account for 94 percent of the banking system.

lack of confidence in the banking sector.[6] The NCBs act as the price leaders for interest rates for the sector. However, their rates are set to deal with their bad debt losses from the past.
*Capital inadequacy.* Another problem is a system-wide capital inadequacy. Although the Basel guidelines (8 percent of rated assets) are officially followed, enforcement is still lax and many banks are not up to standard.
*Bank liquidity.* GDP growth has assisted the liquidity position of the banks. Also, the foreign exchange exposure of the banks and their corporate borrowers is less than in other countries in the region, and this makes the system less vulnerable than that of Asian crisis countries. Since bank lending to the real estate sector in Bangladesh is relatively low as a share of the total economy, there has been no real estate asset price bubble as in several other Asian countries.
*Lack of competition and product innovation.* The legacy of credit ceilings, refinancing of loans to priority sectors and administrative interest rate structures have left a banking sector more concerned with recovering past losses than with moving into more innovative and profitable areas. Particularly, long-term lending activities have received little attention.

In the past the DFIs were the main providers of term finance in Bangladesh. However, their bad debt exposure has severely curtailed their operations. The commercial banks have filled the void and dominate the banking sector, with more than 50 percent of outstanding advances. Yet, they have remained in severe distress because of the persistent high percentage of non-performing loans and the deficiency of loan loss provisions. Banking reform is a high priority recognized by the government. Yet, there does not appear to be a sense of urgency to address the fundamental problems of non-performing loans (see proposals for reform in World Bank,1997, p.17). The weak banking system is considered a threat to macro-economic stability (World Bank, Asian Development Bank 1998, p.16). It certainly is a hindrance for the development of the residential real estate sector, driving up interest rates and limiting the interest of the banks to lend long-term.

A recent announcement by the Bangladesh Rural Advancement Committee (BRAC), the largest micro-finance and development NGO in Bangladesh, that it will establish a progressive commercial bank within the year, may prove a critical turning point in Bangladesh's banking sector.

## C. Capital Markets

Capital markets include both debt and equity markets. Debt markets are, however, not well developed and revolve around the commercial banks and DFIs. With the weak position of the NCBs, debt markets play a small role in the housing sector outside of BHBFC. Equity markets, dominated by the Dhaka and Chittagong Stock Exchanges, remain equally weak with an unclear regulatory and supervisory system, inefficient

[6] Interest rates are liberalized except for three sectors; agricultural, cottage industry and export.

trading, clearing and settlement systems, limited supply of securities and underdeveloped institutional demand (World Bank, 1998). The short-lived boom and bust cycle of 1996 was driven mostly by foreign portfolio investment and new regulations have been put in place to protect investor's interest and improve the institutional structure. International agencies have initiated programs to strengthen both debt and equities markets.

## D. Cooperative and Credit- Cooperative Societies

There are 145,000 cooperative societies in Bangladesh, of which only 144 are housing cooperatives. The great majority are farmer and agro-farm cooperatives. The housing cooperatives are mostly set up by high and middle income households to allow them to jointly acquire land for the construction of housing units for their members. Less than 14,000 plots have been developed through the housing cooperatives.

There are at present 20 credit co-operative societies with less than 1400 members and total resources of Tk.164 million. The apex bank for the co-operative sector is Bangladesh Samabya Bank Ltd. The sector has experienced severe structural problems and presently no new credit societies are allowed to register.

## E. The Micro-Finance Sector

The non-governmental micro-finance sector is growing rapidly, based on the Grameen model. There are more than 1000 micro-finance organizations operating in Bangladesh (Credit and Development Forum, 1998). The four dominant institutions are the Grameen Bank, BRAC, Proshika and Association for Social Advancement (ASA). The Grameen Bank was started as a majority Government-owned bank established under a special Grameen Bank Act. The other micro-finance institutions were set up under the Societies Act without government participation. Even though the government's share in the Grameen Bank is presently only 7 percent, it has a different status vis-a-vis the government. For example, when the Grameen Bank experienced a liquidity crunch caused by a large proportion of loan defaults after the recent floods, the government provided the needed funds to carry it over. The type of lending and savings operations of the large micro-finance operations are, however, very similar. Most depend to some degree on grants or low-cost funds from foreign donors. The large institutions are trying to increase the proportion of equity and working capital raised by their own members. All receive tax concessions or are tax exempt.

The focus for all micro-finance institutions has been on group-based micro credit for small individual ventures of the lowest income groups in rural and to a lesser extent in urban areas, based on the well-documented system of local support committees. The credit-based income generating activities have been evaluated by several international and national organizations. These have consistently shown that banking for the poor can have positive results, based on debt repayments as an indicator of program effectiveness. So far, housing loans have been a small part of the group-lending system and of the total lending portfolio of the micro-finance institutions. Housing loans have been targeted to the same clients as micro-credit for income-generating activities.

In 1990, a promotional institution for the financing of income generating and related activities was established, the *Palli Karma-Sahayak Foundation (PKSF).* It is a non-profit company which receives grants from the GOB and loans and grants from foreign and local development agencies. In addition, it receives income from activities it is engaged in. PKSF on-lends funds to qualifying partner organizations that are engaged in one-year credit programs for rural poverty groups. PKSF's service charge is 3 to 5 percent and loans have to be repaid within a period of three years, with a three months grace period. PKSF has facilitated access to low-cost funds for the micro-finance sector, while at the same time improving the monitoring and evaluation system of its partner organizations (see below). The total amount of funds disbursed up to October 1998 was Tk.4.43 billion, with a loan recovery rate of 98 percent.

## F. Regulatory and Supervisory Framework

The Companies Act of 1913 and the Banking Companies Act of 1991 are the basis for commercial bank regulation (exclusive the cooperative banks). Non-bank financial institutions are regulated under the Financial Institutions Act of 1993. BHBFC and the Grameen Bank have been set up by specific Acts of Parliament, and fall outside of the jurisdiction of these laws. The Securities and Exchange Commission (Amendment) Bill 1997 and the Securities and Exchange Bill 1997 regulate the securities markets. The Cooperative Societies Ordinance of 1984 regulates the cooperative and credit union sector and allows deposit taking, issuance of debentures and lending to members.

The Bangladesh Bank performs the traditional roles of note issuer and banker to the government and banks. It enforces prudential regulation of the banks and non-bank financial institutions. It also provides deposit insurance to small depositors. The Ministry of Finance (MOF) directly supervises government financial institutions which it gives directives independent of the BB. Therefore, while the BB in general regulates the banking system, it does not have full authority and autonomy to do so effectively. Monitoring of the NCBs, and other state-owned or partly state-owned financial institutions such as the Grameen Bank and BHBFC is done by the Ministry of Finance. The government sets priorities for these institutions that may differ from prudential concerns by the BB. In addition, managerial reforms proposed by the BB are hindered by the interference of strong unions. Because of their special status, supervision of the BHBFC and Grameen Bank have been lax in the past.

The Bangladesh Bank regulates and effectively supervises the non-banking financial institutions. However, certain aspects of NBFIs' operations, such as debentures and securitization are supervised by the Security and Exchange Commission, while regular lending functions are regulated under the Financial Institutions Act of 1993 under the BB. This dual supervisory system creates confusion, particularly for the newly formed housing finance institutions.

The insurance sector is regulated under the Insurance Act of 1938 by the Controller of the Insurance in the Ministry of Commerce. The office has, however, very limited capacity to effectively guide the sector into more innovative practices. The insurance sector is a potential long-term investor in housing, but present regulations hinder its expansion into this sector.

The cooperative and credit union sector is supervised by the Registrar of Cooperatives in the Ministry of Local Government, Rural Development and Co-operatives (MLGRDC), which does not really have the capacity to do so effectively for sizable cooperative financial institutions. The financial situation of the 20 credit unions has been deteriorating steadily and the entire sector is in the process of being liquidated.

The growing NGO micro-finance sector is effectively unsupervised. It is under the NGO Bureau of the Ministry of Welfare (Youth and Women's Affairs), which is not equipped to deal with the large non-profit financial institutions. The size of the sector, and the implicit assumption that government will guarantee payments to the borrowers, has increased the need for a sound regulatory and supervisory system. The Credit and Development Forum is the networking agency for the sector. It maintains a comprehensive data bank on member MFIs and acts as a resource center for its member institutions. The NGO apex funding agency, PKSF, fulfills a de facto monitoring function for its participating NGOs (approximately 75) and requires monthly reports of the entire operation of its clients.

Debt recovery and bankruptcy laws have recently been enacted and the GOB launched a loan recovery drive for its NCB and other state lending institutions in 1997. As part of this initiative, BHBFC has recently announced a major action to deal with its non-performing loans (see below).

***Main issues:***
***The weak financial system hinders savings and investments, hence economic development. The housing sector, which is highly finance dependent, is particularly affected. The troubled banking system cannot provide wholesale or individual long-term funds at an efficient rate for housing finance. Debt markets are not developed and are dominated by government, eliminating another potential source of housing funds. Cleaning up the commercial banking system, strengthening the regulatory and supervisory system for the financial sector and improving and expanding debt markets are of particular concern for the housing finance sector.***

## V HOUSING CONDITIONS AND SUPPLY

Before we turn our attention to the housing finance system, we analyze briefly the present housing conditions and requirements for Bangladesh and the ways housing is produced and supplied. Many studies have been carried out of the urban and rural housing and services situation and housing delivery systems, in particular by the Center for Urban Studies in Dhaka. Here we provide only a summary of pertinent findings important for an understanding of housing finance issues.

### A. Housing Stock

The poor economic situation and income inequality in the country is reflected in the quality of the housing stock. It was estimated that close to half of all housing units in the country (3.3 million in 1993) were made of temporary materials and needed replacement within a 1 to 5 year period. Approximately one third of all houses in urban areas were constructed outside of the formal regulatory system, mostly on land to which the homeowner does not have a formal title. A 1993 survey of Greater Dhaka showed that there were 2,100 slums which comprised 3 million people (MHPW, 1993).

Table Va shows some characteristics of the housing sector compiled from different studies conducted by the Center for Urban Studies.

**Table Va: Housing Sector Characteristics of Bangladesh**

- ***Total number of dwelling units:***

| | |
|---|---|
| Bangladesh | 19,020,489 |
| Rural | 15,474,566 |
| Urban | 3,545,923 |

- ***Per capita floor space:***

| | |
|---|---|
| Bangladesh | 54.9 sq.ft |
| Rural | 53.5 sq.ft |
| Urban | 62.3 sq.ft |

- ***Occupancy level in 1991:***

  5.48 pp/dwelling unit

- ***Proportion permanent structures in 1991:***

| | |
|---|---|
| Rural | 21 percent |
| Urban | 46 percent |

- ***Proportion of rental units in 1993:*** (see table in Appendix 2)

| | |
|---|---|
| Rural | 5% |
| Urban | 40% |
| Dhaka | 65% |

- ***Access to clean water:***

| | |
|---|---|
| Rural | 78 percent[7] |
| Urban | 42 percent |

Tragically, the recent floods have destroyed more than 900,000 houses, mostly in rural areas, and another 1.3 million houses were seriously damaged (UNCHS, 1998). Of course, most affected houses were in the low-income category.

The only detailed figures on the type of housing in urban areas are available for Dhaka (Table V2, Islam, 1998, based on figures from 1985-1986). Although the data is old, the situation has not changed much for the better and it is, therefore, still relevant to provide a broad picture of the urban housing conditions.

The higher and middle-income groups are housed in either low-rise single-family houses, or, increasingly, in multi-family apartment buildings. The lower income households, approximately 70 percent of the urban households, are housed in a variety of house-types that can be described as follows:

- Approximately half of the low-income housing units are in bustees, informal settlements areas that include both private rental and private ownership housing, built either on privately owned land or on illegally occupied public land.
- Conventional tenement slums (rental and owner occupied) take up another quarter of the low-income sector. These multi-unit buildings were originally built to compliance with the code, but are presently seriously overcrowded and ill maintained. Overcrowding in these buildings has increased over the last years due to an influx of rural migrants to work in the expanding garment industry.
- Other categories of low-income housing include: government provided squatter resettlement camps, plots of land with basic services that are provided on a leasehold basis; employee housing consisting mostly of small apartments in high-rise complexes provided by the government; squatters who have built makeshift houses on illegally occupied public or private land; and pavement dwellers.

**Table Vb: Dhaka Urban Area Housing Sub-systems by Income Groups and Land Coverage**

| *Income Groups/ Housing Approximate Sub-system* | *Approximate Proportion of City Population (%)* | *Approximate Coverage of City's Residential Land (%)* |
|---|---|---|
| ***Upper Income Group*** | **2** | **15** |
| ***Middle Income Group*** | **28** | **65** |

[7] While access to water in rural Bangladesh seems remarkable, the arsenic pollution of wells in West and North-West Bangladesh gives a chilling effect to those figures.

| | | |
|---|---|---|
| ***Low Income Group*** | **70** | **20** |
| a) Squatters( including pavement dwellers and vagrants) | 2.5 | 0.5 |
| b) Refugee rehabilitation colonies/ squatter resettlement camps (Govt. assisted housing) | 6 | 2 |
| c) Bustees (Private rental and Private owner occupied) | 35 | 11 |
| d) Conventional tenement slums (rental and owner occupied) | 12 | 4 |
| e) Employees housing | 7 | 2 |
| f) Other low income | 2.5 | 0.5 |

Source: Islam, 1985-86

## B. Urban and Rural Population Trends and Housing Requirements

With a population of approximately 124 million people and a land area of 147,570 square kilometers, the gross density of the country is around 860 people per square kilometer, amongst the highest in the world. In the older parts of Dhaka there are 500 dwellings per ha and in urban slum areas there are more than 2000 persons per acre in single story housing.

While overall population growth has decreased considerably to 1.6 percent per year, the urban growth rate continues to be high (although decreasing compared to previous decades) and is estimated at approximately 4.2 percent per annum.

**Table Vc: Rate of Household Formation by Locality, 1960-1991**

| *Locality* | *1960-73* | *1973-81* | *1981-91* |
|---|---|---|---|
| Bangladesh | 2.1 | 2.1 | 2.6 |
| Rural | 1.8 | 1.3 | 2.0 |
| Urban | 6.2 | 8.9 | 5.7 |

Source: Population census 1991

The total urban population is estimated at 24 million people or close to 20 percent of the total population. Metropolitan Dhaka is by far the largest urban area with a population of 8 to 10 million people, 30 to 40 percent of the total urban population.

Estimates of the requirements for housing in urban areas vary from 550,000 units to 300,000 annually for the next twenty years depending on the number of backlog and replacement units incorporated in the estimates. Karim (1993) made an estimate of the requirement for new urban housing based only on new household formation between 1980 and 2000 and showed figures of 200,000 to 300,000 per year. (See Appendix 3).

Rural housing requirements for new houses are in the order of 3.5 million annually if a two percent rate of household formation is assumed.

## C. House Prices and Housing Production

The provision of standard housing and residential infrastructure has not kept up with population increases, because of constraints in the main supply factors, such as land and finance, and severe affordability problems. Indeed, land and construction prices for new formal sector housing are high relative to incomes, particularly in urban areas. The GOB Housing Indicators Report calculated that urban households spend on avarage 10 to 17.5 percent on housing related expenditures (GOB, 1995).

***House prices***

*Land.* There is an active land market that prices land according to locational characteristics, distance from main centers and physical quality of the site. Because of the exponential increase in population in Dhaka, land prices have escalated during the last few decades. Trends in land prices will be included in the land study, which is simultaneously conducted by UNCHS. Prices for land and construction were only available for Dhaka since most of the formal construction activities take place in the metropolitan area. For the purpose of this study we compiled current prices for developed land within the metropolitan area of Dhaka (estimates by REHAB):

| | **Land price per khata (720sq.ft)** |
|---|---|
| • *High income areas such as Gulshen, Benani* | Tk.2. to 3 million |
| • *Middle income areas such as Dalmundi* | Tk.1.5 to 2 million |
| • *Other Dhaka neighborhoods* | Tk.1 to 1.5 million |
| • *Mirpur and other suburban areas* | Tk.0.7 to 1 million |
| • *Undeveloped land at 20 to 30km from CBD* | Tk.1 million per acre ( 60 khata) |

With a minimum plot area of 2100 sq.ft in urban areas, a building plot in the lowest income area would still exceed Tk.3 million. In suburban areas no minimum plot size is stipulated and land can be subdivided in small plots for single-story housing developments.

*Construction costs*. REHAB provided the following construction costs per sq.ft. at different levels of finishes:

| | **Construction costs per sq.ft** |
|---|---|
| • *High cost construction*/multi-family | Tk.1000 to 1200/sq.ft |
| • *Middle cost construction*/ multi-family | Tk.850 to 1000/sq.ft |
| • *Simple construction*/ multi-family | Tk.650 to 850/sq.ft |

- *Single story low-cost house* Tk.450 to 600/sq.ft

These figures show that the construction costs for a small 300 sq.ft house, excluding land cost, would be in the order of Tk.150,000. Such a house would be quite affordable at a median income level of Tk.5000. The inclusion of the costs of developed land, would multiply the cost by ten, rendering such housing solutions inaccessible even for households well above the median income. These figures show that high-density multi-family developments are the only feasible alternative in Dhaka.

*New apartment/house-prices*. The sale price of new residential real estate varies per neighborhood and depends mostly on construction quality and land prices. REHAB made the following estimates:

| | **Sale prices of Residential Real Estate per sq.ft** |
|---|---|
| High income areas such as Gulshen, Benani | Tk.2400 to 3400/ sq.ft |
| Middle income areas such as Dalmondi | Tk.2000 to 2400/ sq.ft |
| Other Dhaka neighborhoods | Tk.1850 to 2000/ sq.ft |
| Smaller lower middle income pockets in other areas | Tk.1500 to 1600/ sq.ft |

There is very little development going on in areas outside of the main higher and middle-income neighborhoods. These figures show that a small 300 sq.ft newly constructed apartment in one of Dhaka's less expensive neighborhoods would cost approximately Tk.450,000. Even if the household would save for a down-payment of Tk.150,000, and housing finance would be available for the remainder amount, a monthly payment of Tk.4000 per month would be required at present interest rates of 16 percent for a 20-year loan.

*Administrative costs and taxes.* Other hurdles in providing middle and lower-cost housing are the complexity and high cost of developing, selling and purchasing real estate. The following costs are incurred in an average transaction:

- Stamp duty 12 % of the value
- Sale registration fee 4.5% of the sale price
- VAT 9 %
- Payments for permits etcetera 5 - 6 %

Total 31 %

A 1995 REHAB study identified the following issues as the main problems in the real estate business: 1) scarcity of open space in the city, 2) high cost of registration and transfer, 3) lengthy procedures of to get approval for building plans, and 4) lengthy loan procedures of BHBFC. The GOB is presently developing a Real Estate Development Policy with input from REHAB. This policy will specify rules and regulations for land development and construction in metropolitan areas.

### *Housing production*

Suppliers of housing are the public sector, the formal and informal private sector, including owner-households and NGOs.

**Rural housing**. Housing in the rural areas is mostly produced by owner households in an incremental way. While most owners build on their own or rented land, informal occupation and squatting are increasing in rural areas. The Grameen Bank pioneered a housing loan program that provided basic building materials for a simple new house for which repayment could take place over a 15-year period. Other NGOs have followed this example, with shorter payment periods (see below) and a total of approximately 700,000 housing units have been constructed using micro-finance facilities from the time these programs were put in place in the 1970s.

The government has a direct construction program for the rural areas, called Asrayon. It provides low-income barrack-type houses in model villages built by the army. The houses are allocated to low-income households without payment. The program has produced approximately 20,000 units to date.

**Urban housing**. Because of the scarcity and high cost of buildable land in the large urban areas, most new formal sector residential construction in Dhaka and some other large urban areas has, over the last few decades, been in the form of multi-family units. In small towns single family units prevail. Comprehensive production figures are not available, but some estimates for urban areas have been provided by Islam et. al, 1997.

- *The public sector*. Several public agencies are, or have been involved in the financing and development of housing and residential infrastructure projects: the Housing and Settlement Directorate (HSD) and Public Works Department of the Ministry of Housing and Public Works (see Appendix for present projects of the HSD), the Local Government Engineering Department of the MLGRDC, and the City Corporations of the four larger cities. Their funds come mostly from foreign aid and to a lesser extent from national revenues. Both City Corporations and the central government are developing residential subdivisions for lease to upper and upper middle income households and resettlement programs and site-and-services schemes for lower to middle income groups. The tenant purchase and sales projects require large down payments (25 to 30 percent) and a small number of annual payments. Arrears are a major problem with all government projects. Also, it has always been difficult to reach lower income households with the site-and-services projects and the size of the combined public housing programs has remained extremely small in relation to housing requirements and new construction. Altogether the public sector has only produced approximately one to two percent of total urban residential land and housing requirements (not more than 6000 units per annum) over the past years. These programs have been extensively discussed in ADB, 1993 and Shafi, 1999 forthcoming[8].

---

[8] The present five year plan has the following division of tasks in mind for the various government agencies involved in urban housing: The City Corporations develop areas for the high-income groups on a self-financing basis. The focus of HSD is to develop areas for low-income groups (with government or donor financing, nominally on an affordable but cost recoverable basis). LGED, jointly with UNICEF, is to continue with a long-term project to

- *Non-governmental sector*. The NGO sector has only been marginally involved in urban housing. The discrepancy between urban land and house prices, and incomes of the below median income groups has made sustainable housing solutions difficult to conceive for that income group. Recently, the larger micro-finance institutions have shown an interest in entering the multi-family residential market for moderate and lower income households. Proshika and BRAC have plans to invest in large-scale low-and moderate-income housing developments 30 to 40 km outside of Dhaka. Some projects will receive free government land. The plan is to develop hostel type rental housing for urban workers and small low-cost family apartments for tenant-purchase. The NGOs have access to international funds, which they complement by borrowing and other income sources. Their cheap sources of funds make it possible for them to make long-term investments in social housing. None of these plans, however, have been implemented as yet. The ramifications of NGOs becoming long-term managers and financiers of multi-family low-cost housing developments have not yet been considered in any detail.
- *The formal private and cooperative development sector*. Private developers are increasingly important players in the urban land and housing markets, particularly in the market for apartment buildings. A 1995 study by REHAB showed that there were 142 real estate developers in Metropolitan Dhaka, most of whom work in land and apartment development. This sector has produced close to 3 percent of the houses over the last few years, nearly all for the higher income segment of the market, and it is growing rapidly. Private landowners, using the land to finance new construction, are also developing multi-family housing units. They operate either as individuals, as businesses under the Companies Act, or form a housing cooperative, and jointly develop a housing project partly for owner-occupation and partly for rental or sale (see above)[9].

Interestingly, private developers feel that the higher income apartment market is becoming saturated and attempt to move down-market (REHAB, Eastern). The most serious constraint in doing so is the lack of *mortgage financing*. Finding accessible and *affordable land* for middle income housing construction is another challenge, particularly in Dhaka (see above). One of the largest developers in Dhaka felt, however, that there was sufficient land available for the foreseeable future, but the lack of long-term finance for middle income households would prevent them from expanding a middle income line of housing production. *Infrastructure* provision is the third main concern hindering private sector production of middle income houses. Services and infrastructure are the responsibility of the City Corporations and priority is given to their own land developments. It can take a long time for road networks and other services to be installed in new developments.

provide basis services to the large numbers of slum dwellers in the urban areas, in particular Dhaka. A total of 5.8 percent of the budget has been set aside for housing and urban infrastructure.

[9] There are tax advantages to form a cooperative and in many instances a cooperative applying for a parcel of land from the government receives preferential treatment.

- *The formal or semi-formal individual homeowner construction sector*. This is by far the largest housing supply system in all but the main metropolitan areas. Households acquire land, mostly on a freehold basis, and gradually construct their house with or without official approval of plans. Only a small proportion of households access housing finance.
- *Informal private rental housing sector*. Landowners in urban areas construct high-density, low-rise housing units for rental, without adequate services, either for individual households or for group living (mess housing).
- *Squatting***.** People building makeshift houses on public or private land or squatting in buildings.

***Main Issues:***
***The main constraint in housing production is the high cost of housing in relation to incomes. Particularly in urban areas, where land prices are high, the gap between cost of new construction and incomes has some major consequences: 1) It forces new developments for moderate income households further out of the center, while most employment opportunities are still located in inner city areas. 2) Only a small proportion of all required houses (roughly 400,000 per year in urban areas alone) is built in the formal sector . The private sector builds only for those who can afford to pay. Public housing efforts remain small because required subsidies are deep. While NGOs have housing programs in rural areas, the urban housing problem has been too complex and intractable for NGOs to take on. 3) High land prices in urban areas have caused multi-family units to become the predominant house-type. This type of housing makes it difficult for urban middle and lower-income households to use traditional incremental land acquisition and house-construction methods. Mortgage finance is a necessity for this group of households to acquire an apartment. In rural areas and in informal urban areas incremental single-family house-construction is the prevalent way of house building.***

***The lack of housing finance exacerbates the problem. The private development sector is interested in building houses for middle income households, which have been under-served until now. NGOs are beginning to make plans for the development of new lower income housing projects in peri-urban areas. Without access to finance, however, a down-market move in the formal housing sector (particularly for multi-family housing) is virtually impossible. In the meantime, informal housing solutions prevail in urban areas, both in the rental and ownership sector.***

# VI. MORTGAGE FINANCE

## A. Introduction

The housing finance sector in Bangladesh is both underdeveloped and highly segregated. Formal construction and mortgage finance by the banking sector, which requires proof of land ownership or leasehold deeds and the deposit of title documents as collateral, is only used for a small proportion of new house production and for an even smaller proportion of purchases of existing houses. The 1993 ADB survey of homeowners of newly constructed houses showed that the most important source of housing finance was household savings (more than one third). Loans from relatives and friends were the second most common form of finance, followed by the sale of other parcels of land. Employer and bank loans (including Grameen Bank loans, see below) were utilized by 13 percent of new home-owners and HBFC loans were only acquired by 5 percent, all in the higher income brackets. Rotating credit institutions were not mentioned and are, therefore assumed not to play a significant role in house construction.

It is widely acknowledged that new finance systems have to be developed and some promising initiatives have been taken. In this section we discuss the present mortgage-based housing finance systems in Bangladesh and government policy towards the housing finance sector.

## B. Construction Finance for Moderate Income Housing

***Private construction finance***

Most new construction for the urban formal housing market is in the form of apartment buildings. The predominant way of financing the construction of this type of housing is through landowner and developer self-finance, e.g., by selling part of the land parcel or other land and subscribing the housing development fully before construction starts. Buyers of individual units in multi-family apartments have to put down a 25 percent advance and the unit has to be paid for in a few large installments before the house is completed. This type of financing arrangement is difficult for all but the highest income groups in the absence of mortgage financing. Some large developers have access to short-term construction finance from affiliated private commercial banks. It is, however, difficult to obtain construction finance from the NCBs (see below). Developers do not engage in long-term financing of housing units for their clients directly.

***Public construction finance***

After the failed attempt to stimulate BHBFC to lend for lower cost housing developments (see below), the Prime Minister's Office recently established a Housing Fund called the Grihayan Project, which provides low cost funds to NGOs and public sector developers for the construction of low- to moderate-income housing schemes. The Housing Fund is administered by an inter-ministerial committee of 17 members and includes one NGO member (Proshika). A total of Tk.580 million is available at an interest rate of 1 percent for 10 years. The project requires that the borrower on-lends to lower-income households at a rate of 5 percent, which leaves a spread of 4 percent for which the developer has to cover all costs, including loan administration. Indeed the project expects the NGO or public sector developers to put in their own funds for project development and management. Therefore, only well funded NGOs can consider participating in the project. Also, selected agencies have to have the capacity to act both as developers and long-term mortgage financiers for the projects.

Four types of housing solutions are fundable under the project: 1) small single, tin-roofed rural houses at a maximum cost of Tk.25,000, 2) semi-packa rural houses at a maximum cost of Tk.85,000, and, 3) flats in district towns at a maximum cost of Tk.175,000. Loans for the first solution are made for ten years, while a fifteen-year term is set for the two other house types. The target markets were selected because housing finance institutions, apart from MFIs, will not invest in housing in rural and smaller towns.

The Fund received over 850 applicants during the first round of which approximately 20 to 30 institutions will be selected. The idea of a Housing Fund was first suggested by the 1993 ADB study, although a different structure was envisioned.

While an interesting initiative, the fund is small in scale compared to the overwhelming need for low-income housing. It can finance 7000 to 10,000 units depending on the mix. Also, the administrative structure for the program, as an inter-ministerial committee, is extremely weak and ephemeral. The long loan terms would require a more permanent project administration and monitoring unit or a relationship with a financial institution. Also, the project does not build up institutions that could gradually increase lending for low-income housing.

## C. Major Mortgage Lenders

***The Bangladesh House Building Finance Corporation***

The HBFC was established in 1952 to stimulate middle income house construction for civil servants in urban areas and Bangladesh HBFC was recognized in 1973 after independence. While the majority of its clients are still civil servants, its mandate has broadened to include all eligible private citizens or citizen groups. It does not lend to developers or builders.

In 1995/96 BHBFC’s total assets were Tk.26,218 million of which Tk.22,201 were outstanding loans and advances. Authorized capital is Tk.1,100 million with Tk.973 million paid up. BHBFC’s main sources of funds are dedicated government bond issues specifically floated for their programs. Additional transfers directly from the government budget are occasionally provided on a limited scale. The interest rate on the debentures differs and the most recent ones were 8 percent for 7 to 8 years. Previous bond issues ranged from 2 to 6.5 percent[10]. BHBFC is, of course, tax exempt. The GOB decides how much funding BHBFC will receive each year and can determine the specific conditions for new programs.

BHBFC has to operate on a commercial basis and sets its interest rates in accordance to its costs of funds and operating costs.[11] Its net profit has steadily increased since the late eighties and since 1993/94 its profits have exceeded its total expenditures. However, its loan recovery performance is poor and well below that of the commercial banks. Its recovery on current loans is 86 percent (of number of loans) [12], but the cumulative recovery is only 44 percent. No classification system of loans is in place. Indeed, the financial statements do not include adequate loan loss provisions or reflect the low collection of accrued interest. BHBFC does not do its own servicing. It uses one of the NCBs, the Sonali Bank, and its branch network for that purpose. The main office of Jonata Bank in Dhaka, another state owned commercial bank, sells the applications at a fee of Tk.400 to 500.

BHBFC operates presently only in carefully targeted, higher quality housing sub-markets in Dhaka, and on a very limited scale in Chittagong and Rajshahi (which received 9.4 percent and 3.1 percent of disbursed funds in 1995/96 respectively). Poor repayment experience in other urban areas was the reason to concentrate on Dhaka. It has financed 125.000 units since its inception, of which more than 30,000 since 1992, mostly for higher income households.

BHBFC finances three types of housing categories each with their own construction and financing terms:

1. *High Cost Housing* up to Tk.2.5 million and at a maximum construction cost of Tk.900 per sq.ft.
2. *Medium Cost Housing* up to Tk.1.425 million and a maximum construction cost of Tk.700 to 850 per sq.ft.
3. *Groups of maximum 10 households* (soon to be increased to 20) that have jointly bought a piece of land can apply for a mortgage for the construction of their houses (excluding the land)[13]. The maximum construction cost is Tk.500 for the first floor and Tk.400 for additional floors.

The financing terms are as follows: 15 year fixed rate mortgages at interest rates increasing with the loan amount. For loans above Tk.1.5 million a simple rate is charged of 15 percent, for loans below Tk.1.5 million the rate is 13 percent in Dhaka. Outside of Dhaka the interest rate is 10 percent. A simple not-compounded interest rate is charged, which lowers the effective rate; for example the 13 percent rate would amount to

[10] Refinancing of the debt by the Bangladesh Bank in 1993 brought down the average weighted rate from 8.5 to 4.5 percent.
[11] Apart from interest income it receives income through the sale of application forms, application fees and other fees.
[12] Only after loan payments are 24 months overdue is the loan considered to be delinquent, at which point legal action can be introduced.
[13] Many groups are housing co-operatives.

approximately 10 percent over an 18-year period. A grace period of 12 months is allowed before the first payment is due. The first two packages require a Loan-to-Value ratio of 60 percent. The maximum Loan-to-Value ratio for the group loan is 80 percent of the house value, excluding the land. This amounts generally to more than 60 percent equity when land values are included.

Eligibility criteria for the programmes specify that for rental properties, three-quarters of the rental income of the property must cover the loan repayments, and for owner-occupied properties a maximum of fifty percent of the applicant's income is required for loan repayment. The spouse's income can be used as a guarantee if the applicant's personal income is insufficient.

The median cost housing scenario shows that the program aims at an income group above Tk.25,000 per month. For example, on a Tk.2.5 million house, with a 60 percent loan of Tk.1.5 million, the monthly repayment is approximately Tk.12,600, requiring a monthly income of at least Tk.25,000. Indeed the minimum income group considered for any of the above options by BHBFC is Tk.25,000 per month.

The average time to get a loan approved is 7 to 12 months. Although there is no official waiting-list, there are presently 1400 applications for all categories of loans pending. Applications are not computerized. Rationing criteria are set by management and the Board, and are changed at will. In general, priority is given to civil servants and within that group to those with the most years of service.

In June 1998, a special bond issue was floated for BHBFC of Tk.500 million for a special lower-middle income housing finance program. It was meant for individual applicants and for houses of 550 to 1000 sq.ft. in size with a maximum of two dwelling units. BHBFC considered the scheme unfeasible for the Dhaka housing market and it was not widely publicized. Not a single application was received.

According to BHBFC the only way to get private developers to build lower income houses with BHBFC credit is for the GOB to provide land for free to developers. It is preparing a plan to that effect for the financing of low-cost apartments. BHBFC construction finance to the developer will be rolled over into mortgages for moderate income households.

The BB and the MOF differ in their assessment of the potential of the BHBFC to clean up their operation and move down-market. Both agree that, given the bureaucratic nature of the organization and the history of clientilism associated with government-owned banks that serve a predominantly civil servants' clientele, commercializing the institution will be a difficult task. However, BHBFC has recently initiated another campaign to collect on delinquent loans and it has threatened to repossess properties from long-time non-payers. In the meantime, it remains dependent on government funding for its continued operation.

The World Bank conducted a major study of BHBFC in 1988 and concluded that the government should take steps to clean up the bad debt and dissolve BHBFC. Commercial banks were to be encouraged to take up mortgage lending. The 1993 ADB study found the same unwillingness by BHBFC management to move down-market or begin to seriously commercialize and become less dependent on subsidized funds. The discussions with management during this mission uncovered the same discrepancy: *there was a lack of interest to move away from high and upper-middle class markets for fear of increasing the default situation; at the same time there was unwillingness to become a commercial entity, less dependent on subsidized government funds. The target clients of BHBFC are the same as those of the commercial banks and other private sector players in the market.*

*This consultancy would agree with the conclusions of the previous studies that there are no compelling reasons for a government housing "bank" of BHBFC's orientation in the primary market.*

***The banking sector***

The commercial banks, both public and private, and the specialized banks are the only other financial institutions with a considerable proportion of their combined assets in housing. For the entire banking sector (excluding the Grameen Bank) the total housing related advances were Tk.17.7 billion at the end of 1997 of which two thirds (or Tk.11.2 billion) were held by the NCBs. The majority of the accounts held by the banking sector are individual accounts (approximately 54,000), and only approximately 1400 loans were made to housing societies.

**Table VIa: Outstanding Housing Sector Advances with Interest in Million Taka (All banks)**

| **Construction Loan** | **Dec. 95** | **Dec. 96** | **Dec. 97** |
|---|---|---|---|
| Housing Societies/Companies | 2,338 | 967 | 4,138 |
| Housing Individual | 10,204 | 13,183 | 13,552 |
| Other than Housing | 6,297 | 7,018 | 6,837 |
| Total | 18,839 | 21,167 | 24,528 |

* All banks include: Nationalized Commercial Banks, Private Banks, Foreign Banks and Specialized Banks in Bangladesh.

**Table VIb: Outstanding Housing Sector Advances with Interest in Million Taka Nationalized Commercial Banks**

| Construction Loan | Dec. 95 | Dec. 96 | Dec. 97 |
|---|---|---|---|
| Housing Societies/Companies | 1,296 | 297 | 1,119 |
| Housing Individual | 8,026 | 10,732 | 10,084 |
| Other than Housing | 1,324 | 14,848 | 2,338 |
| Total | 10,646 | 12,514 | 13,540 |

Source: Scheduled Banks Statistics, Bangladesh Banks, 1997

The total housing advances amount to only 4 percent of assets[14]. The private banks have the largest proportion of housing related assets (9 percent), and the foreign banks have the least involvement in the sector (2 percent). Credit restrictions, specifying the proportion of deposit funds that could be lent for housing, were only withdrawn in 1988 and after that time investments in the housing sector soared. Over the years, major problems in loan recovery began to plague the housing portfolios and the banks gradually decreased the proportion of advances for housing. In fact the same number of housing accounts are held now as in 1992. During the liquidity crisis of 1994, when the Bangladesh Bank had to bail out the banking sector, it advised the banks not to lend more than 15 percent of their short-term funds in long-term loans.

Discussions with the NCBs made it clear that they were reluctant to extend lending to the housing sector. Most only consider housing loans for clients that have other business with them and have the income and assets to support these loans. The second category of borrowers are the bank's own staff for whom special concessionary conditions apply. Indeed, long-term housing loans are considered risky[15] in comparison to one year merchandise loans, since these loans contributed in the past to the bad recovery record and bad debt situation that plagues the banking system. The recovery rate of housing sector loans in the banking sector averages approximately 70 percent. The poor recovery rate is due mostly to older loans and recovery exceeds 80 percent on loans disbursed after 1990 (Bangladesh Bank). Default and foreclosure laws are complicated and it takes in excess of 5 years before a property can be repossessed.

There is not much competition in the housing lending market and most banks offer the same terms for the different client options. All loans are for new house construction only, and banks only lend for urban housing in secure sub-markets. While in the past a rural house lending program was sponsored by the government through a 3 percent refinancing window at the Bangladesh Bank, this was stopped because of alleged poor recovery rates.

The present terms on individual housing loans for the NCBs are: 10 year discretionary adjustable rate mortgages (just decreased from 15 years), at 16 percent compounded interest rates[16] per annum and a maximum LTV ratio of 50 percent of total cost including land. The allowable LTV ratio is higher for housing societies. The maximum loan amount is decided on the basis of the net rental value of the property and can be as high as 100 percent of the NRV if the owner does not live on the premises. The average loan size is Tk.1.5 to 2.5 million, similar to BHBFC's. All mortgage underwriting is done by specialized departments in the head offices and is done mostly as a desk exercise, rather than in the field. In other words, hardly any market research is done as part of the underwriting process. Loans to bank staff are generally smaller, the interest rate is set at the bank rate (presently at 8 percent) and the value of the land is taken as equity.

[14] The Jonata Bank mentioned that it only had 3.74 percent of the total loan portfolio in housing.
[15] NCBs can officially only receive deposits for a maximum of 3 years.
[16] For good customers a 16 percent simple interest rate is charged.

### ***Private housing finance companies***

In recent years, two housing finance corporations have been registered as public limited companies, of which one has officially opened its door for business. As in India several decades ago, efficiently run housing finance companies may revolutionize formal housing finance in Bangladesh and their development and growth deserves to be encouraged. We discuss the first operating company.

*Delta Brac Housing Finance Corporation Ltd. (DBH).* After a long period of preparation, DHB was licensed as a Non-Bank Financial Institution by the Bangladesh Bank and started its operations in 1997/98. Its initial paid up capital of Tk.200 million was subscribed by both national and international sponsors as follows:

- Delta Life Insurance Co. Ltd. 25 percent
- BRAC 25 percent
- Green Delta Insurance Co. Ltd. 20 percent
- International Finance Corporation (IFC)[17] 15 percent
- Housing Development Finance Corporation Ltd. from India 15 percent.

IFC has also offered 10 year loan guarantees for loans from local banks up to $2.5 million. HDFC, which is the largest and most successful mortgage lender in India, offers technical assistance in the initial stage to get the company off to an efficient start. Management of the company is young, professional and energetic.

Initially it was difficult to find local investors in the company since the housing sector in the country, dominated by the BHBFC, does not have a strong repayment track record. Moreover, new housing finance companies have to compete with BHBFC for the same higher income market niche, at least initially. BHBFC has access to lower cost funds, which allows it to have lending rates below market, while at the same time it does not incorporate the risks of default and bad loans in the same way private firms would. These factors increase the perceived risk to investors in private housing finance companies.

Delta Brac is permitted by government to take deposits and it has developed a deposit scheme, offering 11 percent on one year deposits. However, without an extensive branch network, lack of name recognition and an "un-level playing field" vis-a-vis savings rates offered by several government savings schemes, deposits will in the short run not provide a substantial proportion of the working capital. The main challenge for the new institution is, therefore, to find competitively priced sources of long-term funds, which is hardest in the early years of its existence. Once a strong performance record has been established it should be able to acquire funds at approximately libor plus 2 percent. The development of a debt market will equally assist in resource mobilization.

Delta Brac makes loans for the construction of houses, the acquisition of flats and houses, the extension and improvement of existing housing and the purchase of housing plots for middle and, in the medium term, lower income households. It provides both construction

[17] IFC is the private sector investment arm of the World Bank.

finance and long-term mortgage finance. In the first year 230 individual loans were sanctioned for a total of Tk.208 million, an average loan size of Tk.900,000. The business plan projects a steady increase in the number of loans and a simultaneous decrease in the average loan size. The maximum loan is Tk.2 million or 80 percent of the construction cost or 70 percent of the purchase price, whichever is less. Mortgage loans have a maximum term of 15 years and are discretionary adjustable rate mortgages. Present rates are 16.5 percent. For owner-occupied properties monthly payments cannot exceed 30 percent of household income and in higher risk cases, third party guarantees are required.

The regulatory framework for housing finance companies has not yet been well developed. Because it is the first operating HFI in the country, DBH is lumped together with other non-bank financial institutions such as leasing companies, merchant banks etc. which run very different operations. There is as yet little understanding of the special requirement of long-term lenders such as HFIs. When the sector grows, special regulatory guidelines will likely be developed for HFIs.

***Housing cooperatives and credit unions***

Although the co-operative movement is widespread in Bangladesh, particularly in the agricultural sector, it has not played a large role in the financing of housing. Rather housing cooperatives have been set up as vehicles for joint land development projects and purchases of multi-family properties. Cooperatives receive preferential treatment concerning the allocation of state land and can access funds from the co-operative movement's apex bank, which receives a large part of its funds from government. Members of housing co-operatives belong mostly to the middle income group.

The credit unions, which play a critical role in construction and mortgage lending in many countries, are presently in disarray and insolvent and cannot be looked at for expansion of housing finance for moderate and lower income households.

Table VIc summarizes the outstanding advances and lending terms for mortgage loans by the public and private sector lending institutions in Bangladesh. It shows the small size of the sector relative to GDP, the large loan amounts which are affordable only by the highest income levels, and the structure of interest rates.

**Table VIc: Scale of Mortgage Lending and Lending Conditions by Mortgage Lenders**

| *Lending Institution* | *Outstanding Housing Loans* | *Lending Terms* |
|---|---|---|
| BHBFC | Tk.22,201 million | 15 years<br>13% for loans <1.4 million<br>15% for loans >1.4 million |

| | | |
|---|---|---|
| | | p.a. compounded<br>12 months grace period<br>LTV ratio 60%<br>Max. loan Tk.2.5 million |
| Banking Sector (exclusive Grameen Bank) | Tk.17,700 million | 10 years<br>16% p.a. compounded<br>LTV ratio 50%<br>Av.Loan Tk.1.5 to 2.5 million |
| Private Housing Finance Co. | Tk.208 million (first year) | 15 years<br>16.5%, p.a., compounded<br>LTV ratio 80%<br>Av. Loan Tk.900,000<br>Max. loan Tk.2 million |

## D. Potential Investors in the Mortgage Finance Sector.[18]

The relatively low savings rate in Bangladesh combined with the existence of high yield government savings instruments that attract most of the household savings, makes it necessary for any new private sector housing finance company to access funds from long-term lenders or securities markets, rather than through depository mechanism only. However, there are few long-term cheap funds available in the economy. We briefly review some potential wholesale investors or lenders.

*Commercial banks.* At present, the commercial banks are reluctant to lend longer term (more than 5 year) at lower rates to the housing finance companies even if they would have the funds to do so.

*Post Savings Bank*. With gross deposits in excess of Tk.9,000 million the Post Savings Bank could be a possible investor in the housing sector. However, the deposits are considered as government revenues and are not kept in separate accounts. In other

[18] During this brief consultancy only secondary inquiries were made about the availability and interest of wholesale investors in the housing finance sector.

words, government uses the deposit for its own funding and it is therefore an unlikely source of housing sector funds.

*Insurance companies*. The large public insurance companies presently only invest in the housing sector through the purchase of BHBFC debentures. Most private insurance companies are still relatively small and invest most of their funds in deposit accounts in the commercial banks. However, the equity investment in DBH by the most successful and innovative private sector life and general insurance companies[19], shows the potential of further linking the private housing finance sector and insurance companies. The Insurance Act sets, of course, restrictions as to the proportion and type of assets insurance companies can invest in: 30 percent in government bonds, 30 percent in government approved securities and 40 percent in government approved investments. The World Bank and IFC have discussed with the government the option to have insurance companies make their own decisions on investments for 25 percent of their funds. Such a change in the Insurance Act would simplify participation by the insurance companies in the housing finance sector, either as shareholders or loan providers. The development of securitization and debt markets will further facilitate diversification of investments by insurance companies and other investors.

*State Provident Fund and other pension funds*. There is a State Provident Fund to which all permanent civil servants (those who have completed two years of continuous service) contribute ten percent of their basic salary. Contributors are allowed to borrow against their savings, including for the purchase of a residential plot or house up to 80 percent of the outstanding balance in the individual's account or 36 times the monthly salary of the person whichever is less. There are several smaller public and private pension funds. Most are not paid up presently and pay out pensions from current income. Pension funds are regulated under the Trust Act, but most do not meet disclosure requirements (World Bank). It was, therefore, impossible for this study to evaluate the financial status of the state and other pension funds and we cannot speculate on their potential role in the housing sector.

*Micro-finance institutions.* BRAC's move to enter into a joint venture with Delta Insurance and HDFC from India to set up DeltaBracHousing (DBH), the first private sector non-banking housing finance institution in Bangladesh is an interesting and, for many, unexpected initiative by a MFI. BRAC sees this not only as a good investment opportunity, but its interest in this venture was related to the need for housing finance by its staff members: middle income households that have no access to mortgage loans and cannot afford to purchase a house. While the major NGO financial institutions and the Grameen Bank hold investments in office real estate, they have not participated in the wholesale financing of housing through other financial institutions.

*International investors*. Until recently, housing has not been a priority sector for external and donor funding. Also, the absence of a swap market in Bangladesh makes it difficult

[19] DLIC, established in 1986, has assets of approximately Tk.1.3 billion, and GDIC, established at the same time, has assets of approximately Tk.500 million. Delta Life pioneered a life insurance scheme, Gono Bima, in rural areas that allowed anyone over the age of 18 to acquire life insurance coverage at very low cost. Clients can swap their savings for a lumpsum, buy life insurance or get small loans from the cash flows of their savings.

for foreign investors to come in because of the exchange rate risk.[20] The recent investment by HDFC and IFC in a private housing finance company may prove a turning point. Other bilateral investment institutions, such as the FMO of the Netherlands, may consider investments and loan guarantees for new private housing finance companies. Such international funding is important for reasons other than providing necessary capital. It can assist, through its loan conditions and technical assistance, in the establishment of a proper policy and regulatory environment for the sector.

## E. Government Policy towards the Housing Finance Sector

The National Housing Policy of December 1993 recognizes that formal sector finance is only accessible to a small proportion of the population. It proposes a comprehensive approach to improve the public and private housing finance systems. It emphasizes a private sector approach to housing finance and the need to establish new private sector housing finance institutions. Some of the main objectives stipulated in the policy are 1) resource mobilization through tapping household savings for both public and private sector housing finance institutions; 2) the establishment of a Low Income Housing Fund from which new financial institutions and NGOs could acquire funds for on-lending to low income households, community groups etc. This idea was proposed in the ADB draft report on institutional strengthening for the housing sector (1993); 3) increasing the proportion of funds from insurance companies, unit trusts, commercial banks and other financial institutions to be allocated to housing and providing other incentives for these institutions to increase their role in the housing finance sector; 4) reforming the BHBFC into a self-sustaining premier housing finance institution; 5) introducing a secondary mortgage system in order to attract funds from a wider range of investors.

While this policy is a comprehensive approach to housing finance, it remained a plan without an implementation strategy. The Housing Fund, first proposed by ADB, was recently created but as a one-time injection of funds without a proper institutional structure. It is only accessible to NGOs and government agencies, not to private lending institutions. The BHBFC has only made very limited progress in becoming self-sustainable or in reaching lower income households. Few, but important, new developments took place in the primary market and a secondary mortgage market has remained unfeasible since capital markets are still insufficiently developed and it is not clear who the buyers of the mortgage securities would be. Insurance and Trust Acts have not been changed to facilitate lending by long-term investors in the he housing sector.

[20] GOB does not assume the exchange rate risk for housing sector loans. The Government of India did this during the early years of HDFC's existence.

## F. Main Issues in Expanding the Formal Housing Finance System

The general weaknesses of the financial sector have of course a negative impact on long-term lending for housing. These have been detailed above. Here we will specifically deal with housing finance issues.

***Distortions in the savings rates and resource mobilization***

A main distortion in the savings and debt system is the high rates offered by various government savings plans compared to market rates offered by private deposit taking institutions.[21] The plans have created an inverted yield curve where lower risk savings instruments carry higher returns than higher risk instruments. These distortions make it difficult for private sector institutions to raise household funds and hinder financial market development. Indeed, it is unlikely that the bond market will develop within this financial market structure. Long-term lending operations such as housing finance are particularly affected by the difficulty of raising long-term funds in the domestic financial market.

***Interest rate subsidies***

The BHBFC has access to lower-cost funds and is not yet required to incorporate adequate bad debt provisions in the overall cost of credit. This allows them to set their lending rates below the market rates, making it difficult for the private sector to compete and, therefore, suppressing the development of the private mortgage industry.

Interest rate subsidies have some major drawbacks apart from stifling private mortgage market development. First, they subsidize debt rather than housing directly. A below market interest subsidy encourages people to borrow as much as possible and repay their loans as slowly as possible. Second, the subsidies increase with inflation when interest rates go up, a poor index for subsidization. Third, the subsidies are not transparent. Subsidy amounts are hidden and vary with the market rate of capital. It is only through the constant additional government funding to BHBFC that the cost of the subsidies is apparent.

Alternative ways of subsidizing those households that could, with some assistance, participate in the formal mortgage market, need to be considered. For example, upfront subsidies that could be applied in any public or private financial institution are used in many countries. These can take the form of a direct transfer or allowance or a buy-down mortgage instrument, whereby an upfront subsidy is put in an escrow account and used to pay part of the monthly installment for the mortgage over a fixed period of time.

---

[21] The rate on a one year fixed deposit account by the Post Office Savings Bank is 10,50 percent, and by NCB and private banks approximately 9.00 percent. Other savings instruments of the government carry between 10 and 13 percent interest. The government requires these savings schemes for its debt financing. Moreover, civil servants depend on these plans for their retirement and will resist change. Indeed, the plan is widely known to be misused by higher income groups that should not invest in them, since these were meant for lower income households. Stricter monitoring by the Bangladesh Bank would be required as a first step.

In addition, the government could reduce the stamp-duty and administrative cost of mortgage lending to make it more affordable.

***Subsidy targeting***

The second issue is the poor targeting of the existing interest rate subsidy system. Subsidized loans are presently provided to those that could participate in the private market without assistance. Indeed, there is no difference in the income level of recipients, loan amounts and geographical target areas between the private lenders' and BHBFC's clients. The objectives of the subsidy scheme should be to assist those that do not qualify for a formal sector mortgage loan without some special assistance and thereby increasing the number of middle income households that can avail themselves of housing finance. The BHBFC ought to re-orient their assistance program to that group of beneficiaries. This would not only mean focusing on a different income group and other locations within and outside of Dhaka, but also providing other types of assistance to households not used to dealing with the plethora of requirements of underwriting and mortgage repayments.

***Risks, affordability and mortgage instruments***

Little experimentation has taken place to explicitly introduce different mortgage instruments to address the perceived risks in mortgage lending or to make mortgage finance more affordable to middle income households. Also, the pricing of risks and the conditions attached to the different instruments is often unclear.

*Fixed rate mortgages*. The FRM is the most common instrument in Bangladesh. Interest rates are fixed for the life of the loan and so are the periodic payments, irrespective of interest rate movements in the market. It exposes the lender to interest rate risk if unanticipated inflation occurs. However, lenders seem to feel that if a rate change is needed they can do so even on older loans on their books. In other words, while mortgages are written as fixed rate mortgages, these are in fact adjustable instruments at the discretion of the lender (ARMs). Borrowers are mostly not aware of this provision, however, and it has not been regularly applied. This adjustment feature considerably decreases the interest-rate risk to the lender, however, which should be reflected in the rate structure. An explicit adjustment protocol or index may be useful to consider.

G*raduated Payment Mortgages*. These are also fixed rate mortgages, but the repayment schedule has been set up in such a way that early payments are lower and increase periodically by a specified percentage. Some banks have used this type of mortgage in the past to deal with the tilt problem and to make housing loans more affordable. The tilt occurs because of the fact that under a compounded fixed rate interest system, when inflation is anticipated, interest payments are high in the early repayment period, driving up the regular monthly payment over the life of the loan. The problematic aspect of the GMP is that, by lowering the early payments, there is a period of negative amortization. For that reason banks do not like this instrument. Alternatives to the GPM, such as a 1-2-3-balloon mortgage, buy-down mortgages (see above) could be considered to make mortgage loans more affordable in the early years of payment, without the negative amortization features.

***Dealing with credit risk***
Both banks and non-banks are plagued by bad debt. Yet, very little systematic analysis is taking place on the specific causes for mortgage default. Presently, entire geographical and income segments are excluded from mortgage lending because of their high perceived credit risk. However, underwriting methods are very rudimentary and do not include a careful market analysis of the property. Affordability calculations for all types of residential properties are done mostly on the basis of future rental income even when owners are occupying the building. Also, servicing methods are not inducive to stimulate timely payments and there are long lapses before overdue notices are send out.[22] Foreclosure procedures take on average five years and clients know that financial institutions will only take them to court in extreme cases. It is, therefore, not known whether a poor payment record is based on client's inability to pay, the low value of the building relative to the outstanding loan, or on the perception of clients that no action will follow in case of non-payment.

Credit risk has to be dealt with on the balance sheet as well. Adequate systems have to be developed to classify the loans and deal with the bad debt through special provisions (see above). BHBFC has not yet addressed this issue adequately and the non-performing loans keep compiling on the books.

***Interest rate calculations***
Within the primary mortgage market (and micro-finance market) different types of interest payment calculations are used, which is often confusing to borrowers and increases the difference between government and non-government rate structures. While compounding is the most common way to calculate interest and is used by most of the financial sector, simple interest rates, which lower the effective rate (see Appendix 4), are used for special loans or customers. For example, BHBFC charges simple interest rates for smaller loans and as an incentive system for special customers, which translate into much lower effective rates. Also, NCBs charge simple rates for special customers, using the same nominal interest rate.

MFIs (see below) typically charge a flat rate for the entire loan period. No adjustments are made for principal repayments during the course of the loan. A flat rate therefore has a higher effective rate than the quoted rate. It is used for reasons of simplicity on small loan repayment calculations and because the quoted rate appears low, which has a positive effect on borrowers.

It is not always clear which type of interest rate calculations are used and it is often confusing to inexperienced borrowers who have to compare different costs of credit Also, the NCBs and BHBFC use a simple interest rate as an incentive for good borrowers without clearly calculating how much of a subsidy is provided by moving from compounded to simple interest rates. There is hardly any adjustment made in the rates

[22] For example, servicing for BHBFC loans is done by Sonali Bank. However, Sonali Bank does not run any risk in case of default.

for different risks or loan terms. Moreover, this lack of standardization will make it more difficult to develop secondary lending facilities at a future time.

***In summary, the formal mortgage market 1) is small relative to new housing construction, 2) only serves the highest income groups in carefully selected Dhaka neighborhoods, 3) has weak underwriting, loan administration and risk management practices, and, 4) has a segregated structure that provides advantages to the government owned BHBFC, which operates in the same higher income market. The present establishment of new specialized private housing finance institutions is a hopeful sign for a more healthy development of the mortgage market. However, these HFI have difficulty mobilizing adequate resources because of the lack of financial market development and the competition with government savings schemes.***

## VII ALTERNATIVE HOUSING FINANCE SYSTEMS

Several micro-finance institutions provide long and short-term credit for housing without a mortgage contract based on collateral. In other words, the financial institution does not require documents of ownership of the land and the house as collateral for issuing a loan. Loans are made on the bases of established membership in lending programs and a sound track record of repayments on previous loans. Group pressure and mutual support are used as guarantees for loan repayment. There is no recourse by the financial institution in the case of non-payment other than the persuasive and legal ways to recover the loan and future exclusion of the borrower from the credit program. The MFIs have no right to sell the property. Housing loans are typically based on the same underwriting and repayment structure used for the micro-credit income generating programs for rural and urban poverty groups. The Grameen Bank has the largest housing loan portfolio of this nature, but other MFIs carry housing loan portfolios as well, with different levels of success. Several micro-finance lenders are interested in expanding into housing. We will discuss the largest micro-finance institutions and their housing loan programs below. These four MFIs dominate the micro-finance sector in Bangladesh and have an outreach of 6.3 million clients (1997)

### A. Main Micro-Finance Housing Lenders

***Grameen Bank***.

The Grameen Bank was established in 1983 under the Grameen Bank Ordinance, to provide non-collateral- based credit to the rural landless poor, in particular women, for income-generating activities. Its charter prevents it from working in urban areas. It established the system of small group-based lending for groups of approximately 5 members, whereby the individual’s continued access to credit is related to the repayments made by the entire group. An integral part of the credit program is that members have to save in group-funds, savings accounts and emergency funds. These savings can, however, not simply be retrieved when the individual requires money; group and institutional requirements have to be adhered to. Another characteristic of the credit program is that extensive social development and technical assistance support is provided to the borrowers. These lending and savings systems have been effective in keeping down default rates and dropouts, and increased the savings rate among the rural poor.

The Grameen Bank has more than 1100 branches and approximately 2.3 million members (mostly women) in close to 40,000 villages. The total loan amount disbursed since its inception and until July 1998 was close to Tk.100 billion, with a recovery rate of 97 percent. The average loan size is $180. Total savings are Tk.25.14 billion (12/97), with Tk.808 million outstanding. Its financial margins (excluding grants) were 8 to 8.5 percent in the early 1990s.

The “Moderate Housing Loan” program was established in 1984 with a current loan maximum of Tk.25,000. After the floods of 1987 a “Basic Housing Loan” was introduced which presently has a loan maximum of Tk.12,000. It is targeted to the poorest rural households, similar to the income generating credit. This program has remained the most popular among the target population. There is also a loan program for the purchase of small parcels of land and a fourth one for the repair of houses. For loans above Tk.12,000 specific criteria are followed:

- Only well-established and functioning GB branches are allowed to disburse housing loans.
- Centers or groups that are interested in setting up model villages are given preference over individual or scatter site housing.
- Within groups the most deserving members that do not have their own house are preferred.
- Only groups and individuals that have successfully participated in earlier credit programs can receive a housing loan, the idea being that the housing loan has to be repaid out of the income raised by earlier income generating ventures.

The demand for housing loans has increased over time. The housing loan programs were funded by grant money from several foreign donors.

The Basic Housing Loan program developed a house design of a one-roomed house of 5.8 by 3.5m, with 4 cement pillar, corrugated iron roofing and a wooden frame. Each house has a sanitary latrine with 4 to 5 rings. The pillars and sanitary ring components are provided in kind as an integral part of the loan.

A total of Tk.6,714 million in housing loans had been disbursed until July 1998 for 446,237 loans of which 92 percent to women. Housing loans formed only 4 percent of total loan disbursement in 1997. This figure gradually declined since 1993 when it was 10.5 percent. The average loan size is Tk.15,000. According to the GB the repayments on housing loans were excellent until the floods of July/August 1998, when many houses were washed away or damaged and households found themselves without sources of income. Savings programs were not sufficient to guarantee continued repayments on the long-term loans or could not be accessed by the borrowers and defaults allegedly rose to approximately 50 percent. Earlier evaluations showed that housing loans had a poorer repayment record than income generating loans (source).

General loans, the most common type of credit, are provided for a one-year term at an interest rate of 20 percent. The lending rate for housing loans is 8 percent. Housing is considered a basic human need and providing adequate housing for one's family is part of the *sixteen decisions* to which borrowers must adhere when they participate in the general credit program. This is the rationale behind the internal cross-subsidization of housing loans. However, in reality a 10 year loan at a rate of 20 percent is unaffordable for the present target group and without internal subsidization a housing loan program would not be feasible.

The housing loan, like the other GB loans, are provided without collateral, but the borrower must have title to the land[23], she must sign an individual pledge which includes, among other things, the repayment obligation, and she must obtain a pledge from all members of the group or center, that commits them to repay in case the borrower fails to do so. Repayment is done in weekly installments, beginning five weeks after the start of construction of the house. The repayment period is calculated on the basis of repaying Tk.1000 per year, which is the standard loan repayment for other loans by the Grameen Bank. There is a maximum repayment period of ten years, but faster repayment is encouraged (faster repayment is required to meet the ten year loan period for the average housing loan).

The Grameen Bank as a whole enjoys both financial and economic subsidies. However, according to an evaluation by the World Bank, the overall subsidy level has steadily decreased since 1991 because of a lower dependency on international funding sources (World Bank, 1995). It is unknown how the payment amnesty to borrowers instituted after the recent flood and subsequent concessionary borrowing from the BB will impact the overall subsidy level.

The most critical challenge for the GB is to find cheap sources of funds for its lending programs. Members' shares and savings, Bangladesh Bank funding and international donations cannot meet the ongoing capital needs. Recently, its managing director made a plea to Wall Street investors to research the possibility of securitizing the Grameen loan portfolio, initially with commercial financial sector guarantees.

### *Proshika*

Proshika is one of the largest national NGOs involved in micro-credit. It was established in 1976 and focuses on education, organization and income generating activities for hard-core urban and rural poverty groups. In addition it has an environmental protection program. Proshika works with over 1.5 million members, organized in close to 75,000 groups. Like the other micro-finance lenders Proshika tries to become less dependent on donor funds. Presently, soft loans and grants from donors, either directly or through PKSF (see above), account for 43 percent of its funds, while members bring in close to 30 percent. Proshika started its urban program in 1990. It includes a component that focuses on the improvement of water, sanitation and electricity for the urban poor, in targeted squatter areas.

Proshika started a housing program for rural areas in 1988 and has provided assistance for the construction of more than 30,000 houses to date. The total amount disbursed for housing is Tk.193 million. Housing loans are based within the group and the group selects the member most deserving of a housing loan under strict allocation rules; i.e., only three housing loans per year per group, housing loans can only be provided to groups that are at least three years in existence. Loans have a maximum of Tk.10,000 with an equity contribution of Tk.1000. Loans carry a 5 percent flat interest rate

[23] Since most borrowers are women, the title deeds to the properties are registered in the name of women.

(reduced from 10 percent because of affordability reasons). There is no collateral to the loan. Loans have to be repaid in 75 months (6.25 years) at installments of Tk.144. Similar to the Grameen Bank housing package, the program works with a specific house design and part of the loan is disbursed in building materials (pillars, treated bamboo materials and a sanitary latrine) from one of the production groups set up by the program. The group, with assistance form a Proshika technical worker, supervises construction. Only those that have a loan for income-generating activities are eligible for a housing loan in order to ensure repayment capacity. However, this requirement increases the burden for the borrower, who now has to repay both a housing loans, involve herself in income generating activities and engage in house building activities.

The performance of the housing loan portfolio is not as good as that for the income-generating loans. While housing recoveries are at 85 percent cumulative, loan recovery for the entire portfolio is 96 percent. Yet interest rates for micro-lending are 18 percent while the housing loans at 5 percent receive a deep cross-subsidy.

Proshika plans to broaden its housing programs in the future. It will expand its individual house construction program and add a program for renovation and repair of existing houses, using its appropriate technologies program.

Proshika also intends to move into large-scale moderate-income housing development in Dhaka with the assistance of government funds and land (see above). It is the only NGO represented on the Board of the newly established Housing Fund for low-income housing developments by NGOs and governmental agencies.

***BRAC***

BRAC was established in 1972 as a relief organization to resettle households after the liberation war. In 1976, it started focusing on the improvement of the living conditions of the landless rural people through a system of village organizations, savings programs and micro-credit. It has approximately the same number of members as the Grameen Bank and a total cumulative disbursement of Tk.21,585 million. It is a professionally run organization with major investments in real estate.

BRAC's urban program began in 1991 and focused on education for city children. It is now proposing to extend its urban work to economic development, health, in particular water and sanitation, and other services.

The housing loans program started after the flood of 1988 and focused on the same rural poverty group. Only members who successfully repaid an income generation loan and saved for 6 months an equivalent amount to the monthly repayments for a housing loan, are eligible. The loans are smaller than those provided by the Grameen Bank and Proshika and have a maximum of Tk.8,000. Interest rates on housing loans are 5 percent and the repayment period is 3 years. Housing loans were only 2.25 percent of the total loan disbursements at the end of 1997 (BRAC 1997).

BRAC is considering to establish a moderate-income rural housing loan program with loans up to Tk.20,000. It is at the same time concerned to move into this market in view of the massive defaults that plagued the housing portfolio of the Grameen Bank after the recent floods.

BRAC also initiated a home loan program for its own staff members. It provides fifteen year loans at a flat rate of 10 percent (equivalent to a compounded rate of approximately 15 percent) for housing of a maximum size of 500 sq.ft.

***ASA***

ASA is another professionally managed NGO micro-finance institution with a very strong track record of the quality of its loan portfolio and its overall lean operational structure. It has a total of 1.4 million borrowers and savers and has a disbursed Tk.8,320 million in loans and accumulated Tk.720 million in savings since its lending program started in 1991. Consistent recovery rates of 99 percent have been achieved and the recent floods only had a minimal impact on loan recovery because of the strong savings program that allows borrowers to use their savings during bad times. ASA tries not to be overly dependent on donor grants and soft loans and, presently, close to half (47 percent) of their funds comes from members savings, 35 percent from borrowing and only 5 percent from donor grants. Its profit margin is 3 to 4 percent.

ASA runs both rural and urban micro-credit programs and has a total of 750 branches of which 90 are in urban areas. Recovery rates are the same in urban and rural areas. In order to save on operational costs it does not work with small groups or group-based loans like the Grameen Bank, Proshika and BRAC. Each branch needs to become financially self-sustainable and requires a minimum of 300 to 350 clients per worker.

Its average loan for income generating activities is $150, which is repaid in 50 weekly installments on a 12.5 percent flat rate (approximately 23 to 24 percent compounded per year).

ASA started a rural housing credit program in 1989/90. Loans with a maximum of Tk.9000 were issued at a flat rate of 10 percent. It issued about 2000 to 3000 loans but it did not have satisfactory results as far as repayment is concerned. The target group for its lending programs are poverty groups that earn less than Tk.2000 in rural and less than Tk.3000 in urban areas and these groups can only afford to repay Tk.25 per week for their micro-credit. ASA’s management considers housing loans to the lowest income group unfeasible and intends to target the rural middle class farmers for that lending activity in the future. Interestingly, a sizable group of borrowers (close to 15 percent) use part of the income-generating loans they receive for other purposes such as the improvement of their homes, even though that is explicitly forbidden. This is an indication that the demand for housing loans is large.

## B. Critical features of the micro-finance housing loans

*Scope and scale*
Housing loans form only a small proportion of the MFIs total loan portfolio (never more than a few percent), and have only been available to rural landless borrowers, the majority of which are women. A total of approximately 700,000 housing loans have been issued since the programs started in the 1970s and 1980s. No urban housing lending programs exist.

***Loan terms***
Equity requirements, interest rates and loan periods vary widely. Flat interest rates range from 5 to 10 percent. The term varies from 6 years for Proshika to 15 years with GB. Where repayment amounts are fixed but loan amounts vary, the term is dependent on the loan amount. The 15-year loan issued by the Grameen Bank is the longest and is considered too long by the other MFIs for the rural poor to carry. GB may reconsider the period after their recent high default experience on their housing loan portfolio. The housing loans have simple application and approval procedures and assistance is provided with the design and purchase of cheap and appropriate building materials.

***Targeted Households***
Housing loans are considered social sector loans and are provided to the most deserving members of rural groups, those without land and shelter. All MFIs require a track record of successful loan repayment of an income-generating loan or a simultaneous loan for income generating activities that would guarantee the repayment of the housing loan. However, the size of the housing loans and the related repayment obligations and period is least suitable for this rural low-income group (although these clients are not the hard-core poor either).

There is a growing awareness among some of the micro-finance institutions that there is a need to differentiate among subgroups of rural and urban poor that have different needs for credit, including housing credit[24]. Several MFIs are interested in expanding micro-finance to small individual entrepreneurs to set up businesses and move to another level of economic development than possible with micro-credit for individual income-generating activities. Similarly, housing loans could be targeted to those who have established more secure incomes and can more easily afford market rate payments, rather than to the poorest households alone. This would allow the expansion of the housing programs considerably and reduce their risk.

***Internal cross subsidies***
All housing loans carry a lower rate than income-generating loans and are internally cross-subsidized within the MFI. There are several related reasons for this cross-subsidization: first, housing is considered a social good and a basic need worthy of subsidization; second, without subsidization the rural poor would not be able to afford a

[24] Remenyi (1993) makes a distinction in: vulnerable/ultra poor, laboring poor, self-employed poor, entrepreneurial poor and near poor.

housing loan. However, if housing lending programs are targeted to those who have established a solid income base established through previous micro-credit and micro-finance programs, such deep cross-subsidization would not be necessary and more rural households could be assisted with housing loans.

***Credit risk***

The micro-finance sector does not use a mortgage instrument for its housing loans. Land titles are cumbersome and costly to get and many households live on land that is not legally theirs. Loans are collateral free and lenders do not have recourse in case of delinquency. Foreclosing on a housing loan and repossessing the house would, in any case, be a theoretical option only. In rural areas the market for houses of delinquent households would be non-existent. Security is provided by group support and social pressure on the borrower to pay and the threat of future sanctions when additional credit is sought. Some past programs have used a chattel mortgage, which secures the loan through a claim on the house only (instead of on the land and the house).

Housing loan portfolios have a slightly higher level of default than the income-generating loans, although defaults are generally much lower than in the private mortgage sector. Defaults are due mostly to inability to pay, rather than to low equity in the house or lax recovery systems (which are the main causes of default in the formal housing finance sector). Also, the recent floods have emphasized again that rural housing loans are exposed to systemic risks of default when floods or cyclones strike the country. Under the present cross-subsidy system, the higher risk on the housing loans is perversely reflected in the interest rate structure of MFIs which applies lower rates to these loans than to the regular micro-credit loans. In addition, savings schemes attached to the micro-credit loans are too small to act as a buffer in case of payment problems for housing loans, and, for most of the programs, savings cannot be accessed when needed to bridge a difficult period in a household's life cycle or deal with natural catastrophes.

***Housing solutions***

Loans are only provided for new home construction, mostly for specific house designs. Only GB has a small loan program for rehabilitation or extension of houses. Yet many households use part of their income-generating loans for housing improvement, even though that is explicitly forbidden. An extension of housing loan programs to cover housing rehabilitation may be a worthwhile option.

None of the MFIs have an urban housing loan program, not even for small towns. This rural focus is related to the overall orientation of MFIs towards rural poverty alleviation (e.g. the GB is not allowed to lend in urban areas). But even for MFIs working in urban areas, the housing sector is too big a challenge, because of the high cost of new housing in relation to incomes, particularly if land costs are included. Also, there is a perception that the greater mobility of the urban population poses a higher credit risk for longer-term credit such as housing credit. However, ASA, for example has successfully run credit programs for urban households, even without the rigid group structure utilized by other MFIs as a guarantee for repayment. Moreover, urban housing problems are severe and several NGOs and MFIs are interested in extending their housing assistance to urban areas.

***In summary, while Bangladesh is unique in having several large MFIs operating a housing credit and construction program in the rural areas, the following characteristics of these programs constrain their extension: 1) the targeting to the poorest rural households who are recipients of income-generating credit, 2) the lack of housing improvement and extension loans, 3) the high internal cross-subsidy provided for housing loans, 4) the vulnerability of the programs to systemic default risks, and, 5) the lack of a savings cushion to deal with these risks. The problem of extending the housing programs to urban areas is tied to the high costs of land and the perceived difficulty to run longer-term credit programs for the urban poor. However, ASA has successfully run credit programs for urban households, even without the rigid group structure utilized by other MFIs as a guarantee for repayment. The larger MFIs agree that under specific conditions the extension of credit for urban housing may be considered.***

# VIII ANALYSIS AND MAIN RECOMMENDATIONS

## A. Summary of Main Issues

One of the main determinants of housing affordability is the cost and availability of housing credit, both short-term construction credit and long-term mortgage credit. Urban housing, which is more expensive than rural housing because of land costs and higher building standards, and is increasingly dominated by multi-family housing, is particularly affected by the availability of credit. With present high urbanization rates in Bangladesh the need for urban lower-middle and low-income housing is enormous and this drives the need for improvements in the housing finance system. Without upfront finance for house construction or purchase, delivery of formal sector housing, even to middle income households, becomes impossible. In rural areas and informal urban areas, small non-collateralized loans for house-construction or improvement can facilitate the improvement of housing conditions.

The present housing finance system in Bangladesh is extremely small and highly segmented:

- Formal mortgage finance is only available to households with incomes above Tk.25,000 per month (well above the $10^{th}$ percentile of the urban income distribution) and is restricted to selected housing sub-markets in Dhaka. Within this section of the market, government subsidized housing finance through the BHBFC is most prevalent, while the NCBs are decreasing their housing loan portfolios. Recently, new private housing finance institutions have started to operate in this market.
- Non-collateralized credit for house-construction by MFIs is only available to a small proportion of poor rural households that have participated in income-generation credit programs.

All other households that aspire to home-ownership are dependent on their own savings with additional contributions from relatives, friends or employers, or short-term money-lenders. Given the lack of credit and the overall low levels of income, informal and non-permanent housing prevails, both in urban and rural areas.

The challenges facing the housing finance sector in Bangladesh in narrowing this extraordinary gap in access to housing credit can best be divided in three parts: 1) how to increase the number of households that have access to formal construction and mortgage finance to build or purchase a home in the formal urban housing sector, 2) how to extend credit to lower-income urban households that already own a house in the informal sector or could, with special assistance, acquire an apartment or plot but would not qualify for formal mortgage programs, 3) how to enhance and expand rural housing lending programs. We will look at each in turn.

## B. Downward-Market Expansion of Formal Mortgage Lending

The formal housing and housing finance sectors are in a transition stage. There is presently tension between movements in the property market for space and the responsiveness of the asset market driven by developers. The property market shows excess demand in the middle income sector and a tightening of demand for high cost housing; the developers produce housing that gives them the highest profit at the lowest risk. Until recently, developers considered the high-cost housing market the most profitable and risk free. However, that situation is changing with decreasing demand for top of the market housing. The middle income market is large in comparison and therefore less risky. Indeed, private developers have begun to produce smaller and cheaper units. However, to respond to the existing demand for middle income housing (for both multi-family housing produced by developers and owner-built single family houses), mortgage finance is required at efficient rates.

Government funded housing credit will remain limited and the weak financial position of the NCBs will prevent increase of housing finance through those institutions. The expansion of the sector has to come through new private sector mortgage lenders. With existing capital constraints in the financial sector, the competition by government savings and lending institutions and the weak debt market, new HFIs face a challenge mobilizing funds and it is unlikely that the cost of longer term funds will come down in the short term. Also, the housing finance sector has to show that it can be a profitable investment sector with long-term potential. This is the dilemma faced by DHB and other new housing finance companies. When more technically and financially strong HFIs enter this sector, these should be transitional problems. With the right support and policy changes, the private development and housing finance sector could move down-market to serve a much larger proportion of middle income households. In its turn this will alleviate the pressure on lower income housing. Several reforms and innovations could be considered and discussed:

***Expanding financial resources available to the private housing finance sector.***

- *Changes in the Trust laws and Insurance Act* in order to allow long-term investors to participate more freely in the housing finance sector.
- *Assistance in the development of a debt market* that would facilitate the link between housing finance institutions and long-term investors. The World Bank is launching a project to support non-bank financial institutions through the establishment of a credit, bridge and standby facility and the development of debt and equity markets. While HFIs are excluded from participating in the first round of the project because of their short track record and specialized nature, it would be critical to include them in a later phase.
- *Enforcement of the rules guiding participation in the GOB special savings schemes* to those lower income individuals for whom these were intended.
- *Encouragement to the larger and professionally run MFIs to set up banks or non-bank financial institutions* in order to create a more vigorous domestic financial sector environment that can provide support for the emerging housing finance sector

and its move towards middle-income lending. Encouragement of joint ventures between MFIs and new HFIs as is the case in the new DBH.
- *Stimulation of foreign investment in, and foreign lending and guarantees to the new HFIs* by carefully selected parties (e.g., IFC, FMO, HDFC), both to strengthen technical ability and financial stability. In particular, arrangements are needed to deal with the foreign exchange risk by potential investors.

***Leveling the housing finance playing field.***
- *Deciding on the role of BHBFC and detailing an implementation strategy*. If it is perceived that it is unlikely for BHBFC to change to an efficient and innovative middle and lower-income mortgage lender, its borrowing / debt raising privileges could be adjusted in order to discourage its competition with the newly developing private HFIs for the same customers.

***Increasing access to formal mortgage finance by middle-income households***
- *Discussion of introducing alternative subsidy instruments for presently under-served lower and middle-income households in specific housing markets*, that will not distort private mortgage market development and can be utilized by all mortgage lenders, public and private. These would replace BHBFC subsidized funds and public servant subsidized government lending schemes. For example, upfront subsidies to selected beneficiaries would lower the down-payment requirements or the monthly payments during the initial phase of the loan period, and would allow this group to acquire a house and a mortgage through the private sector and with a loan from formal mortgage lenders. This would constitute a move towards a demand driven subsidy system rather than a subsidy through the supply of government built houses or government subsidized credit. An alternative subsidy scheme could incorporate a counseling service to assist households in the process of acquiring a mortgage.
- *Decreasing the administrative costs related to mortgage lending*. Presently, the administrative requirements and costs related to the construction and mortgaging of a house are considerable and have been identified by REHAB as an unnecessary hurdle to acquire a house.

***Improving the efficiency of the primary mortgage market***
- *Training in state-of-the-art mortgage lending and servicing operations for those actively involved in changing the mortgage industry in the country*. There are presently few professionals in Bangladesh with detailed knowledge of mortgage design, specific risk management issues related to mortgage lending and loan underwriting, processing and servicing procedures necessary to establish a healthy mortgage sector.
- *Improving the regulatory system for new HFIs* which is now divided among various agencies, none of which have experience with mortgage lending operations and risks.

## C. Expanding Access to Micro-Finance for Housing in Urban and Rural Areas

Bangladesh has some of the most developed and successful micro-credit institutions in the developing world. Few MFIs have ventured into un-collateralized housing credit, however, and those that have, maintain only small housing loan portfolios and serve only the poorest rural households that are already engaged in group-based income-generating credit programs. Part of the reluctance to expand the rural housing programs is the lack of affordability of these larger loans by the present rural target population and the need for internal cross-subsidization of housing loans. Also, priority is given to productive ventures, mostly micro-credit for income-generating activities. Expansion of housing loans to urban areas has not been considered because of a lack of affordable housing options in urban areas and the fear that the lack of social control and cohesion in urban neighborhoods may increase loan defaults. However, there is an interest to expand rural lending to other groups than the poorest landless households. In the same vein, housing loans may be appropriately targeted to a slightly higher income rural population. In urban areas, housing conditions are so poor for the majority of urban households that several micro-finance institutions are beginning to seek ways to become engaged in the improvement of urban housing and services. A number of institutional changes may be considered for a successful extension of housing credit programs in rural and urban areas.

***Improving the sustainability of micro-finance housing programs***

- *Limiting cross-subsidization of housing loans*. Present micro-credit loans for housing are considered a small, special benefit program for rural poverty groups by most MFIs, funding for which is cross-subsidized by income-generating credit programs. If housing lending is to be extended to a variety of rural income groups and to urban lower income households, it cannot depend on internal cross-subsidization, which increases the cost of micro-credit and will, by necessity, limit the scale of the housing programs. It is, therefore, timely to consider separating longer term housing finance in MFIs from the general micro-finance portfolio, both in terms of sources of funds and as a credit program with its own types of lending terms, conditions and break-even requirements.
- *Targeting borrower groups that can afford longer-term loans*. A second consideration to make housing credit programs more sustainable is to target households that have already established a solid income base through previous income-generating credit programs or micro-finance loans. Those that are in the process of repaying micro-credit loans and are still without a stable income would not be the preferred candidates to receive a housing loan.
- *Requiring savings accounts*. Carefully crafted income and employment requirements ought to guide the loan underwriting process. In addition, a more stringent savings requirement could be built into the housing loan package, not only for upfront payment for part of the house, but also as a savings account that would be accessible in case of possible delinquencies (see above for the successful life insurance savings schemes through Delta Life). Such a savings scheme would have to be different from the Grameen type compulsory savings scheme. The savings should be available when needed by the client. ASA has had good results with this type of savings mechanism.

- *Assessing housing quality and location for disaster vulnerability*. Natural disasters plague the rural housing sector and cause large defaults in housing portfolios. When two-thirds of the country are affected by floods, it is difficult to devise strategies that will provide insurance for this type of natural disasters. However, housing loan programs may more carefully analyze the minimum quality of housing required to withstand flooding or cyclones. Similarly, the location of funded houses should minimize the danger for the house to be damaged.

***Extending micro-finance for housing to urban households***

- *Extending housing rehabilitation and extension options in housing credit programs*. A housing improvement loan program for owners of informal housing may be a starting point for the extension of micro-credit to urban households, for example, in conjunction with existing services improvement projects (UNICEF) in bustees.
- *Analyzing lending options for new urban lower-income housing*. Given that the cost of land is the main constraint for urban housing programs, a possible collaboration with local government land allocation and development programs may be explored. In addition, NGOs / MFIs could experiment with joint land ownership forms for low-income housing projects, where credit for ownership housing is provided for the unit only but the land remains the ownership of the group.
- *Establishing more professional micro- and mortgage lending programs for housing*. Moving towards urban lending programs for new house construction for lower income households will require that MFIs develop a different set of underwriting criteria, equity and savings arrangements and interest rate structures based on the actual risks to which they are exposed. Subsidies may have to shift more towards land cost than the cost of finance.

***Creating a funding and monitoring window for micro-finance for housing through PKSF***[25]

*Expanding and professionalizing the housing loan programs by interested MFIs, will require a more reliable source of finance earmarked for housing; an apex housing fund for low-income housing lending*. Such a fund should have the capacity to carefully monitor the housing loan programs implemented by participating MFIs and provide technical assistance in the specialized field of housing lending where necessary. Presently, MFIs only can access outside funds through the PKSF apex funding window for micro-credit. They have to find their own funds for housing programs.

PKSF would be the most suitable organization to manage such a housing fund. It has a strong professional track record and is trusted by GOB, International Agencies and NGO/MFIs alike. PKSF is a typical innovative Bangladesh financial institution in the way it combines government, private sector and NGO participation in micro-finance. It receives GOB and international agency funds and on-lends these to pre-qualified MFIs (see above). Importantly, in the effectively unregulated NGO/MFI environment, it

[25] PKSF was established in 1990 by GOB and was initially wholly funded by the government. It is registered, however, as a non-profit private limited company, governed by a general board of 7 people of whom three are from the government.

provides professional guidance and supervision of its participating organizations. This task is even more critical for a longer term housing loan program.

Initial discussions with PKSF found the organization open to explore an extension into the housing sector. The housing fund should be separate from the micro-credit fund and could have different lending rates and other requirements. Typically, interest rates for housing loans would be closer to market rates than micro-credit loans. A PKSF housing fund could begin with a small number of the most experienced NGOs and initially focus on rural areas. When experience is gained, an extension to urban areas could be considered. PKSF would need to acquire housing finance expertise for this new venture.

***In conclusion, the formal mortgage market can expand its lending operations to middle income households by improving efficiency, mobilizing additional resources for housing lending from long-term investors, and redirecting present mortgage subsidies tied to government programs and institutions to demand oriented programs that can be implemented through the public and private mortgage lending sector. At the same time non-collateralized housing credit can be expanded by the professional MFIs through increasing access to funds earmarked for housing, reducing the need to provide internal cross-subsidies for housing loans, broadening the target population to rural entrepreneurs and urban lower income households in specific geographic locations and developing more varied and professional housing finance products. The combination of these two approaches have the potential to dramatically increase access to housing credit and finance for low and moderate income households, with related improvements in the quality of housing in Bangladesh.***

**Appendix 1: Weighted Average Rates Of Interest On Deposits, 30-06-1997**

| Banks | All Deposits | Savings Deposits | Deposits Withdrawal at Notice | Fixed Deposits | Break-up of Fixed Deposits | | | | | Other Deposits |
|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | 3 months to less than 6 months | 6 months to less than 1 year | 1 year to less than 2 years | 2 years to less than 3 years | 3 years and above | |
| All Bank | 6.67 | 7.37 | 5.10 | 8.66 | 8.04 | 8.50 | 8.52 | 8.92 | 9.56 | 4.23 |
| Nationalised Commercial Banks | 6.96 | 7.50 | 5.22 | 8.79 | 8.13 | 8.44 | 8.47 | 8.94 | 9.78 | 5.08 |
| Private Banks (a+b) | 5.80 | 6.90 | 4.88 | 8.45 | 8.00 | 8.58 | 8.56 | 8.83 | 8.85 | 1.38 |
| a). Domestic | 5.96 | 6.92 | 4.82 | 8.51 | 8.18 | 8.44 | 8.55 | 8.84 | 8.84 | 1.68 |
| b). Foreign | 5.08 | 6.50 | 5.00 | 8.23 | 7.65 | 9.05 | 8.64 | 8.33 | 9.19 | 0.23 |
| Specialised Banks | 8.73 | 7.93 | 5.88 | 8.90 | 7.82 | 8.45 | 8.75 | 9.17 | 9.57 | 10.11 |

Source: Scheduled Bank Statistics, Bangladesh Bank, 1997

## Appendix 2: Housing Tenure

**Housing by tenure (%)**

| *Tenure* | *Dhaka* | *Chittagong* | *Tangail* | *National* |
|---|---|---|---|---|
| Owned | 31.34 | 52.43 | 75.00 | 88.00 |
| Purchasing | 0.08 | n.a | n.a | n.a |
| Private rental | 53.55 | 31.93 | 15.00 | 6.65 |
| Social housing | 1.16 | 1.25 | 0.72 | - |
| Sub-tenant | n.a | n.a | n.a | - |
| Rent free | 6.50 | 2.94 | 0.33 | 5.28 |
| Squatter no rent | n.a | n.a | n.a | - |
| Squatter paying rent | n.a | n.a | 6.79 | - |
| Others | 6.77 | 11.45 | 2.16 | - |

Source: Bangladesh National Report for Habitat II, 1996, p 68

**Appendix 3: Urban Housing Requirements, 1981-2000**

**Estimated New Urban Housing Requirements, 1981-2000**

| **Location** | **Total Population 1981** *millions* | **Total Housing Stock** *millions* | **Projected Population 2000** *millions* | **Projected Housing Stock 2000** *millions* | **New Housing Need 1980-2000** *millions* |
|---|---|---|---|---|---|
| Dhaka SMA | 3.35 | 0.515 | 9.3 | 1.691 | 1.176 |
| Chittagong SMA | 1.43 | 0.220 | 4.0 | 0.727 | 0.507 |
| Khulna SMA | 0.70 | 0.108 | 2.3 | 0.418 | 0.310 |
| Other cities | 0.79 | 0.121 | 3.5 | 0.636 | 0.515 |
| 100,000-50,000 towns | 1.03 | 0.158 | 3.7 | 0.672 | 0.514 |
| Other urban | 4.50 | 0.698 | 16.3 | 2.963 | 2.265 |
| TOTAL | 11.8 | 1.820 | 39.1 | 7.107 | 5.287 |

Source: Rafiul Karim, The journal of Local Government, vol 22, no 1, 1993

## Appendix 4: Different ways of interest rate calculations in mortgage lending in Bangladesh

*Compounded interest.* Under compound interest calculations a fixed monthly payment is made throughout the life of the loan on an annuity basis. Periodic payments on compound interest loans include mostly interest payments in the early years of the loan and principal payments only become important when the loan matures. This is the most common way to calculate interest and is used by most of the financial sector.

*Simple interest*. Under a simple interest loan a fixed amount of principal is repaid every period and interest is charged on the outstanding balance only. Periodic payments on a simple interest loan are the sum of interest and principal installments over the life of the loan divided by the number of payments to be made. Therefore, repayments made in the early years do not cover the interest on the outstanding principal adequately, effectively lowering the interest rate on the loan.

*Flat rate.* Several MFIs charge a flat rate for the entire loan period. No adjustments are made for principal repayments during the course of the loan. A flat rate therefore has a higher effective rate than the quoted rate. It is used for reasons of simplicity on small loan repayment calculations and because the quoted rate appears low, which has a positive effect on borrowers.