

A Report on
Real Estate Financing in Nepal:
A Case Study of Kathmandu Valley



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FOREWORD

Real estate has been one of the main sectors absorbing a large chunk of banks' lending. An unwarranted credit surge to real estate sector can generate asset price bubbles which can lead to financial fragility and financial crisis. In this regard, the attention of Nepal Rastra Bank has thus been drawn to the growing trend of credit flows to the real estate sector despite sluggish overall economic situation. To address this situation, the NRB has issued a number of directives to reduce the credit flows to this sector and minimize the risk profiles of the banking sector, in an attempt to preempt the situation of domestic financial crisis.

The study examines the situation of real estate financing undertaken by banks and financial institutions, the procedures of real estate lending and the impact of policy changes on the nature of real estate financing. The study has collected the information from three different parties involving in the real estate sector such as banks and financial institutions, professional real estate developers, and individual buyers of real estate assets. I believe that the findings of this study will be useful for policy makers in analyzing the current situation of the real estate financing in Nepal.

This in-house project of NRB's Research Department was led by Dr. Bishnu Prasad Gautam, Deputy Director, with support of Deputy Directors Dr. Dilli Ram Pokharel, Dr. Ram Saran Kharel and Mr. Rajan Krishna Panta, and Assistant Director Mr. Suman Neupane. I would also acknowledge the feedback and suggestions from Director Dr. Bhubanesh Pant which have contributed to enrich the study.

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Real Estate Financing in Nepal

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Abbreviations

ADB	Asian Development Bank
BDT	Bangladesh Taka
BFI	Banks and Financial Institutions
BHBFC	Bangladesh House Building Finance Corporation
CA	Credit Appraisal
CAD	Credit Administration Department
CRAD	Credit Risk Assessment Department
DFI	Development Finance Institutions
EPF	Employees' Provident Fund
FC	Finance Company
FSI	Financial soundness indicator
GDP	Gross Domestic Product
HBFC	House Building Finance Corporation (Pakistan)
HDFC	Housing Development Finance Corporation
HSBC	Hong Kong and Shanghai Banking Corporation
HUDCO	Housing Udyog Development Corporation
IFC	International Finance Corporation
IMF	International Monetary Fund
LGD	Loss given default
LROs	Land Revenue Offices
NHB	National Housing Bank
NPA(s)	Nonperforming asset(s)
NRB	Nepal Rastra Bank
NSB	National Savings Bank
o/d	Over draft
PD	Probability of default
SMIB	State Mortgage and Investment Bank

Executive Summary

This study aims at analyzing banking sector's exposures to real estate. The specific objectives are to measure and classify the actual real estate financing undertaken by banks and financial institutions in Kathmandu Valley; to identify the real estate financing procedure by banks and financial institutions; and to assess the impact of policy changes on real estate financing in Nepal.

This study has collected information from three different parties of the real estate sector; first, the banks and financial institutions (Group A); second, professional real estate developers (Group B); and third, individual buyers of real estate assets (Group C).

Major findings of the study are as follows:

- Commercial banks are found to be financing 60.9 percent of total project cost whereas the figures for development banks and finance companies stood at 49.4 percent and 59.4 percent respectively.
- Real estate and housing sector has been ranked as a number one lending sector by the respondents (weighted rank of 2.3).
- The real estate exposure of commercial banks is found to be 32.4 percent of total lending, on average, whereas that of finance companies and development banks is 27.5 percent and 24.1 percent respectively.
- The majority of respondents (45 percent) ranked 'lack of alternative investment opportunities' as number one reason for the increase in the demand for real estate loan.
- The survey result disclosed that almost 60 percent of the loan and advances of banks and financial institutions are backed by real estate collateral.
- NPA level of the real estate loans of commercial banks is reported to be 12.4 percent, on an average, whereas that of finance companies and development banks is 3.7 percent and 0.8 percent, on an average respectively.
- The directive for the real estate loan issued by the NRB has decreased the number of loan applications and approvals in surveyed banks and financial institutions.
- The respondents of Group 'B' and Group 'C' suggested for the reforms in loan processing and improvements in the financing procedure.
- Respondents of Groups 'B' and 'C' have used bank and financial institutions for the loan and had pledged land and building as collateral for the loan.
- Majority of respondents in Group 'C' have used their own resources to purchase the land for their personal residence.

Followings are the suggestions for supporting the development of the real estate sector.

- There are no specialized mortgage institutions and insurance companies for the real estate. A multi-tier real estate financing mechanism should be framed immediately.
- Regulation and supervision mechanism of the real estate market should be improved. Standards on real estate financing need to be established promptly.
- The NRB needs to pay close attention towards property prices in order to regulate and prevent financial risks through monetary and credit policies.
- It is crucial to develop Real Estate or Housing Price Index.
- Independent and specialized institutions for asset management, credit rating and securitization needs to be set up.

Real Estate Financing in Nepal

Chapter I Introduction

1.1 Preamble

Real estate refers to the immovable property such as land, land and house or any type of building or infrastructure used for either residential or business or any other purposes. Until recently, investment in real estate sector was increasing in Nepal due to lack of alternative investment opportunity in the country. The increase in the demand for land, especially in urban areas, is attributed to the inelastic supply of land and absence of viable investment opportunity. The speculative assumption of people that price of real estate will never decline and it is the safest sector to invest, has played an instrumental role in increasing in the real estate price.

Since the past few years, remittances have become the most important source of financing economic activities in Nepal. Lack of employment opportunities accompanied by political instability and delayed peace process in the country pushed thousands of Nepalese workers abroad for employment. This resulted into massive inflows of remittances accounting for about 20 percent of GDP. With accelerating growth of remittances and lack of alternative investment opportunities, huge amount of money has gone into land and housing business that created a real estate boom. The proliferation of financial institutions together with an excess liquidity situation in the past also fueled the real estate boom, especially in the urban areas.

According to the IMF (2010a) “the land transactions in the urban area almost doubled in 2009 alone compared to the previous year and the prices in the Kathmandu valley were reported to have quintupled in some areas in the recent years. However, in response to the corrective measures undertaken by the NRB, these trends have started reversing in the recent months.” The tendency of migrating from rural areas to urban has

fueled the real estate business in Nepal. Basically people are purchasing real estate (land or land with house) for two general motives: first, for self residence and second, for business purpose. The first motive has boosted up the second one. There are different views pertaining to the extent the motive of self residence has shaped the business scenario in Nepal. The banks and financial institutions are financing in real estate sector as one of the important sector for lending. In the loan portfolio of banks and financial institutions the real estate lending has a significant share. Similarly, in the composition of collateral types, house and land holds 61 percent of share (NRB, 2010).

According to the IMF (2010a) “Although banks’ direct exposure to real estate and housing loans is not particularly high at about 20 percent of the total loan portfolio, the actual exposure could be higher due to loan misclassification problems. In addition, total exposure, including loans collateralized with real estate properties, account for 70 percent of total.”

Due to upsurge in loan in real estate, the NRB has issued some regulatory directives to banks and financial institutions to limit the loan flow in real estate. The Monetary Policy of 2010/11 has provided some guidelines for real estate financing. Paragraph 59 of the policy urges bank and financial institutions to curb down the real estate and housing loan to a specified limit. This is to reduce the risk associated with the high concentration of loan in a single sector. Similarly, paragraph 98 of the policy has reduced the limit in housing and residential lending. It has also restricted lending to 10 percent limit in land purchase and plotting (NRB, 2010).

The real estate business is being done largely in the unorganized sector that purchases large area of land and do plotting with or without developing residential facility. However, there is a growing trend to develop land and construct residential housing by organized real estate developers. The organized sectors are those which are formally registered institutions for the real estate business that are involved in developing mass residential infrastructures. They are basically involved in purchase of large area of land and developing the land with proper planning along with various residential facilities. They can often sell the plotted land with basic infrastructures. The organized

sector comes under the government law and regulations, but the unorganized sector generally does not come under the law and regulation of government.

1.2 Statement of the Problem

The development of any sector in the economy needs financing. Real estate sector is not an exception; it certainly needs continuous and huge investment. Nepal, being a developing country with limited infrastructure and lack of accumulated capital, seriously requires huge investment in most of its socio-economic sectors. Further, real estate, being a capital-intensive industry, also demands considerable amount of capital for the infrastructure. This is also required for the expansion, growth and sustaining of the sector. In addition to this, more financing is necessary for the support services and for the promotion of related industries. Moreover, adequate supply of financing also facilitates the overall growth of the country.

Until recently, the increasing demand for finance in the real estate sector and supply of financing by BFIs have been the serious economic issues in Nepal. Nepal Rastra Bank, being the central bank of Nepal, has a basic concern to discourage risky lending in real estate and encourage lending in productive sectors for the country's economic growth. It is against this background that this study on real estate financing is undertaken.

1.3 Objectives of the Study

The present study is confined to the financing aspect of real estate sector. This has been further categorized into the supply side and demand side. The banks and financial institutions that finance real estate financing pertain to the supply side and individual household, real estate buyer, the professional real estate developers or business persons or institutions pertain to the demand side.

The study's primary objective is to measure and classify the real estate financing in Nepal. The specific objectives are a) to examine the scenario of real estate financing undertaken by banks and financial institutions in Nepal; b) to identify the real estate

financing procedure by banks and financial institutions; and c) to assess the impact of policy changes on real estate financing in Nepal.

The present study, therefore attempts to address some fundamental questions related to the real estate sector and financing in Nepal.

- What is the current position of real estate financing in Nepal?
- What was the growth rate of real estate financing during the last 3 years?
- What is the lending procedure followed by banks and financial institutions for real estate financing?
- What is the impact of directive issued by the NRB particularly on real estate sector lending?

1.4 Methodology of the Study

1.4.1 Data Sources and Research Design

The study is based on data collected from both primary and secondary sources. The primary data for the study are collected from the questionnaire survey. The secondary data are collected mainly from various publications of Nepal Rastra Bank and Ministry of Finance as well as from various newspapers, magazines, journals and internet. In addition, some data are collected directly from banks and financial institutions. To supplement the secondary data, some primary data have also been used which are collected through interviews and personal contacts.

The present study is of analytical and exploratory nature. It has utilized various mathematical and statistical techniques to analyze the existing status of housing and real estate financing.

1.4.2 Population and Sample

As the study tries to incorporate the existing status of real estate financing, it has categorized the population into three groups: first, the banks and financial institutions that supply financing for real estate; second, the real estate developer that demand real estate financing from banks and financial institutions; and third, the real estate buyer who come at the Land Revenue Offices to transfer the ownership of land and building in their name.

The samples are selected considering the real estate exposure of the banks and financial institutions under Group 'A'. Housing companies and professional real estate developers (Group 'B') were selected from the members' list of Nepal Land and Housing Developer's Association. However, the process of sample selection under Group 'C' was different. The customers that come to Land Revenue Offices to purchase land, house or apartment are directly selected as samples.

Table 1.1

Distribution of Population and Sample

Group	Name	Population	Sample	Percent
A	Bank and Financial Institutions *	185	45	24.3
	Commercial Banks	27	14	51.9
	Development Banks	79	6	7.6
	Finance Companies	79	25	31.6
B	Professional Real Estate Builders and Developers #	118	36	30.5
C	Real Estate Buyers/Customers @	-	60	-

* The figure represents the total number of banks and financial institutions as at mid-July, 2010

Based on the Members List of Nepal Land and Housing Developer's Association

@ Initially, 40 individuals from each districts of the Valley were supposed to be selected as a sample. After the pilot survey, the sample was reduced to 60 only.

1.5 Significance of the Study

Since the last few years, lending by banks and financial institutions in real estate sector has increased remarkably with the concomitant increase in the risk in financial system. In order to limit the risk, the NRB has issued some regulatory directives to banks and financial institutions to limit the loan flow in real estate. However, there is need of a study to identify the optimum composition of real estate loan in the loan portfolio of banks and financial institutions for facilitating the central bank to have a particular policy stance regarding real estate financing.

Proper regulation is desired in real estate sector and absence of which may reflect improper way of financing the real estate projects. That is why it has become necessary to

identify the status of real estate financing, financing procedure and impact of directive in the real estate financing. Again, this type of study has not been conducted in Nepal. The study will be helpful in capturing the existing real scenario of real estate sector and can make plausible policy recommendations for formulating necessary regulatory policy guidelines for the real estate sector.

1.6 Limitations of the Study

The study has tried to present briefly the overall financing situation of real estate sector in Nepal, in general, and Kathmandu Valley, in particular. Nevertheless, the study is constrained with the following limitations.

- NRB's Directive for real estate lending has been subject to amendments from time to time. This has certain effects on the data maintenance and product-wise loan classifications. Therefore, it is difficult to construct the time-series data for analytical purposes.
- Demand for and Supply of real estate financing could not be estimated from available data.
- Some respondents from Group 'B' and many from Group 'C' seemed reluctant to respond to the questionnaires and disclose the facts and figures.

1.7 Structure of the Study

The study is divided into five chapters. The next chapter briefly reviews the most relevant literature regarding housing and real estate sector with due focus on the financing aspects of real estate sector.

The third chapter examines the policies and practices of housing and real estate financing in Nepal whereas the fourth chapter summarizes the survey response from banks and financial institutions, professional real estate developers and builders as well as from customers that purchase the land, building or apartment. Finally, the concluding chapter summarizes the findings and also makes suggestions for the overall development of the real estate sector.

Real Estate Financing in Nepal

Chapter II Review of Literature

2.1 Real Estate Sector

Housing provides shelter. As it is a basic need of every human being, it provides security, pride and ownership. It has great significance in human life. Real estate is a legal term that encompasses land along with improvements to the land, such as buildings, fences, walls and other site improvements that are fixed in location--immovable (http://en.wikipedia.org/wiki/Real_estate). Real estate is often considered synonymous with real property (also sometimes called realty), and housing is one component of real estate. Real estate covers both commercial and personal properties.

Housing and real estate sector play an important role in overall economic growth, social uplift, and employment in the context of the rapidly expanding economies. Personal residences account for 75–90 percent of household wealth in emerging-market countries, which amounts to three to six times their annual income. Housing represents 15–40 percent of the monthly expenditure of households worldwide. Similarly, investment in housing accounts for 15–35 percent of aggregate investment, whereas housing construction and housing-related sectors constitute approximately 9 percent of the labor force worldwide (Nenova, 2010; Sarker *et.al*, 2011).

With the development of private property ownership, real estate has become a major area of business. Purchasing real estate requires a significant investment and each parcel of land has unique characteristics; so, real estate industry has evolved into several distinct fields. Some kinds of real estate businesses include 1) Appraisal (professional valuation services), 2) Brokerage (assisting buyers and sellers in transactions), 3) Development (improving land for use by adding or replacing buildings), 4) Property Management (managing a property for its owner), 5) Real Estate Marketing (managing

the sale side of the property business) and 6) Relocation Services (relocating people or business to different country) (Singh *et al*, 2009).

The main participants in real estate markets are:

- Owner/User - These people are both owners and tenants. They purchase houses as an investment and also to live in.
- Owner - These people are pure investors. They do not consume the real estate that they purchase. Typically they rent out the property to someone else.
- Renter - These people are pure consumers.
- Developers - These people prepare raw land for building which results in new product for the market.
- Renovators - These people supply refurbished buildings to the market.
- Facilitators - This includes banks, real estate brokers, lawyers, and others that facilitate the purchase and sale of real estate.

(Source: http://www.edinformatics.com/real_estate/real_estate_economics.htm)

The owner/user, owner and renter comprise the demand side of the market, while the developers and renovators constitute the supply side. The unique features of the real estate market such as durability, heterogeneity, high transaction cost, long time delays, use as both consumption and investment goods and immobility, among others, distinguishes it from other markets (Singh *et al*, 2009).

According to Singh *et al.* (2009), the following factors influence the price and cost of the real estate:

- Physical characteristics of the property
- Property rights
- Time horizon of holding the property
- Geographical area
- Development rate

Though real estate markets have grown dramatically over the years, there are concerns about its impact in the economy. Given the lumpiness and long-term nature of real estate investment, the misallocation of resources through bursts of irrational exuberance and subsequent under-utilization may indeed be especially undesirable.

Excessive bank lending to the real estate sector was one of the responsible factors that led to the Asian financial crisis and the recent global financial crisis. The excessive risky lending of banks and financial institutions created the inflation of asset prices. A large body of literature has examined the role of the banking sector in propagating business cycles. In the aftermath of the Asian financial crisis, many researchers have examined the role played by the real estate sector in the crisis, and have argued for reforms in the regulation of the real estate markets and the treatment of real estate loans by financial institutions in order to prevent the recurrence of the kind of asset bubbles that contributed to the financial crisis (Koh et al, 2004). The recent financial crisis has drawn worldwide attention and there have been proliferation of literature regarding the devastating impact of the real estate boom and bust on the economy.

The global financial turmoil raised issues on how central banks should respond to asset price bubbles.¹ Asset prices have played a more prominent role in monetary and financial stability frameworks. They have acted as sources of information on market expectations and markets' risk attitudes; leading indicators of output, inflation and financial distress; and indicators of shocks that hit the economy. They also provide signals to profitable investments, affect the wealth of households, and influence the cost of capital to firms and households. Thus, asset prices are useful in that they provide policymakers forward-looking information. However, once asset price bubbles develop and eventually burst, they can lead to widespread financial and economic disruptions (Laquindanum, 2010).

Credit concentration in certain sector of the economy has attracted the attention of both regulators and business enterprises. A variety of measurement and management techniques have been developed to review such concentration. The measure, most often used to express risk levels in general, is credit exposure. Exposure indicates the level of loss should a credit event occur, in the absence of mitigating credit terms and conditions.

¹ An asset bubble is a sharp rise in the price of an asset or a range of assets in a continuous process, with the initial rise generating expectations of further increases in asset prices and attracting new buyers—generally speculators who are more interested in profits from trading in the asset rather than its use or earning capacity (Laquindanum, 2010).

Typically, it is calculated as the total amount at risk, adjusted for mitigating factors such as netting and collateral. Other factors determine the credit quality of the name and the nature of the exposure. These factors are typically incorporated into measures of probability of default (PD), or rating, and loss given default (LGD). The tendency for losses to bunch together (and create problems) is quantified through correlation. Capturing correlation, along with the other key factors of exposure, PD and LGD leads to a measure such as credit value-at-risk defined at a particular confidence level (Reynolds, 2009).

The International Monetary Fund (IMF) has developed the financial soundness indicator (FSI) to respond to the need for better tools to assess the strengths and vulnerabilities of the financial system. Among the various indicators, there are four indicators related to the real estate market viz.

- 1) Residential real estate prices,
- 2) Commercial real estate prices,
- 3) Residential real estate loans to total loans and,
- 4) Commercial real estate loans to total loans

(Source: <http://www.imf.org/external/np/sta/fsi/eng/fsi.htm>).

However, the country definitions of the above indicators may vary significantly.

Table 2.1 provides a glimpse on some of the FSI indicators.

Table: 2.1
Real Estate Loans in Some Economies

	Arm- enia	Bhutan	Latvia	Mauritius	Philippines	Romania	Russia	Turkey
	Dec 2009	Q4 2009	2009	Q4 2009	2009	2009	2009	Q4 2009
Residential real estate loans to total loans	11.2	24.6	27.2	6.8	6.6	18.1	5.8	10.7
Commercial real estate loans to total loans			19.3	2.1	6.8	24.6	6.3	0.8

Note: Q4 means fourth quarter of the year.

Source: IMF (2010b)

2.2 Real Estate Financing

McKinney, Jr. (1952) has identified four sources of real estate financing (in the order of contribution) during the housing boom in the United States, such as savings and loan associations followed by commercial banks, insurance companies, and mutual savings banks. Edwards, (1964) has also pointed out that savings and loan associations continued to grow more rapidly than other mortgage lenders. They cited the use of these institutions as the dominant force in the home mortgage markets. In spite of an increasing focus on urban housing and development, informal systems are still the dominant producers in many developing countries. It is estimated that 60 to 70 percent of Mexico's and Brazil's current housing stock is built informally because current value chains are not adapted to the needs and realities of this growing market (Franck and Ferguson, 2004). The informal sources of informal finance have lesser legal formalities and have developed good relationships with customers. They are popular even if they charge exorbitant interest rates (Schmidt and Budinich, 2006).

According to the Housing Finance Group of the International Finance Corporation (IFC), housing finance contributes to social stability by enabling households to purchase an asset which represent their largest single investment. Personal residences account for 75 to 90 per cent of household wealth in emerging market countries, which amounts to 3 to 6 times their annual income. Furthermore, housing represents 15 to 40 per cent of the monthly expenditure of households worldwide. Globally, investment in the housing sector accounts for 15-35 per cent of aggregate investment (Housing Finance Group, 2006).

The Housing Finance Group has identified numerous challenges of the housing finance sector in order to increase the availability and affordability of residential housing in developing countries. These are lending restrictions, infrastructure (emerging markets often lack the infrastructure that is fundamental to the support of home ownership),

regulatory environment, capacity (the pool of skilled managers and field staff experienced in housing finance is limited), and outreach (Housing Finance Group, 2006).

2.3 Real Estate Financing in Some South Asian Countries

Real estate sector is a large, huge diversified sector, one with many verticals such as land, design, construction, development, investment and lending, among others. Real estate development is taking place in residential, retail, office, hotels and industrial sectors. In recent years, real estate markets have grown dramatically. However, real estate financing could not follow the sustainable path over the years. There are various economic and non-economic factors behind this. These factors may vary as per the real estate sector and economic condition of the country.

Although several potential sources of housing finance for mid- and high-income consumers exist, most of the low-income families' needs are still unmet. Government subsidies tend to be insufficient or inappropriate; mortgage markets tend to serve only the richest 10-20 per cent of the population; in spite of its strong value proposition, housing microfinance is still an emerging industry; and informal systems are not efficient. Only 3 per cent of outstanding credit in low income countries is held in the form of housing loans compared to 27 per cent in high-income countries (de Soto, 2003 in Sarker, 2011).

From a regional perspective, the mortgage markets in South Asia are small and fragmented with the unorganized sector. Regarding the organized segments, there are distinct commonalities that characterize some of the mortgage markets of South Asia, such as a heavily subsidized monolith-like state run institution, a fledgling private sector catering to the middle and upper income segments and players from the banking sector that provide housing finance as a part of their retail portfolio. The mortgage markets in Sri Lanka, Bangladesh and Pakistan are such archetypes (Karnad, 2004 in Serker, 2011). A brief discussion follows about the real estate financing in some of the South Asian countries.

2.3.1 India

In India, the large shortage of housing has continuously fueled the growth in the real estate sector. The demand for the affordable residential housing and financing is the main driver for such growth. The rising middle class and its consumer demand is driving the real estate boom in India. For example, for every rupee invested in housing, Re 0.78 gets added to the national GDP and the construction sector provides direct employment to 16 percent of India's workforce; and the housing sector alone is the second largest employment generator after agriculture, accounting for 58 percent of the workforce in the construction sector (Nenova, 2010).

There was a substantial change in the financing system during the late 1990s, against the backdrop of lower interest rates, industrial slowdown, sluggish credit off-take and ample liquidity. In fact, the lower interest rate regime, rising disposable incomes, stable property prices and fiscal incentives made housing finance an attractive business. Further, housing finance traditionally has been characterized by low nonperforming assets (NPAs) and given the vast demand for housing loans, almost all the major commercial banks plunged into the business of housing finance.

Over the years, banks have realized that while the demand for housing loans is tremendous, there is no substitute for prudent lending policies. Some banks have withdrawn from the housing loan market after being saddled with an unduly high amount of nonperforming loans (Karnad, 2004). Further, there have been several problems in the real estate financing with several warnings raised for cautious lending and recovery.

2.3.2 Bangladesh

Sarker *et.al* (2011), in their paper, have briefly illustrated the real estate market of Bangladesh with problems and prospects of financing. They argued about the residential housing sector of Bangladesh as having three-tier market characteristics. "First are those households with the highest disposable income (less than 3 percent of the housing market), able to afford high-quality housing in fully serviced neighborhoods, and able to

utilize bank financing or specialized housing finance institutions. The second tier is the relatively narrow stratum of middle-income households (represents 12 to 15 per cent of the housing market) that are the main users of specialized housing financial institutions such as Bangladesh House Building Finance Corporation (BHBFC). This group is the major beneficiary of available public subsidies and is composed predominantly of public servants and wage/salary earners of large private companies and public sector corporations. The third and largest of the tiers is the low-income households, for which housing is provided largely by the private sector, often under illegal and unsatisfactory site conditions (ADB, 1995).”

In addition, Sarker *et.al* (2011) have discussed about the financing mechanism of real estate sector in Bangladesh. While state-owned BHBFC is the major player of real estate financing, other sources of housing finance are commercial banks, employee loans, insurance companies, and informal means. In the rural sector, some housing co-operatives are the major providers of housing finance (Banglapedia, 2005 in Sarker *et.al* (2011). Moreover, several public agencies, such as the Housing and Settlement Directorate, Public Works Department, Local Government Engineering Department and different City Corporations are involved in the financing and development of housing and residential infrastructure projects.

However, the present housing finance system in Bangladesh is extremely small and highly segmented: formal mortgage finance is only available to households with incomes above BDT 25,000 per month and is restricted to selected housing sub-markets in Dhaka. Government subsidized housing finance through the BHBFC is most prevalent, while the nationalized commercial banks are decreasing their housing loan portfolios. Recently, new private housing finance institutions have started to operate in this market targeting middle income households. Non-collateralized credit for house construction by micro finance institutions is also available to a small proportion of poor rural households. 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 (Sarker, et.al; 2011).

2.3.3 Pakistan

In Pakistan, the formal financial sector provides housing support through two major sources namely the Government-owned House Building Finance Corporation (HBFC) and commercial banks. The private sector housing finance companies also caters to a negligible consumer base. The formal financial sector caters to only 1 to 2 percent of all housing transactions in the country, whereas the informal lending also caters up to 10% of such transactions. Some studies indicated that lack of finance from a formal source is a primary supply problem. Hence, most of the housing finance is being arranged through personal resources (Shehzad, 2009).

The HBFC was historically providing housing finance to lower or average income group since 1952. In 1994, the Government decided that HBFC should operate as a market oriented financial institution. Commercial banks though providing mortgage loans on a much selected basis entered the mortgage business during 2002 in a structured way and registered their share in the housing finance system. The majority of commercial banks' loans has been or is being extended to middle and high income group, particularly in major cities.

The total housing finance portfolio reported by banks and development finance institutions (DFIs) was Rs. 88.2 billion (US\$1.10 billion) as at December 31, 2008 witnessing a growth of 59% over the last three years. However, the mortgage debt to GDP ratio is less than even 1% as compared to 5% in India, 18% in Malaysia and 15% in China. The total number of borrowers at the end of December 2008 just exceeds 123,000. In absolute numbers, the HBFC accounts for more than 75% of these borrowers, due to its wider customer base; but, in terms of financing, as indicated earlier, the commercial banks hold the majority share in overall housing finance portfolio.

Despite the growing economic and social importance that development economists are attributing to housing finance, it remains largely underdeveloped in

Pakistan. Private mortgages remain small and unaffordable and are provided by only a limited number of depository institutions. However, it does give comfort that strategic measures to address key impediments and challenges have been initiated and a roadmap has been set for further direction.

2.3.4 Sri Lanka

Banking and non-banking institutions provide housing finance in Sri Lanka. There are three specialized housing banks in the country. Two of them are government-owned: the State Mortgage and Investment Bank (SMIB) and the Housing Development Finance Corporation (HDFC). The only private sector housing finance institution is Housing Bank, a new entrant that was established in 2001. In addition, the National Savings Bank (NSB), which again is a government-owned entity, is a significant contributor to the housing finance market. These institutions are the main players in housing finance among the specialized banks. They account for a significant volume of the housing finance business in the country (Piyasiri, 2006).

Practically all the domestic commercial banks currently provide housing finance. All advertise and promote housing finance aggressively. Special housing product brands are available in the market. Among the foreign banks, and more recently, the Hong Kong and Shanghai Banking Corporation (HSBC) has become a very aggressive player in the market, with variable interest rate. These would fall into the category of specialized banks. Smaller volumes of housing finance are provided by rural development banks as well. A number of micro-finance institutions seem to be providing limited housing finance to the low-income segment of the population. Most of these institutions have the objective of uplifting the quality of life through income-generating activities. In that process, they find that one aspect of uplifting involves improving housing conditions as well. Another group that contributes to the housing sector is the finance companies. One of the key asset products of these institutions is real estate development. Most of these institutions specialize in land development only. However, a few have also been involved in construction as well.

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 of enlarging its retail portfolio has helped its housing finance operations immensely. Most commercial banks deploy their own mobilized funds for housing finance operations (Piyasiri, 2006).

Housing finance has grown significantly in the last few years. Most commercial banks have housing finance in their product range. The estimated housing portfolio of commercial banks stands at around Rs. 55-60 billion. The specialized banks, including three specialized housing banks, have an estimated portfolio of around Rs 25 billion. Rural development banks and a number of micro-finance institutions are also involved in housing finance. The total estimated housing finance portfolio in the country may be in the region of Rs 80-85 billion. A large variety of housing products/brands and competitive options are available in the market. However, rate volatility would always be a challenge and hurdle for sustained growth.

As per the 2001 survey, there were 4.7million housing units in the country. The Central Bank annual report of 2003 estimated the housing shortage in the country at 400,000 units. The report also stated that the shortage is expected to increase to 600,000 units by 2010. This means that the annual demand for new housing is not being met by new construction. In addition, the above shortfall is prior to the December 2004 tsunami. The housing need of the war-affected regions of the Northeast of the country is also acute. Moreover, analysis of the quality of housing reveals that significant upgrading of existing housing can be effected. Therefore, the need for new housing and for financing is very significant.

Real Estate Financing in Nepal

Chapter III

Policies and Practices of Real Estate Financing in Nepal

3.1 Introduction

Generally, real estate business is considered as an unproductive and risky business. However, it has many backward and forward linkages with many other sectors in the economy and generates positive impacts, too. The real estate sector may contribute significantly in employment generation and in developing land and housing in the country. In addition, it may contribute through the consumption of building materials. Moreover, it is a sector associated with fulfillment of basic needs of people.

Therefore, the question is: how much emphasis should be given for the development and financing of this sector? What type of policies should be devised for the optimum development and financing of this sector? How can the housing and real estate finance be supplied in proper way? What level of financing is called risky? Thus, for maintaining sustainable real estate investment, trading off between too much and too less real estate financing should be the focal issue while designing a policy prescription. This chapter briefly discusses the policies and practices of real estate financing in Nepal.

3.2 Policies and Institutional Arrangement for Real Estate Financing

The Government of Nepal has given certain priority for urban development and housing program in Kathmandu Valley through its various plans and programs. The Three Year Plan has set clear objectives, strategies and policies for housing and urban development, the most relevant ones being the following:

- Implementation of national building code will be made obligatory.
- Technicians will be produced in order to construct qualitative, less costly and safe buildings.

- Updated and effective regulatory provisions for the construction of multi-storey building in the urban areas will be made.
- Satellite cities will be developed around the capital city.

Likewise, the Budget Speech for the Fiscal Year 2009/10 has mentioned about developing infrastructures through land integration in Chobhar-Satungal part and demolishing illegally built houses and sheds in the river banks of Kathmandu valley. In addition, it has stated about identifying and providing proper housing facilities to real landless communities. Similarly, the Budget Speech for the Fiscal Year 2010/11 has focused attention for the revision and implementation of the “National Building Code” in order to manage and facilitate modern amenities to address increasingly unmanaged urbanization and housings in Kathmandu Valley.

In Nepal, the majority of real estate builders and developers are working as sole proprietorships or partnerships business with limited capital base. They have poor corporate governance and fragile structures. This is creating various challenges for the proper growth and advancement of the sector. Lack of regulation, organizational structure and professionalism has led to the illegal construction process with unreliable building permits and use of substandard materials in construction. In addition, poor legal framework cannot cater to the interest of all the stakeholders in the sector. Nevertheless, the private sector is playing an active role for the development of housing and real estate sector. Professional real estate developers have mobilized their scarce financial resources and even borrowed from banks and financial institutions to invest in this sector.

Housing supply in Kathmandu has been taking place almost entirely with private sector initiation and through owner-builder process, financed mainly from personal savings, sale of family assets such as land and jewelry, family loans, and to some extent, provident-fund loans. In addition to the above sources, the financing is also supported by loans from employer institution and bank loans. Family income compared to the price of land and house is quite low. It takes five to ten years, on an average, for low-income families to save to buy a plot of land and then almost as many years more to

build a house. It is common to build low- and middle-income housing incrementally (Mathema, 1999).

Another interesting story can be noticed in the construction of house in the Kathmandu Valley. Virtually all the houses are constructed on prototype manner, one story at a time, with provisions to add floors later². Mostly, housing facility is acquired by different means including personal and family loan either from formal or from informal sector. This is basically due to the high cost of housing facility and lower level of income and saving. It takes quite a long time to repay the loan for majority of the people. However, the case is quite different for professional real estate developers, builders and real estate brokers.

Nowadays, different private real estate developers and housing companies are involved in construction of low-price housing, apartments and commercial complex. They usually enter into the agreements with banks and financial institutions for such financing.

The banks and financial institutions licensed by the NRB can lend in real estate sector (within a specified limit). The bank has issued directive to regulate the lending however, without closing the window of real estate financing. In addition, Employees' Provident Fund provides housing loans to its members (depositors). Another vista of financing of the real estate sector is from the perspective of various saving and credit cooperatives.

3.3 NRB's Regulation on Real Estate Financing

The financial and economic instability that followed the plunge in asset prices prompted central banks to revisit their policy responses. Central bankers generally have two options when faced with a surge in asset prices: they can either be proactive or reactive. To be proactive would be to lean against the wind, that is, to tighten monetary policy during the boom phase. The reactive policy would be to mitigate the consequences of an expected or an actual asset price bust (Laquindanum, 2010).

² For details, see Mathema (1999).

The NRB is fully cognizant of all issues and constraints of real estate sector. It has been working scrupulously to establish a dedicated infrastructure and institutional mechanism along with some deliberate initiatives to strengthen the real estate sector.

The NRB has been conducting research/analysis on the existing status of regulatory and policy frameworks. It has designed and implemented regulation to address the burning issue of housing and real estate sector. The following exhibit is designed to describe the major directives related to the real estate sector issued by the NRB along with their key features.

Exhibit: 3.1

Directives Related to Real Estate Sector

Directives/Date	Key Features
Unified Directives, 3/067 2066-09-02 (17-12-2009)	<ul style="list-style-type: none"> • Loan against the collaterals of real estate or housing/land should not exceed the 60% of fair market value of the collateral • No banks and financial institutions should exceed 25% and 40% of total loans on real estate and real estate and residential housing loans respectively • The real estate loans and real estate and residential housing loans should be brought down to following proportion of total loan within the stipulated time frame: <i>Real Estate Loan: 15% by the end of FY 2068 and 10% by the end of FY 2069</i> <i>Real Estate Loan and Residential Housing loan: 30% by the end of FY 2068 and 25% by the end of FY 2069</i> • Borrowers can restructure/reschedule the real estate loan upto one year if they have paid 25% of the principal and interest. • If the real estate/residential and housing loans are not brought within the limit in stipulated time, the amount exceeded should be given the risk weight of 150%.
Directive 5/067/68, Amendment 2067/06/05 (21-09-2010)	<ul style="list-style-type: none"> • Residential loan against the of house/land should not exceed the two-third of fair market value of the collateral • Reclassification of real estate loan into: 1) residential housing loan, 2) commercial complex and residential apartment construction, 3) trading complex already built

	<p>and which have begun earning and 4) other real estate loan. The real estate loans should be brought down to following proportion of total loan within the stipulated time frame: <i>Total of categories 1), 2) and 3) : 30% and 25% by the end of FY 2068 and FY 2069 respectively</i> <i>Other Real Estate Loan: 15% and 10% by the end of FY 2068 and FY 2069 respectively.</i> <i>Totals of 1), 2), 3) and 4): 30% and 25% by the end of FY 2068 and FY 2069 respectively.</i></p>
<p>Directive 21/067/68, Amendment 2067/12/04 (18-03-2010)</p>	<ul style="list-style-type: none"> • Borrowers can restructure/reschedule the real estate loan up to one year only if they have paid due interest. • Relaxation of real estate loan definition so that the personal home loan of less than Rs 6 million may not be included in the real estate loan. The home loan can be provided by only one bank or financial institutions to one family only once.

Source: www.nrb.org.np

In fact, corrections were mostly undertaken at the time when housing demand was robust, speculation was excess and government regulation was weak and fragmented. The unprecedented rise in the price of housing and land has posed several questions in terms of adversely affecting macroeconomic stability. The central bank has initiated several efforts to curb down unhealthy practices in real estate activities through the regulatory framework for commercial banks and financial institutions to manage concentration risk and prudently match maturity profile of their assets and liabilities.

3.4 Product-wise Loan Classification of Commercial Banks

The loan portfolio of banks and financial institutions of Nepal signifies that real estate financing is increasing over the period. The product-wise loan classification of commercial bank is presented in Table 3.1 which summarizes the credit outstanding in Real Estate Loan, Personal Residential Home Loan and Total Loan and Advances of commercial banks.

Table 3.1
Product-wise Loan Classification of Commercial Banks

(in Rs. Million)

Particulars	July 2009	Jan 2010	July 2010	Oct 2010	Jan 2011*
Real Estate Loan	47,415.5	64,605	61,954.1	59,820	60,352
Personal Residential Home Loan	29,061.6	34,735	35,208.1	39,127	38,741
All Other Loans	325,450.4	369,778	369,945.0	390,567	411,048
Total Loan	401,927.5	469,118	467,107.2	489,514	510,142
Real Estate Loan on Total (%)	11.8	13.8	13.3	12.2	11.8
Personal Residential Home Loan on Total Loan and Advances (%)	7.2	7.4	7.5	8.0	7.6
Real Estate & Personal Residential Home Loan on Total Loan and Advances (%)	19.0	21.2	20.8	20.2	19.4

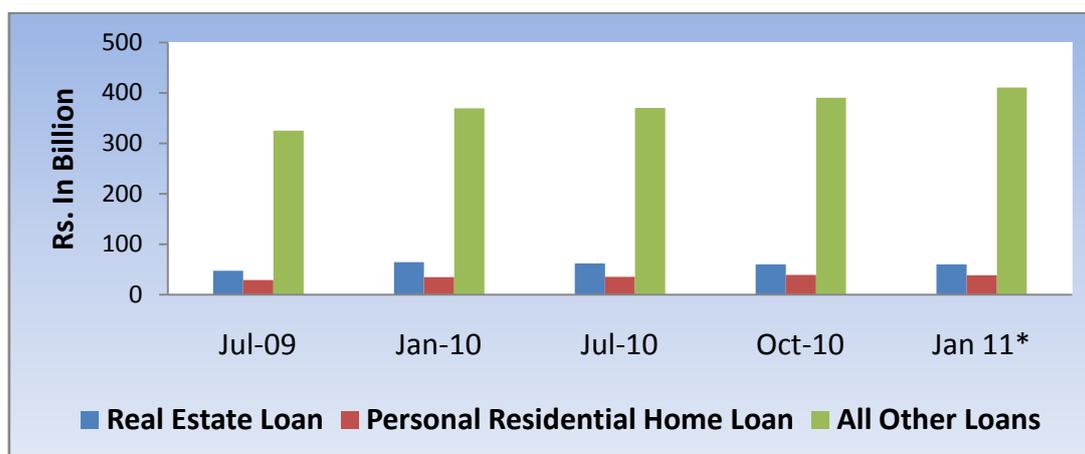
* Personal Home loan represents the figure of Personal Residential Home Loan.

Source: Bank and Financial Statistics, No. 53 and 54, NRB

Table 3.1 clearly depicts the distribution of real estate and personal residential home loan of commercial banks. In mid-July 2009, the real estate loan and personal residential home loan formed 11.8 percent and 7.2 percent share of the total loan respectively. In July 2010, the respective share of both the loans has slightly increased to 13.3 percent and 7.5 percent respectively. However, in January 2011, the share of above-mentioned loans exhibited slackness and declined to 11.8 percent and 7.6 percent respectively. The share of real estate loan on total loan and advances increased to 21.2 percent in January compared to 19.0 percent in July 2009. It declined to 20.8 percent in July 2010 and 19.4 percent in January 2011.

In mid-July 2010 total real estate loan increased by 27.0 percent compared to the previous year whereas the real estate loan and personal residential home loan increased by 30.7 percent and 21.1 percent respectively.

Figure 3.1
Product wise Loan of Commercial Banks



3.5 Distribution of Real Estate Loan in BFIs

Table 3.2 presents the share of real estate loan and personal residential home loan on total loan of real estate sector and its distribution among the banks and financial institutions as of mid-April 2011. The table presents the credit exposure of commercial banks, development banks and finance companies as per real estate loan classification based on NRB Directives.

Table 3.2
Real Estate and Personal Home Loan of BFIs
As at mid-April 2011³

(Rs. In Million)						
S. No.	Particulars	Real Estate Loan (1)	Personal Home Loan(2)	Total (1 + 2)	Share in Real Total Estate Loan %	Share in Total Personal Res. Home Loan %
1	Finance Companies	18,914.02	6,644.97	25,558.99	18.3	17.8
2	Development Banks	13,424.62	4,653.83	18,078.45	13.0	12.5
3	Commercial Banks	71,084.20	26,054.80	97,139.00	68.7	69.8
	Total	103,422.84	37,353.60	140,776.44	100.00	100.00

As illustrated in Table 3.2, the share of finance companies, development banks and commercial banks in personal residential home loan stood at 17.8%, 12.5% and 69.8 percent respectively in total. The majority of share in real estate loan and personal home loan is occupied by commercial banks which is natural. There is a minor difference in the distribution of the loans in real estate sector.

³ First Nine months of the Fiscal Year

3.6 Economic Contribution of Real Estate Sector

Nepal is considered as a remittance based economy. Millions of Nepalese youths are going overseas for employment. They are sending significant amount of remittances for the livelihood of their families and relatives in the country. The ratio of workers' remittance to GDP has been about 20.0 percent, on average during the last three years. It is remarkable that such a big amount is coming from a single sector and most of it is spent on imported goods and real estate purchases. Due to lack of the proper and secure investment opportunities, people are spending their hard-earned income from abroad in unproductive sector. Construction sub-sector has recorded a satisfactory growth rate in the last five years averaging 4.5 percent while contributing 6.7 percent to the GDP. The loan disbursement of the banks and financial institutions in real estate and housing sector might have contributed for the development of this sector (Economic Survey 2009/10).⁴

Figure 3.2 presents the contribution of real estate to the GDP and annual growth rate of real estate sector. The share of real estate sector in GDP has remained fairly constant with around 8.7 percent of GDP in the last decade while the growth rate has remained at 3.8 percent during the decade. This sector has shown a consistent growth in the last seven years though the growth rate has been variable.

Figure 3.2
Growth Rate and Share of Real Estate in GDP



⁴ Source: Ministry of Finance (2010)

Real Estate Financing in Nepal

Chapter IV

Field Survey Analysis

4.1 Introduction

The present study has focused on various aspects of real estate sector. A questionnaire survey was conducted and information received from the survey has been duly processed and discussed in various sections of this chapter concentrating mainly on the financing aspect of real estate sector.

In recent years, land and housing development and construction business is increasing rapidly in Kathmandu valley. The tendency is fueled by the migration from other parts of the country (rural or urban) to Kathmandu valley. This study is designed to present the case study of real estate financing in Kathmandu Valley.

4.2 Profile of Respondents

The survey was focused on three different groups involved in real estate sector, as mentioned in Chapter 1. Table 4.1 briefly presents the sample and response of the survey. As evident in the table, Group 'A' has a very satisfactory response rate whereas Group 'B' and Group 'C' have shown poor responses. This was particularly noticed during the survey, and further steps were initiated to increase the response rate. Finally, the response rate from Group 'A', Group 'B' and Group 'C' stood at 91.1 percent, 33.3 percent and 40.0 percent respectively.

Table 4.1
Profile of Respondents

Group	Name	Sample	Response	Response Rate
A	Bank and Financial Institutions	45	41	91.1
	Commercial Banks	14	11	78.6
	Development Banks	6	6	100.0
	Finance Companies	25	24	96.0
B	Housing Companies	36	12	33.3
C	Real Estate Buyers/Customers	60	24	40.0

Note: The detail list of respondents in Group A and B is given in Appendix.

4.3 Role of Banking Sector in Real Estate Financing

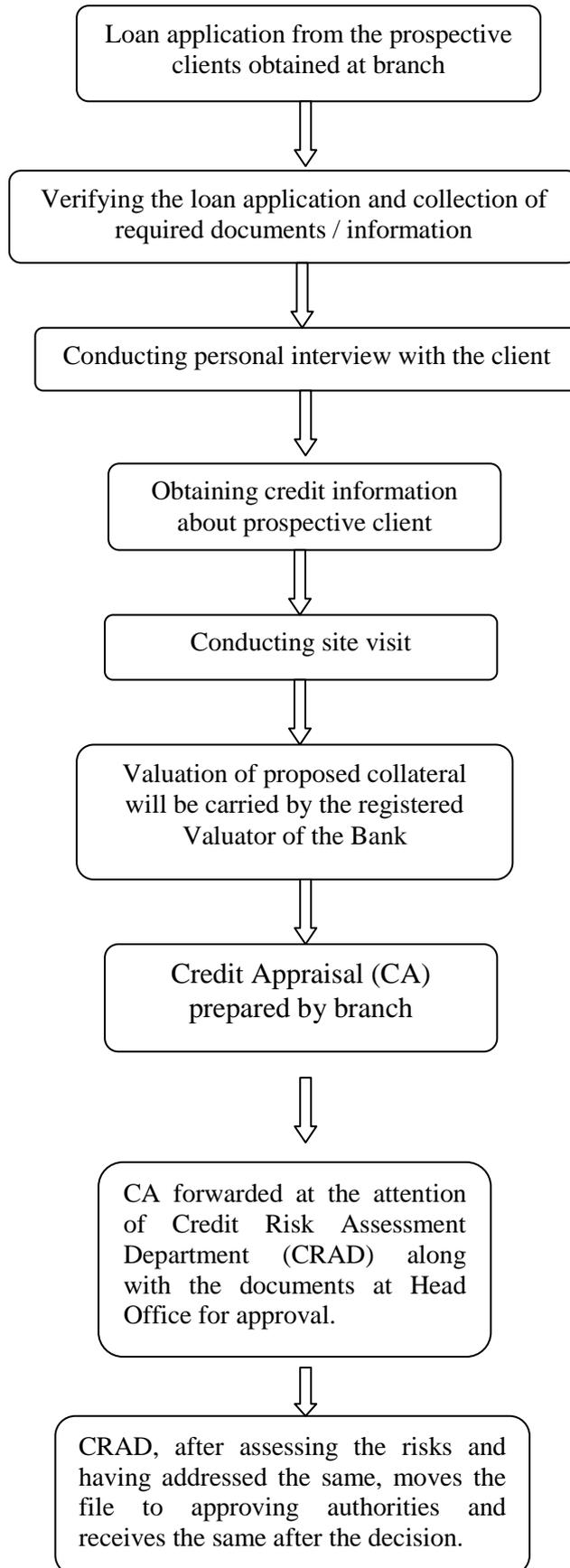
The study concentrates on the role of banking sector in financing real estate sector. It discusses the lending procedure, types of the customers, collateral aspects, financing limit, credit exposure and various aspects related to the real estate and personal residential home loan. In addition, the supply of real estate financing by the banks and financial institutions is assessed considering various financing aspects.

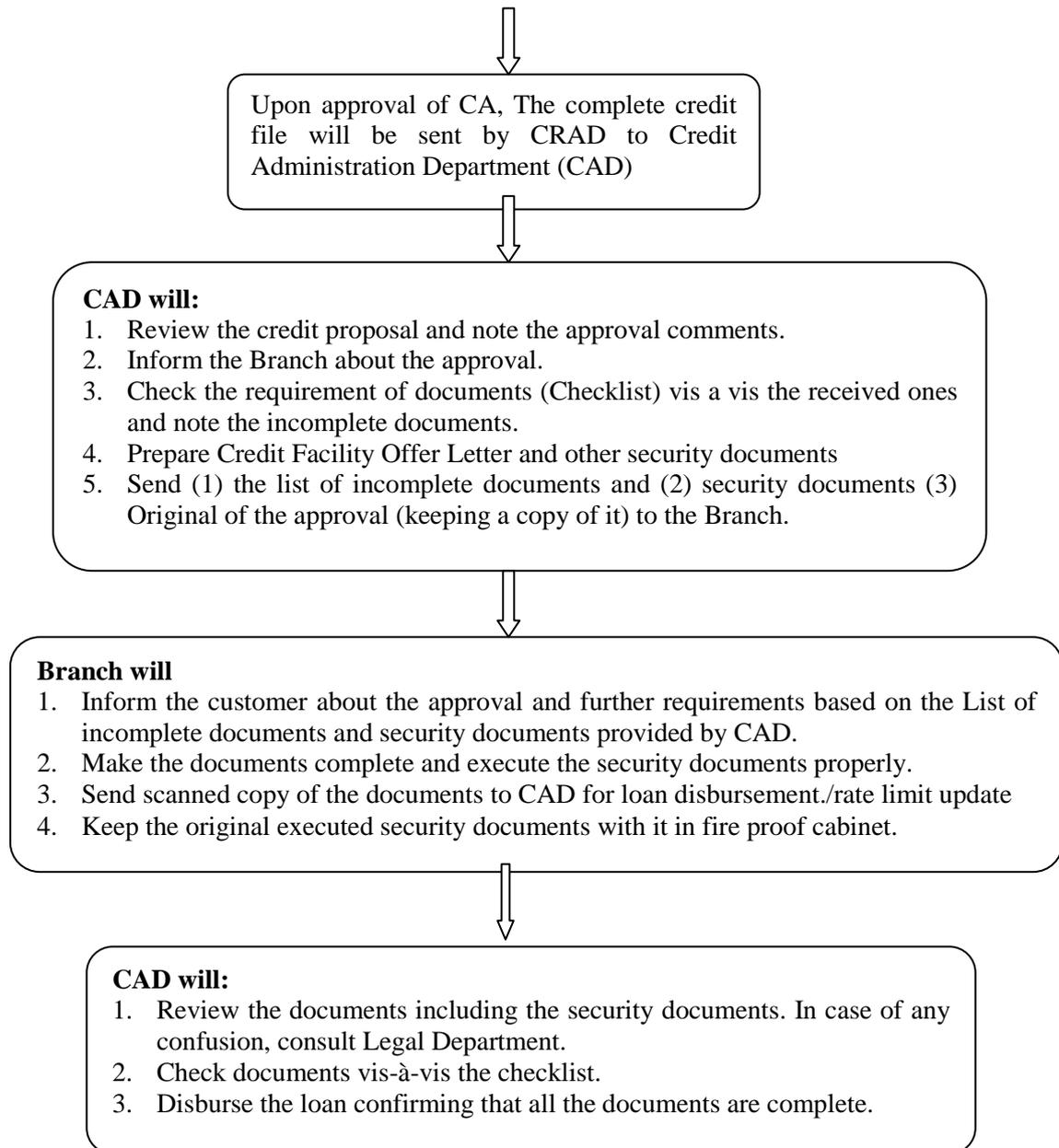
4.3.1 Lending Procedure in Real Estate

During the survey, selected banks and financial institutions were asked to furnish the information about the lending procedure in the form of flow-chart. The response was very positive as most of them have sent lending procedures that were complied with during the lending process. Some of them submitted the procedure with detailed drawing. Figure 4.1 exhibits the detail lending procedure followed by various banks and financial institutions.

Figure 4.1

Flow Chart of Lending Procedure





Though different banks have their own guidelines and procedures for loan approval, the above chart depicts the general procedure followed from the very beginning of the submission of the loan application to the very end or finalization of the loan (disbursement and utilization).

4.3.2 Types of Customers

In the questionnaire, one question was designed to find out the types of customers that come in banks and financial institutions to apply for the real estate loan (including

home loan). As they were asked to rank the response, personal residents captured the majority of responses (29 out of 41). The second and the third highest response relates to professional land/housing developers (17) and commercial complex builders (14) respectively. In fact, the types of customers also gives an idea about the purpose of the loan to be taken.

Table 4.2

Types of Customers

Types / Rank	1	2	3	4
Personal residents	29	7	4	0
Commercial complex builders	2	9	14	5
Professional land/housing developers	8	17	12	0
Other (specify): other sector business, personal use, renovation, o/d etc	1	5	4	8

4.3.3 Collateral Value

Respondents were asked to mention the percentage of real estate value in order to find out the maximum limit of real estate collateral for loan approval. The response is presented in Table 4.3. The table shows that commercial banks seemed aggressive in accepting, on average, 71.4 percent of real estate value as collateral followed by development banks and finance companies with 65.0 percent and 59.5 percent respectively.

Table 4.3

Percentage of Real Estate Value Approved as Collateral

S. No.	Institution	Average Percentage
1	Finance Companies	59.48
2	Development Banks	65.00
3	Commercial Banks	71.44

There is a high tendency of lending against collateral of land and building in formal financial system of Nepal. The lending is done on the basis of market valuation of the collateral. This could generate high risk in the system. In this respect, it seems relevant to compare the survey results with that of mid-July 2009. As of mid-July 2009, out of loans amounting to Rs. 402 billion, lending equivalent to Rs. 247 billion has been done against collateral of land and building which forms 61.44 percent of total loan of commercial banks and 48.24 percent of total loan of entire financial system.⁵ Hence the result from the primary survey seems even more alarming.

4.3.4 Financing Limit on Total Project Cost

With respect to the maximum percentage of financing real estate project by banks and financial institutions, commercial banks are found to be financing 60.9 percent of total project cost with development banks and finance companies financing 49.43 percent and 59.35 percent respectively.

Table 4.4

Percentage of Financing in Total project cost (Real Estate)

S. No.	Institution	Average Percentage
1	Finance Companies	59.35
2	Development Banks	49.43
3	Commercial Banks	60.93

4.3.5 Major Lending Sectors

All the banks and financial institutions were asked to rank their lending sectors. Table 4.5 presents the response with separate ranking for various sectors. In their business portfolio, real estate and housing sector received the highest weighted rank of 2.3. In fact, in recent years, real estate/housing sector has stood as a prime lending sector. This has also been a global phenomenon with the results leading to urbanization, real estate boom, sub-prime crisis and financial crisis as evident from the recent global financial crisis.

⁵ These figures are taken from NRB, *Quarterly Economic Bulletin*, Volume 44.

Table 4.5

Major Lending Sectors

Lending Sector	Rank						Total	Weighted Rank
	1	2	3	4	5	6		
Production/Manufacturing	5	10	5	6	5	3	34	3.1
Real Estate/Housing	16	5	12	3	1	2	39	2.3
Wholesale	4	9	11	3	5	0	32	2.9
Retail Business	8	8	8	8	8	0	40	3.0
Consumable	0	1	4	7	13	4	29	4.5
Others (specify)	6	8	2	6	2	4	28	3.1
Total	39	41	42	33	34	13		

Further, the banks and financial institutions have given separate ranking for 'Others' sector. They have specified various lending categories under 'Others' sector. The distribution of the other sector is presented in Table 4.6.

Table 4.6

Distribution of Other Loan

Catagories	Finance Companies	Development Banks	Commercial Banks	Total	Percent
Margin Lending	2	1	1	4	12.1
Hire Purchase	4	1	-	5	15.2
Personal Loan	5	1	-	6	18.2
Deprived Sector	3	-	2	5	15.2
Vehicle & Transport	1	-	1	2	6.1
Hotel & Restaurant	2	1	1	4	12.1
Education Loan	1		1	2	6.1
Share- Loan	5			5	15.2
Total	23	4	6	33	100.0

Personal loan stood on the top with 18.2 percent followed by hire purchase, deprived sector and share loan with 15.2 percent each.

4.4 Pattern of Real Estate Financing

With regard to the share of real estate lending on total lending, commercial banks stood at the top with 32.4 percent, on average, compared to finance companies with 27.5 percent and development banks with 24.1 percent. It is natural but seems risky. As the housing finance industry started to expand rapidly, home loans became easy business for

banks and financial institutions. As a result, the supply of real estate financing increased rapidly.

Table 4.7
Share of Real Estate Lending on Total Lending

S. No.	Institution	Average Percentage
1	Finance Companies	27.55
2	Development Banks	24.07
3	Commercial Banks	32.45

4.4.1 Main Reasons for Increasing Demand for Real Estate Loan

It is imperative to investigate the major reasons behind the steady growth in the demand for real estate loans. Respondents were asked to mention the underlying reasons with ranking. Majority of respondents (45 percent) have stressed 'lack of alternative investment opportunities' as number one reason. This corresponds with general business phenomena inside the country emanating primarily from political instability.

Table 4.8
Reasons for Increasing Demand

S.No.	Reasons	Rank	1	2	3	4	Total
1	Rapid urbanization		14	10	15	1	40
2	Lack of alternative investment opportunities		18	16	6	0	40
3	Speculation		8	13	14	2	37
4	Low interest rate		0	0	4	22	26
5	Other (specify)		0	0	0	5	5
	Total		40	39	39	30	

4.4.2 Share of Lending Collateralized by Real Estate

There is high tendency of lending against collateral of land and building in Nepalese financial system. The lending in most of the sector is collateralized with land

and land and building. The survey results show that almost 3/5 of the loan and advances of banks and financial institutions are backed by real estate collateral. The distribution of response among commercial banks, development banks and finance companies do not differ significantly with average of 56.9 percent, 61.1 percent and 55.2 percent respectively.

Table 4.9

Real Estate Collateral on Total Collateralized Loan

S.No.	Institution	Average Percentage
1	Finance Companies	55.19
2	Development Banks	61.07
3	Commercial Banks	56.89

4.4.3 Real Estate Loan as Other Loan

The survey results indicate that the banks and financial institutions have disbursed a small portion of 'other loan' to real estate sector. Commercial banks have provided 3.6 percent of 'other loan' in real estate sector whereas development banks and finance companies have provided 7.6 percent and 9.4 percent respectively. In fact, the actual exposure in real estate sector increases if these figures are incorporated in the sector-wise loan outstanding.

Table 4.10

Percentage of Other Loan that has gone to Real Estate

S.No.	Institution	Average Percentage
1	Finance Companies	9.36
2	Development Banks	7.62
3	Commercial Banks	3.56

4.4.4 Quality of Real Estate Loan (NPA)

It is imperative to investigate the quality of real estate loan and compare it with the general NPA level of banks and financial institutions. The survey results reported the NPA of commercial banks, on average, as 12.4 percent, development banks as 0.8 percent and finance companies as 3.7 percent. The ratio from the survey is high compared to the average figure of mid-July 2010, where the NPA level of commercial banks, development banks and finance companies was 2.39 percent, 1.56 percent and 1.54 percent respectively.

Table 4.11
Non-Performing Asset in Real Estate Sector

S. No.	Institution	Average Percentage
1	Finance Companies	3.68
2	Development Banks	0.83
3	Commercial Banks	12.40

4.5 Impact of NRB's Directive on Real Estate Financing

In the aftermath of the global crisis and lessons learnt from the impact of the excessive real estate exposure by the banks and financial institutions on the economy, The NRB has issued directives to limit the credit exposure within the certain time frame. The directive has been subsequently amended and relaxed considering the compliance and demand from financial sector. The modification was also desired to accommodate the home loans which were not of speculative nature.

4.5.1 General Trend of Loan Application and Approval in Real Estate

The general impact can be assessed on the basis of trend in the receipt of number of loan applications before and after the issuance of directives. This is exhibited in Table 4.12. There is a sharp decrease in the number of loan application in commercial banks (35.0 percent), followed by finance companies (31.3 percent) and development banks (16.7 percent).

Table 4.12

Proposals Received Before and After the Directives

S.No.	Institution	Before Mid-January 2010	After Mid-January 2010	Decrease in Percentage
1	Finance Companies	16	11	31.3
2	Development Banks	18	15	16.7
3	Commercial Banks	20	13	35.0

The response for the number of loan applications approved is exhibited in Table 4.13 which also shows the impact of the directive. There is a sharp drop (almost 34.0 percent) in the number of approvals of loan application in banks and financial institutions. The number of loan application approved in finance companies decreased by 37.5 percent followed by commercial banks and development banks with a decline by 35.7 percent and 28.6 percent respectively. This indicates that there was some sort of speculation in the real estate and the directive from central bank has rightly addressed the problem.

Table 4.13

Real Estate Loan Approval Before and After the Directives

S.No.	Institution	Before Mid-January 2010	After Mid-January 2010	Decrease Percentage
1	Finance Companies	8	5	37.5
2	Development Banks	7	5	28.6
3	Commercial Banks	14	9	35.7

4.6 Response of Organized Real Estate Developers

The housing and real estate business in Nepal had been conducted largely in unorganized sector. Nowadays, the situation is changing and there is growing tendency to develop land and construct residential housing and apartments by organized real estate developers. These professional developers and construction companies are formally

registered institutions involved in real estate business. These companies/brokers purchase large area of land and develop it with mass residential facilities.

As discussed in Chapter 1, these professional real estate developers or business persons were selected as respondents as Group ‘B’ for the opinion survey. They provided information about the demand side of real estate sector, in general and financing sources, types of collateral, price movements and impact of NRB directive in particular. Accordingly the survey response is summarized and presented below.

4.6.1 Financing Sources

Professional real estate developers or business persons have mostly used bank and financial institutions as source for real estate loan.⁶ In fact, all the respondents have borrowed loans from commercial banks. However, fifty percent of the respondents have used funds from both the sources (combining either commercial and development banks or commercial banks and finance companies).

4.6.2 Type of Collateral Pledged for the Loan

All respondents under Group ‘B’ (professional real estate developers) have pledged same project (land and house/building) as collateral for the loan. Moreover, most of them (80.0 percent) have pledged own-land and house as collateral for the loan. Only twenty percent have pledged inventory stock.

Table 4.14
Types of Collateral Pledged

S. No.	Institution	Average Percentage
1	Same Project (Land and House)	100.0
2	Own Land and House	80.0
3	Gold and Silver	0.0
4	Inventory Stock	20.0
5	Others	10.0

⁶ Note: Respondents can have a multiple choice.

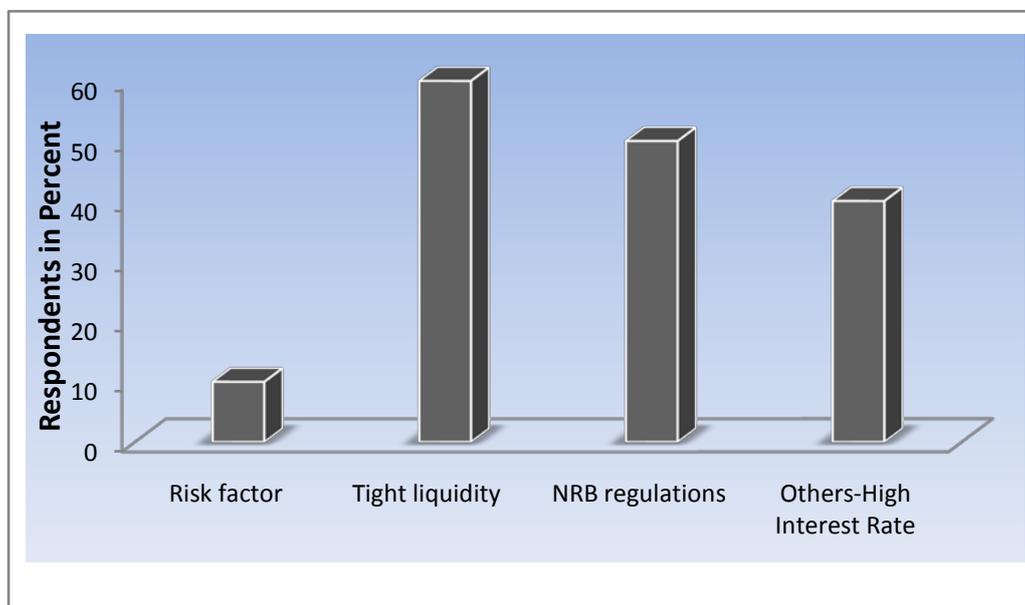
4.6.3 Easiness of Lending Procedure

With reference to easiness of the lending procedure, half of the respondents viewed the procedure as reasonable while the other half viewed it as difficult. This calls for some sort of reforms and improvements in the lending procedure.

In addition, these respondents have viewed tight liquidity as a major difficulty (60.0 percent) for the lending procedure followed by NRB regulation (50.0 percent) and increasing interest rate (40.0 percent).

Figure 4.2

Easiness of Lending Procedure

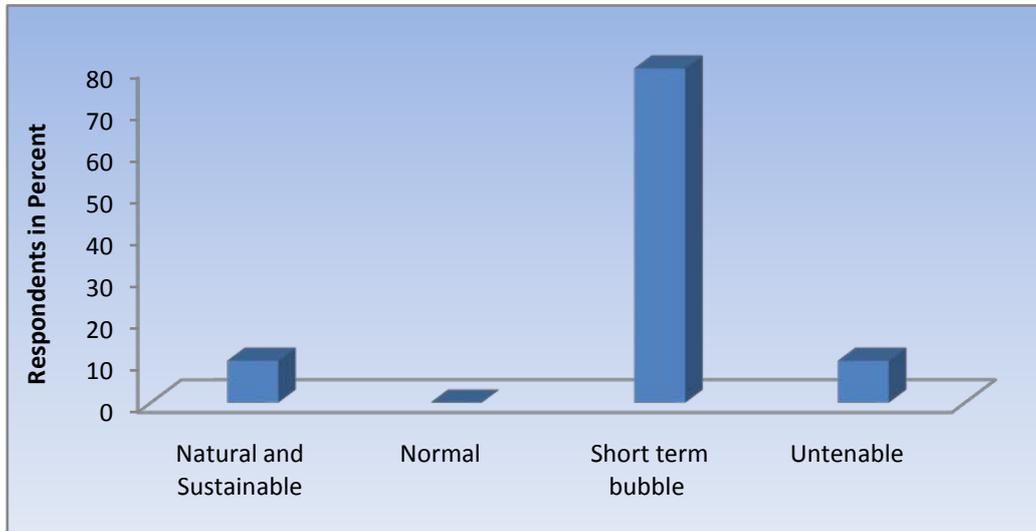


Note: Respondents can have a multiple choice.

4.6.4 Opinion about the Current Price Movement

Most of the respondents (80.0 percent) have indicated that some sort of short term bubble in real estate business prevailed in the past. While other respondents were equally distributed in viewing the current price movement either as natural and sustainable or as untenable (10.0 percent each).

Figure 4.3
Current Price Movement



4.7 Response of Individual Buyers of Real Estate and Housing

This section presents the response from opinion survey of Group 'C'. This group represents the customers that purchase land, house or apartment and come to Land Revenue Offices of Kathmandu Valley. Most of them are individual buyers purchasing land, building, bungalow or apartment for their own use or for commercial purpose.

These customers of real estate business provided information about the demand side of real estate sector, in general and purpose of purchase, sources of financing and impact of NRB directive, in particular. Majority of the respondents did not disclose information about the financing amount, interest rate and valuation of collateral. Hence, very little information was acquired from them.

Regarding the purpose of purchasing land or building, majority of respondents purchased it for their residential usage. They are found to be using their own financial resources to purchase the land and building. Analogously, most of them have not borrowed loans from banks and financial institutions.

4.8 Respondents' Opinion for NRB's Directive on Real Estate

In addition to the trend of loan application and approval in real estate sector before and after the issue of NRB's directive, a question was designed to obtain the opinions from all the groups. The response from Group 'A' is presented in Table 4.15. It is really interesting to note that 73.0 percent respondents opined that the regulation was 'reasonable'. Though some respondents (13.5 percent) expressed that the directive was 'unnecessarily tight,' others asked for the gradual tightness in the regulation. Further, a major portion of respondents (50.0 percent) in Group 'B' viewed NRB Directive as unnecessarily tight. Nevertheless, 40.0 of them viewed it as reasonable. However, most of respondents in Group 'C' also viewed it as unnecessarily tight.

Table 4.15
Opinion on NRB Directive

Opinion	No of Institutions	Percentage
Unnecessarily tight	5	13.5
Reasonable	27	73.0
Further tight regulation is required	1	2.7
Other (specify) - Gradual tightness	4	10.8
Total	37	100.0

Real Estate Financing in Nepal

Chapter V Findings, Conclusion and Recommendation

5.1 Summary of Findings

Housing is a basic need of every human beings, it provides security, pride and ownership. It has great significance in human life. Possession of the shelter is not required only for the protection against natural elements and hostile weather, but also for the maintenance of accepted standard of family and society. The real estate consisting of land or building with necessary living amenities makes better housing to live in. Housing and real estate sector plays an important role in civilization, social well-being and overall economic development of the country.

Housing finance contributes to social stability by enabling households to purchase the asset that is largest single investment. Personal residences account for 75 to 90 per cent of household wealth in emerging market countries. Furthermore, housing represents 15 to 40 per cent of the monthly expenditure of households worldwide. Globally, investment in the housing sector accounts for 15-35 per cent of aggregate investment.

Although several potential sources of housing finance for mid- and high-income consumers exist, most of the low-income families' needs are still unmet. Government subsidies tend to be insufficient or inappropriate; mortgage markets tend to serve only the richest 10-20 per cent of the population; housing microfinance is still an emerging industry; and informal systems are not efficient. Only 3 per cent of outstanding credit in low income countries is held in the form of housing loans compared to 27 per cent in high-income countries.

From a regional perspective, the mortgage markets in South Asia are small and fragmented though it has grown significantly during the last few years. Most of the countries have Housing Development Banks and commercial banks with housing finance

in their product range. The housing portfolio of commercial banks including the specialized housing banks is growing significantly.

Housing supply in Kathmandu has been taking place almost entirely with private sector initiation. It is mainly financed from informal sources such as personal savings, sale of family assets (land and jewelry), family loans, and to some extent, provident-fund loans. In addition, the financing is also supported by loans from employers and banks. The Government of Nepal has given certain priority for urban development and housing program in Kathmandu Valley through its various plans and programs.

Nowadays, different private real estate developers and housing companies are involved in construction of low-price housing, apartments and commercial complex. The share of real estate sector in GDP has remained fairly constant with around 8.7 percent of GDP in the last decade while the growth rate has remained at 3.8 percent during the decade. The unprecedented rise in the price of housing and land has posed several questions even for macroeconomic stability. Not only this, the fast growth without much value addition in the economy is indicative of the real estate bubble that adversely impacts an economy. This is what the recent global financial crisis divulged. The central bank has initiated several efforts to curb down unhealthy practices in real estate activities through the regulatory framework for commercial banks and financial institutions.

The study has focused on various aspects of real estate financing and conducted a questionnaire survey to collect various information. From the thorough reviews and analysis of the data, the study has provided several findings. The major findings are listed as follows:

1. The real estate exposure of commercial banks is found to be 32.4 percent, on average whereas that of finance companies and development banks is 27.5 percent and 24.1 percent respectively.
2. Personal residential home loan and real estate loan comprised 26.2 percent and 73.8 percent share in total real estate portfolio of commercial banks, development banks and finance companies.

3. Bank and financial institutions are found to be lending 61.44 percent of market value of collateral of land and building.
4. Real estate and housing sector has been ranked as a number one lending sector by most of the selected banks and financial institutions (weighted rank of 2.3).
5. Commercial banks are found to be financing 60.9 percent of total project cost whereas the figures for development banks and finance companies stood at 49.43 percent and 59.35 percent respectively.
6. The majority of respondents (45 percent) ranked 'lack of alternative investment opportunities' as number one reason for the rise in the demand for real estate loan.
7. Most of customers that visit the selected banks and financial institutions are found to be applying for personal residence (home loan).
8. The surveyed BFIs have disbursed a minor portion of 'other loan' in real estate sector.
9. Personal loan has a greater share of 18.2 percent in 'Other Loan' followed by hire purchase, deprived sector and share loan with 15.2 percent each.
10. The NPA level of the real estate loans of commercial banks is reported to be 12.4 percent, on an average whereas that of finance companies and development banks is 3.7 percent and 0.8 percent, on an average respectively.
11. Majority of respondents in Group 'C' have used their own resources to purchase the land for their personal residence.
12. The respondents of Group 'B' and Group 'C' suggested for the reforms in loan processing and improvements in the financing procedure.
13. With a proactive approach, the NRB came up with a specific directive for the real estate loan. The policy resulted in a sharp decrease in the number of loan application and approval in commercial banks and financial institutions.
14. The majority of respondents (73.0 percent) viewed NRB directive on real estate loan as 'reasonable'. Although some respondents (13.5 percent) expressed that

the directive was ‘unnecessarily tight’, others (10.8 percent) asked for the gradual tightness in the regulation.

15. They were of the view that some sorts of short term bubble in real estate had occurred in the past.
16. Commercial banks were found to be accepting 71.4 percent of real estate value as collateral whereas development banks and finance companies were found to be accepting 65.0 percent and 59.5 percent respectively.
17. Respondents of Groups ‘B’ and ‘C’ have used bank and financial institutions for the loan and pledged land and building as collateral for the loan.
18. The contribution of real estate sector to the GDP has remained fairly constant with 8.7 percent, on an average, during the last decade.

5.2 Conclusion

As the housing and real estate sector plays an important role in employment generation and economic growth in the economy, it has been receiving priority. Banks and financial institutions have been finding it as an emerging sector and have been providing necessary financing. If BFIs fail to prevent risks associated with these loans, relax lending criteria, and grant more individual mortgage and housing development loans, then real estate bubbles may appear. The long-term nature of real estate investment has an adverse impact on the proper allocation of resources and creates distortions in the financial system. Ultimately, it poses questions for the financial health and for macroeconomic stability. **It is high time to learn from experiences of other countries, review our practices and design a proper policy to develop and strengthen the real estate sector.** Some of these relate to the following:

- The housing and real estate market is still fresh in Nepal. There is a need to explore new products, modality of regulation and supervision.
- Credit Information Bureau only provides the information about the credit outstanding and list of defaulters. Hence, there is no system to examine credit worthiness of the borrowers.

- Some commercial banks simplified terms and conditions of the loan and formalities to speed up the process of real estate loans.
- Weak loan management unveils the risks associated with ‘fake mortgage’ and ‘overvalued mortgage’.
- There is some sort of competition among the banks and financial institutions for the real estate loan.
- Banks and financial institutions provide mortgage finance, refinance and additional loans without proper assessment and analysis.
- The real estate credit has been curbed down within the specified limit after the directive issued by the NRB, though some of the banks and financial institutions are still striving to bring down the credit exposure within the specified limit.

5.3 Recommendations

The NRB has recently issued another directive related to real estate finance to relax the process of real estate loan classification. After this, the banks and financial institutions are not required to include the personal home loan (upto Rs 6.0 million) under real estate loan. Hence, the actual size of the real estate loan will appear smaller and is expected to be within the prescribed limit. However, this seems to be a short term remedial measure to address the immediate situation. Hence, policy related to the real estate financing should be introduced based on international experiences combined with Nepal’s reality and requirements.

- **Real estate sector is one of the important economic sectors. The central bank needs to frame conducive policies to safeguard real estate financing and to ensure overall development of the sector.**
- **A multi-tier real estate financing mechanism needs to be framed immediately.** The current market is mainly composed of commercial banks and financial institutions and some investment companies, without specialized mortgage institutions and insurance companies.

- **Regulation and supervision mechanism of the real estate market should be improved** to keep up with the public concern about the financial health and efficiency. Standards on real estate financial businesses need to be established promptly.
- The NRB directives should not be directed only by the price movements and pressure from the major player of real estate market. They should mitigate public sentiments, consider the vulnerability of the sector and come up with the long-term policies.
- **It is highly desirable for NRB to pay close attention towards property prices in order to regulate and prevent financial risks through monetary and credit policies because the instability of the property market may directly lead to financial risks, endangering macro-economic stability.**
- Focus should be accorded for the use of workers' remittances in the productive sector as well as in infrastructure development. .
- **As there is no specific price index pertaining to the real estate or housing sector in Nepal, a real estate or housing price index needs to be developed.**
- There is a need to design legal framework governing the real estate market. Emphasis should be accorded to proper market supervision, early warning system and forward-looking risk-guidance.
- Independent and specialized institutions particularly for asset management, credit rating, securitization and legal matters need to be developed. Such institutions are necessary for the sustainable development of the real estate sector.
- **Financing for real estate and housing business is an emerging concept. There is a need to explore new sources, products, and mechanism for the successful financing of the real estate sector.**

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Appendix

LIST OF RESPONDENTS

GROUP A Banks and Financial Institutions

Commercial banks

Bank of Asia Nepal Ltd.	Laxmi Bank Ltd.
Citizens Bank International Ltd.	Nepal SBI Bank Ltd.
Everest Bank Ltd.	Prime Commercial Bank Ltd.
Global Bank Ltd.	Standard Chartered Bank Nepal Ltd.
Kist Bank Ltd.	Sunrise Bank Ltd.
Kumari Bank Ltd.	

Development Banks

Ace Development Bank Ltd.	Nepal Industrial Development Corp
Jyoti Bikas Bank Ltd.	Sanima Bikas Bank Ltd.
NDEP Development Bank Ltd.	Vibor Bikas Bank Ltd.

Finance Companies

Bhajuratna Finance & Saving Co. Ltd.	Nepal Housing and Merchant Finance Ltd.
CMB Finance Ltd.	People's Finance Ltd.
Crystal Finance Ltd.	Premier Finance Co. Ltd.
General Finance Ltd.	Progressive Finance Ltd.
Goodwill Finance Ltd.	Shree Investment and Finance Com. Ltd
Himalaya Finance Ltd.	Standard Finance Ltd.
IME Financial Institution Ltd.	Swastic Merchant Finance Company Ltd.
Kathmandu Finance Ltd.	Union Finance Ltd.
Lalitpur Finance Ltd.	Universal Finance Ltd.
Lumbini Finance Ltd.	Valley Finance Ltd.
Nepal Awash Finance Ltd.	Zenith Finance Ltd.
Nepal Finance Ltd.	

GROUP B Housing Development Companies

CE Construction P Ltd	Comfort Housing P Ltd
Varun Developers P Ltd	Bagmati Properties P Ltd
Oriental Builders P Ltd	Sanjivani Awash Co P Ltd
CM Developers P Ltd	CD Developers P Ltd
Continental Developers P Ltd	Civil Homes P Ltd
Brihat Investment P Ltd	Maharjan Builders P Ltd
