Home Loans – Recent Trends in Sri Lanka

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There is a rising demand for home loans in Sri Lanka. The market has grown at a compound rate with the escalation of per capita income and changing patterns of consumption and saving habits in the recent past.

Sri Lanka is an island situated in the Indian Ocean with a population of 19 million. Its GDP has been growing by an average of 6% for the last 3 years. GDP per capita stood at US$1,200 in 2005. The Colombo Consumer Price index - the official price index to measure inflation – showed growth of 11.1% in the year to January 2006 compared to 8.8% one year ago. The overall rise in consumer products and the rise in international commodity prices contributed to domestic inflation during 2005. The unemployment rate, which is around 8%, has remained unchanged for the last 3 years. In the banking and financial sector, the Average Weighted Price lending Rate (AWPR) of commercial banks stood at 12.1% in January 2006. However, during the same period, the Average Weighted Deposit Rate (AWDR) remained as low as 6.34%. The rate of interest charged on housing loans currently varies from 11% to 15%. These spreads suggest that the banks in Sri Lanka keep very high margins even for secured lending.

The key factors triggering the progressive growth of home loans on the demand side are:

a) Declining interest rates over the past year have encouraged investment in properties rather than in low income yielding government securities and term deposits.[1]

b) Rapid rises in income in the private sector, which makes housing more affordable. Increasing income levels have shifted consumption to areas such as housing.

c) Tax benefits extended to borrowers, which have further reduced the effective cost of borrowings.

d) The demand arising from migrant workers and Sri Lankans residing abroad. Many Sri Lankans residing abroad prefer to invest in housing in Sri Lanka, as an alternate means of investment. Migrant employees who work and reside abroad, desire to have a house of their own in Sri Lanka once they return to the country. Therefore they invest their hard-earned money on real estate for two specific reasons: first, the return on investments is comparatively high due to the appreciation of prices; second, they cannot expect a real positive return on their bank deposits due to negative interest rates prevailing in the country.

Certain factors on the supply side have also supported growth in housing finance. They are:

a) Emerging competition in the housing finance sector between lenders; this has resulted in lenders charging lower rates of interest and offering more and better facilities.

b) An increasing number of new entrants to the housing finance market such as foreign and local commercial banks.

c) The introduction of several new products by lending institutions to meet the needs of a wide variety of customers . Floating rate mortgages, branded housing loan products and expansion of loan portfolios by lending institutions by way of securitization, are new to Sri Lanka.

d) Increasing collaboration between lending institutions and housing developers. Such collaboration minimizes legal issues relating to mortgages, thus making it easier to purchase a property. In Sri Lanka, housing loans are mostly obtained for individual house building. The development of land by developers and condominiums are rather new in Sri Lanka. In the case of developers who develop land for sale, banks are now in collaboration with them to ensure clearance of title for the entire land so that the bank need not clear title for each block. This has minimized legal issues for individual house builders.

e) Introduction of home loans at floating rates which have become popular among borrowers, since the cost of borrowing at short term rates is comparatively less than long term fixed rates. This is mainly due to the perception among borrowers that they could enjoy lower short-term rates as the variable rate product is new to Sri Lanka.

[1] In Sri Lanka the real return on savings is currently negative: i.e. – the rate of inflation is higher than the interest rate on deposits. Therefore, people prefer to invest in properties.

Demand for Housing

The annual demand for housing in Sri Lanka is estimated at a rate of 80,000 to 100,000 units. This number is expected to substantially increase in the future. In addition, there is a growing demand for condominium units in the Western provinces of Sri Lanka from expatriates and Sri Lankans residing abroad.

The construction of high-rise apartments has become a lucrative business and the number of such buildings in the city area is increasing rapidly. The Apartment Ownership Law No 11 of 1973 has been amended by Act No 45 of 1982 and further amended by Act No 39 of 2003 giving more and more authority and flexibility to apartment owners and lenders.

There are a large number of houses all over the country which require upgrading. The latest figures published by the Department of Census and Statistics have put the number of fully and partially damaged units after the Tsunami at 77,561.

Major Players

State owned institutions play a major role in the housing finance market in Sri Lanka. Traditionally, the housing finance market has concentrated on State funded sources since housing development strategies in Sri Lanka have been mainly initiated through State owned institutions. The Government concentrates mainly on affordable housing for low and middle-income earning groups. This policy includes subsidized housing loans, participatory housing schemes for low-income groups and apartment complexes in urban areas for middle-income groups. In urban areas, shanties are cleared and the land is released for development of apartments for shanty dwellers. The income derived from the acquired and released land would be sufficient to construct apartments for shanty dwellers who abstain from the right of living on the land acquired.

State owned lending institutions include State Mortgage & Investment Bank (SMIB), Housing Development Finance Corporation (HDFC), National Housing Development Authority (NHDA) and the National Savings Bank (NSB). These institutions have a combined market share of 65 % of the housing finance market.

However, Government sponsored housing finance strategies have become more and more non-viable due to the non-availability of government funds for these institutions. The government now realizes the need to develop a self-sustaining housing finance market with the participation of private institutions.

Currently, state owned commercial banks and local and foreign private commercial banks which have aggressively entered the housing finance market, play a major role in these activities. For example, NDB Housing Bank Ltd. (NDBH) commenced its operations in 2001 as a bank specializing in housing finance and is the only specialized private sector housing finance institution at present. NDBH is an extremely small entity with an asset base of US$ 14.5Mn and a market share of around 2%. Therefore it is yet too early to evaluate its performance.

In addition, certain micro-finance institutions introduced housing loans to their members as a part of an attempt to develop the living conditions of the poor. This scheme is becoming more and more popular among the members of such communities, as the processing of loans is less cumbersome when compared with that of traditional housing finance. Micro-finance institutions release loans to their members for housing purposes only on a group guarantee. The cumbersome documentation procedure of title reports, extracts, approved building plans, etc is not followed and no mortgages are involved.

Source of Finance

Housing development lacks Government funding due to budgetary constraints. Consequently, activities of institutions such as the National Housing Development Authority are confined to recoveries only. Other State owned institutions such as SMIB and HDFC depend on deposit mobilization and funds borrowed from the debt market for their mortgage market activities. In contrast, the NSB funds its housing finance operations by deploying 100% of its own mobilized funds. NSB's current strategy for enlarging its retail portfolio has helped its housing finance operations immensely, as it is one of the viable and productive areas of finance that the NSB is permitted to operate, within statutory limits. Most commercial banks deploy their own mobilized funds for housing finance operations. Although the AWDR in Sri Lanka is around 6%, the current lending rates vary from 11% to 15%, demonstrating a wide gap between deposit terms and loan terms. However, the banking community claims that high margins are due to taxes on banking operations such as corporate tax at 35%, VAT on certain banking operations at 20% and stamp duty etc. The other main contributory factor is the high non-performing loan (NPL) ratio currently prevailing in Sri Lanka.

Since the debt market is not yet adequately developed, access to long-term funds for housing finance still poses difficulties. Most banks use short-term funds from savings and current accounts and deploy these funds to disburse long term housing loans, thereby creating an asset-liability mismatch. In Sri Lanka, the Central Bank does not specifically require lending institutions to prepare a duration gap analysis periodically, in order to verify their asset-liability mismatch. Although there are no specific regulatory provisions, the Central Bank of Sri Lanka nevertheless continuously monitors the asset liability mismatch of banks in order to ensure their liquidity.

The Employees' Provident Fund (EPF) provides housing loans to its members through State banks, retaining the fund balance of members as collateral. There has been a steady demand for loans under this scheme since loans are granted purely on the recommendations of the EPF. The main drawback of this scheme is that borrowers use the EPF loan scheme to make early withdrawals from their Provident Fund balance, which would otherwise become available to them only on reaching the age of 55 years.

In order to overcome the lack of funds for long term housing loans, housing finance institutions could develop credit instruments backed by their mortgage portfolio, thus enabling lending institutions to issue mortgage backed securities to raise long term funds. HDFC has already issued Mortgage Backed Notes to raise funds from the debt market. However, the absence of a proper legal framework, the lack of uniformity in arranging such notes, and the lack of understanding by the players are some of the hindrances in developing a secondary mortgage market in Sri Lanka.

Loan Products

Most loan products offered are fairly standardized because the demand for loan products is mostly uniform.

The common features of currently available housing loan product are shown in the table below.

The attempt made by certain lending institutions to add value to loan products has not been a success due to lack of demand for such value additions. For example, some lending institutions offered a loan package that includes building materials at a discounted price, but the response to such schemes has not been encouraging.

Cross selling of products and services to the prospective borrowers is also not very popular in Sri Lanka. In the Indian market, on the contrary, cross selling is very popular. For example, a person looking for a housing loan is also offered a life insurance, home protection insurance, personal loans and other banking products.

Going beyond standardized housing products, the National Savings Bank offered to its customers loans for the improvement of their living conditions. They could get finance from the NSB to beautify their houses through new furniture, landscaping, curtaining, air-conditioning etc. As a result, a bare building could be converted into a home by furnishing, landscaping, curtaining and providing many more extra facilities such as hot water, air conditioning, internet connection etc. NSB also offers loans to existing home loan customers, for personal consumption purposes such as education, health, purchase of consumables and motor vehicles.

Fixed or Floating Rates of Interest

Most new entrants to the home finance market have introduced variable interest rates on housing loans. The interest rate, the financial cost of the loan, is not fixed during the tenure of the loan. Instead, the interest rate is benchmarked against a certain index. As the benchmark rate moves up or down, the cost of the loan too changes at pre-determined intervals, usually once a month or quarter. The interest rate on floating rate mortgages may be re-set at predetermined intervals, on either monthly or quarterly basis, so that the interest component either goes up or down depending on the movements of the benchmark rate. The borrowers could be at a risk in instances where the rate of interest goes up.

Most government banks still follow the fixed rate system for home loans. Although it is a fixed rate, the lending bank enjoys the right to change the rate at its discretion, even upwards. Practically this does not happen in Sri Lanka.

There are three important factors which one needs to consider before opting for one type of loan over the other. The long-term expectation of interest rates is the first and most important determinant that needs to be considered when opting for a particular type of loan. If one expects rates to rise in the first years, but then decline gradually over the following years, a floating rate product would be preferable. The other option of going in for a fixed rate product and then switching over at the end of the year will entail additional costs such as prepayment fees and may not make financial sense.

The attraction of a floating rate home loan is that it is not subject to pre-payment charges. This would appeal to individuals who expect lump sum money, which could be used to reduce their loan exposure.

When considering a fixed rate home loan over a floating rate loan, the important consideration for the customer is that if the interest rates were to rise, he would be protected from the interest rate risk.

Fixed rate loans are generally priced higher when compared with floating rate products. The difference in interest rates depends on the long term expectation of interest rates. If the borrower thinks that the rate will move up only to the extent of the difference, he will be indifferent to the options available. The deciding factors then, should be when he thinks the rates will increase, and also the long term expectations of interest rates.

In conclusion, there is no exact answer to whether one should go in for a floating or a fixed rate loan. It is a business decision that should be taken by the borrower. However the guidelines given below would help borrowers to arrive at a decision. In a falling interest rate scenario, it is always advisable for the borrower to go for a floating rate

Loan to value ratio	Security	Rate of interest	Duration	Upper age limit	Method of Recovery
75% of Forced Sale Value or purchasing price, whichever is lower.	Primary Mortgage	Fixed Term	15 to 20 years	65 years	Equated monthly instalments calculated on reducing balance.

mortgage and in a rising interest rate scenario, to go for a fixed rate and lock on a long-term contract. If the borrower intends to fully settle the loan prior to the agreed term of the loan or make lump sum payments without a penalty, the floating rate mortgages are more appropriate since there are no pre-payment damages involved. The lenders of floating rate mortgages will lift or lower the interest rate taking into account the movements of the market rates which results in the borrower having to pay more or less than the originally agreed amount. Therefore if the borrower prefers to pay a fixed amount during the tenure of the loan, a fixed rate mortgage would be more advisable. When the rates are relatively low in the market compared to the historical information, it would be advisable to go for a fixed rate in order to enjoy lower interest rates on long-term basis.

Collection Ratios and Provisioning

Collection ratios of housing finance institutions in Sri Lanka are estimated to be in the range of 80 – 95%. In certain cases the non-performing loans (NPL) ratio is around 20%. The following reasons have been attributed to such high default ratios:

1) Political interference in granting loans.
2) Defaulted loans being written-off by successive governments.
3) Lack of credit information and credit ratings.
4) Inefficiency in government-owned banks.
5) Loopholes in regulatory provisions in taking action against defaulting customers.
6) Social and cultural problems, eg auctioning of a residential house could be difficult due to social pressure.

However, NPL ratios of most lending institutions are relatively better, since the majority of NPLs fall in the 3 – 6 month category and the 6 – 12 month category. The NPLs falling within the loss category, ie over 18 months, are relatively low.

Most banks follow the provisioning direction mandated by the Central Bank. Currently Licensed Commercial banks and Licensed Specialized banks are mandated to provide 20% for sub-standard category, 50% for doubtful category and 100% for the loss category after deducting the realizable value of the collateral giving due consideration to the minimum haircut of valuation and the age of the NPL.

Tax Incentives for Housing Finance

Taking into consideration the grave need to construct sufficient houses for the country, the government has introduced incentives to housing lenders, borrowers as well as to property developers. The Budget for 2004 reduced the corporate tax rate applicable to specialized housing finance lending institutions to 20%. Tax concessions are also available for individuals who obtain loans for specific housing purposes. Accordingly, interest paid on housing loans could be deducted from statutory income in the tax declaration. Concessions are also available for individuals on capital payments of housing loans and the rental income received subject to limitations.

Parate Rights

Parate rights, ie the right to execution whereby lending institutions can sell debtors' mortgaged assets without intervention of the court, have been accorded to some selected lending institutions by the Central Bank. Banks that do not fall under this preferential treatment complained about this regulation, pointing out that they would be discouraged from entering into the housing finance business.

Issues in Developing the Housing Finance Sector

The enforcement of Parate Execution rights do not seem to be very effective. Social and political pressure has been brought upon state owned banks to abstain from Parate action. Even after the execution of Parate rights, lending institutions are sometimes hampered in their efforts to obtain possession of such properties. The existing Parate regulations do not entitle the banks to obtain possession of foreclosed property. Therefore the lending institutions need to seek assistance from the courts which is a lengthy and time-consuming procedure.

In order to protect the interest of lenders, it is highly recommended that suitable amendments should be made in order to include the right to obtain possession of mortgaged property without intervention of the courts.

The high rate of stamp duty on the purchase of property has also become a serious problem to borrowers. If stamp duty rates could be reduced, buyers will be motivated to declare the true buying prices to lending institutions.

On the positive side, the government has extended tax concessions to individuals as well as to lending institutions which are dealing with housing loans. The recent amendment to the Rent Act No7 of 1972 which was originally in favour of tenants has drastically removed the problem encountered by house owners with regard to renting of houses.

Conclusion

Recent experiences demonstrate that the formal housing finance sector continues to be elusive to the lower income groups. This needs to be addressed by the government by introducing concessionary housing loan schemes for low-income groups, credit guarantee schemes and re-finance schemes for housing finance lending institutions.

Further efforts of the government are required to strengthen foreclosure laws and land records. It would also be inevitable that expansion of mortgage insurance and credit bureaus should be encouraged.

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