

# The importance of ancillary services for residential mortgage borrowers in default in Sri Lanka

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## 1. Introduction

The demand for housing and housing finance is high and this basic need should be addressed by society. This study aims to provide insights into the loan customer's use of ancillary services in relation to mortgage loans and the effects of the use of ancillary services on loan default in the Sri Lankan residential mortgage market. In general housing loan customers may not be fully aware of related matters such as financial, legal, technical, social and economic factors. The broader objective of this study is to be aware of loan customers' perceptions of the ancillary services offered by mortgage loan suppliers and the implications of taking up these services for mortgage default. Further, it aims to identify the importance of the mortgage loan counseling service for the mortgage market in Sri Lanka.

Typically, banks and other financial institutions assess the risks of housing loans on the basis of loan features (term to maturity, interest rate, size of down-payment), borrower financial characteristics (income, total debt, credit limit), and the value of the property pledged as collateral. These are all important measures affecting the probability of recovery of mortgage loans granted by lenders. Further, there are some other measures which are important and contribute to timely loan servicing by the customers. The financial abilities of customers are relevant influencing factors in relation to servicing a housing loan which is usually a long-term transaction. Further, customers have to have competence to cope with economic and political changes and with managing day to day activities while loan obligations are met. Unfortunately, there are currently no studies being conducted of mortgage counseling specifically designed to meet these needs Lind, (2011).

In the local mortgage market, one can notice large variations in interest rates within the last few years and further considerable rate variations between loan suppliers in the market. In the beginning of 2009 market interest rates on mortgage loans were at around 19.5% and varied over the period up to 2013 down to 12.5% at bottom. This is an immense change to interest rates for transactions of this nature. However, the prevailing interest rate is still high when comparing it with other mortgage rates in the region; around 10% in India, around 7.5% in China, and around 5% in Malaysia.

This study has focused on one important pillar of the housing finance market in Sri Lanka. This follows a survey of borrowers in order to examine their views on ancillary services provided by mortgage lenders before and after loan disbursement. While housing finance is a vital component of a finance system of a country, there has not been a systematic analysis of loan counseling across the country. Among others the ratio of average value of a house and the time it would take a borrower to pay that full value out of their irregular earnings is an important measure of their ability to afford a mortgage loan in the market. Analysis of the labor force also reveals that only around 20% of the population is in regular employment. Among existing low-income loan holders, poor recovery rates have been a major problem.

Default on a housing loan is usually a result of a significant and unexpected event which ultimately affects both the financial institution/loan provider and the borrower. The borrower may not have the capability to manage such incidents but financial institutions should take more responsibility in counseling/guiding customers and supporting them in relation to the issues they are facing. This should cover the finan-

cial, insurance, legal and technical/engineering aspects of house construction under mortgage arrangements and therefore the loan provider has to play a wider role beyond only acting as a financial institution that provides a loan. On the other hand in practice it is not easy to evict borrowers and realize collateral, given the social and cultural values of the society although loan providers have all legal powers for recovery of losses through insurance or foreclosure. As a result of this situation, lenders must think twice about the implementation of parate rights (that is, the ability of a lender to foreclose and sell a property where the mortgage loan is in default, without going to court). This was mentioned by Ahmed et al.(2007). As yet the effectiveness of foreclosure is hampered for most lenders by weak eviction powers. In this situation a pre-planned loan counseling service may help to minimize default by building links between borrowers and their lenders. It might help to cultivate financial literacy/discipline among loan customers and to find solutions to other issues/problems they may have, if they work together to identify potential solutions to problems arising for borrowers when a loan payment is due.

## 2. The mortgaged housing sector in Sri Lanka

Niriella, (2011) identified 28 housing financial institutions in Sri Lanka in 2009. All these financial institutions play an important role in the residential mortgage market in the country and most of them offer many other services in addition to mortgage loan disbursement. One can obtain mortgage loans to purchase land, for the purchase of a house, or the construction of a house, for an apartment/condominium, to cover any land purchase related expenses, for a

home extension such as constructing an annex or extra rooms, for home improvements, to build a second home, for renovation, for landscaping, for furnishing, etc. An effective system of housing finance provides key economic benefits and positively affects savings, investment, and household wealth. Beyond this, a functional mortgage market is a key factor in supporting the urbanizing trend in society, in meeting demographic challenges in terms of growing housing demand and in preventing slum proliferation.

The Sri Lankan housing market and the financing of housing has been strongly supported by government agencies for a long period under a number of programs but in future further state sponsored funding is at its minimum level. As a result of government recognition of the need for a self-sustaining housing market in the country, it has already implemented some initiatives to promote housing finance via the mortgage market while continuing with a few state sponsored housing programs. However, Ahmed et al. (2007) has mentioned that many middle and lower-income households have no access to housing finance in Sri Lanka and have identified that the bulk of commercial bank housing lending is for personal housing construction and purchases.

The relative dearth of housing finance options for middle- and low-income households means that these households often build their own housing over time, creating a form of equity (house ownership) finance which is a hurdle in their life for a long period. "Newspapers are full of real estate classified ads for both rental and purchase properties. At the same time, more than 80% of the households in Sri Lanka have no access to housing finance, and about 7% are lacking homes. One third live in semi-permanent housing and 6% live in line room (very small houses with minimum facilities for tea estate workers) estates and shanties," it says in a report on housing finance, *The Sunday Times* (2010). "The census reveals that Sri Lanka has been successful in managing the national housing backlog, which was approximately 350,000 units in 2001. However, a shortage still prevails within the low and lower middle income sector particularly because of the natural expansion of housing need. It is believed that a sizeable portion of the existing units are substandard hence require substantial improvement and upgrading", Pathirathna (2012). The above two citations provide evidence that the real unmet need for mortgage loans is among lower and impermanent income earners in society. The non-availability of a mortgage loan scheme for impermanent income earners in the formal mortgage market is a big issue.

Housing mortgage loans are inherently different from other types of loan products as for most individuals investment in a house is only undertaken once in their life time. Mortgage finance arrangements for housing in Sri Lanka do not have much history but there are milestones for the development of the industry since the mortgage commission appointed in 1945, which recommended major changes to the common law (<http://www.fjgdesaram.com/history.htm>). The gap in housing finance provision in Sri Lanka potentially includes up to half of the Sri Lankan population, Ahmed et al. (2007). This section of the population may be capable of servicing a mortgage loan but has no access to finance and may not have sufficient financial literacy. This segment of society might benefit significantly from ancillary services in the mortgage market. This allows us to reasonably estimate the net benefits to investors/lenders, borrowers and in general to society of offering mortgage loan counseling to distressed borrowers.

### 3. Residential mortgage default in Sri Lanka

It is important to answer the question 'What are the key triggers and causes of mortgage default?' Berry M. et al. (2010). The terms and conditions laid down by the banks and other financial institutions for customers clearly indicate that for the poorer section of society it is not easy to get approval for a loan, or to afford a housing loan from a financial institution, to make their dream home a reality Niriella, (2011). Piyasiri (2006) has mentioned that collection ratios for housing finance institutions in Sri Lanka are estimated to range between 80 and 95% and Karnad (2004) recognized this as a continuing issue. Further she identified that in certain instances the Non Performing Loans [NPL] ratio is around 20%. Ahmed et al. (2007) mentioned that State-owned banks continue to have some problems with NPLs, particularly the State Mortgage and Investment Bank with 25%.

In 2011, the National Savings Bank [NSB] originated housing and property loans of 36,839,073 (Rs' 000). In 2010 it was 33,011,819 which showed an increase over the 2009 balance of 28,339,675. This makes an increase of housing and property loan of 16.48% in 2010 and 11.59% in 2011. Comparatively, loan loss provision on housing and property loans at the end of 2011 were 2,592, 254 and the balance at the end of 2010 was 2,046,181 compared to 2,290,968 at the beginning of 2010. However, suspended interest payments on housing and property loans were 170,346 (Rs' 000) in 2009, 202,706 in 2010 and 254,787 in 2011 showing

a rising trend (NSB, Annual Report, 2009, 2010, and 2011). The above figures indicate a 16% and 11% increase in loan balances in 2010 and 2011 respectively and show suspension of housing and property loan interest payments increasing by 19% and 26% increase in the same years which is a much higher increase than the increase of value of loans granted.

The State Mortgage & Investment Bank (SMIB) with its vision 'To be the Leader in Housing and Development Finance in Sri Lanka' indicates in their annual reports 41.28%, 37.11% and 34.06% of NPL for years 2009, 2010 and 2011 respectively. Further, income from interest on loans and advances has slightly come down from 2,362,259 (Rs' 000) in 2010 to 2,307,130 in 2011.

The District-wide summary of the Housing Development Finance Corporation [HDFC] (April 2012) shows that there were 70,380 loans granted and out of this 36,713 were under Employee Provident Fund [EPF] security which was 52.16% of total loans granted with the balance of 33,667 loans under other types of securities. There were 24,178 loans making 34.35% of the total loans which were identified as in default and out of them 19, 588 loans in default had been granted under the EPF security amounting to 81.01% of the total of loans in default. There were 4,590 loans in default out of the non EPF security loans.

In the light of the above facts mortgage lending will remain confined to the top income groups, and it will continue to rely on regular salary income and other assurances of palpable monetary value Ahmed et al. (2007), so that lenders can ensure repayments. This underpinned with 95% of the sample made up of government workers Rathnasingha et al (2012).

### 4. Ancillary services in the mortgage market

Lind, (2011) has identified that one of the major challenges faced today by mortgage investors and servicers is the inability to contact distressed borrowers with payments due who do not have adequate communication with their lenders. Ahmad et. al, (2012) has mentioned that 'In the absence of the formal arrangements between the housing developers/real estate agents etc and financial institutions, the protection of individual purchasers remains limited as the market is dominated by cash transactions with limited availability of systematic information in a transparent manner'. However, Lind, (2011) has listed diagnosis of a consumer's payment

problems, updated borrower status and financial information, review of income and expenditures resulting in the creation of a budget, prioritization of all debt, developing repayment strategies, including mortgage modification, establishing a “trust” relationship with the consumer, and helping the consumer qualify for a mortgage modification through reduced overall consumer debt and lifestyle spending as features of consumer credit counseling. Further, Hartarska et.al (2001) presents empirical evidence to support the hypothesis that, when properly designed, the innovation of credit counseling reduces the incidence of default on low-income mortgage loans.

In the Sri Lankan mortgage market, a mortgage applicant has to submit a list of documents and these include an approved plan of construction, title, title report, pedigree insurance etc. Submission of these is not easy for the type of person who is in most need of a mortgage loan in Sri Lanka. Even after the submission of those documents, there is a critical need for financial, legal, and technical/engineering knowledge on the construction of a house as house construction or its supervision has to be carried out by the owner and most houses are self-build or involve the house owner, with support from relatives, hiring individuals to undertake work. Most households build their own housing over a long period, facing a range of hurdles. In this situation excellent ancillary services connected to the mortgage market spur the development of that mortgage market. House developers are not yet popular in many parts of the country and few of such service providers are available in city areas. Against this background, this study has considered financial, legal and technical/engineering advice services provided by mortgages suppliers.

#### 4.1 Financial advice

Financial education and counseling hold the promise of improving financial knowledge and facilitating behavior change, Collins et.al (2010). They mention that it is quite clear that better studies are needed to refine how financial education and counseling strategies are designed and implemented. Credit counseling should reduce the number of distressed borrowers. In the current financial market financial literacy is a critically important issue among many potential mortgage borrowers. This is recognized as an issue even in developed economies. A significant number of Americans, including many highly educated people, seem to understand very little about residential mortgage finance decision-making and how their personal financial circumstances can determine whether their mortgage loan is approved, the interest rate,

settlement fees, and the overall costs of mortgage financing, Rose (2011). This provides an important clue as to the need for loan counseling services in local markets as well. Such counselors typically concern themselves with counseling borrowers on behavior and actions they can take that can help them avoid future financial difficulties.

#### 4.2 Legal advice

The Mortgage Act with amendments is a document of more than 38 pages using technical jargon which can only be understood by an expert in the field of law. Beyond that there are many other legal requirements relating to insurance, debt recovery, deed, stamp duty etc. The mass of mortgage holders are not aware about the content and provisions of the Mortgage Act. There are legal experts working for accepted/registered mortgage loan suppliers. Their work is a part of the mortgage loan supply process but it is only to fulfill the legal requirements of the loan supplier. All legal requirements of the borrower have to be arranged by them, which is a critical barrier and which has a high cost. Further, most mortgage customers do not clearly understand about the legal arrangements and the importance of them for their security.

#### 4.3 Technical advice

In countries like Sri Lanka, almost all income groups partially or fully construct their own houses but their technical and engineering capabilities are not at an acceptable level to manage such works. However, in this environment it is still accepted that much of the existing stock of houses has been self-constructed by the house owner. In relation to technical or engineering skills, there are technical experts in mortgage loan supply institutions to evaluate the house or work plans submitted under the mortgage loan application. However, their services do not extend beyond the mortgage loan approval although construction works may be ongoing. This may create issues for the house owner in terms of extra costs, the inability to complete works as planned and so forth. This failure may cause a number of other issues and those issues may finally put the lender in difficulty.

### 5. Methodology

This article will use examples mainly from individuals who have experienced mortgage default. Information was gathered on the ancillary services provided by mortgage lenders with structured interviews conducted with borrowers in default. This study was not intended to

provide a quantitative statistical analysis of the sample of mortgage lending institutions in the market. Face-to-face interviews with borrowers were held and conducted without any intervention by the lender in the discussions. Each borrower was asked specific questions relating to their satisfaction with the ancillary services provided. The information provided by the loan holders on existing mortgage loan ancillary services included loan counseling, legal advice and technical advice offered by their lending institutions. In order to ensure the privacy and confidentiality of the information provided by each loan holder they were informed that only aggregate summary data would be reported. The total number of borrowers interviewed was 30 and face-to-face interviews were held from December 2012 to February 2013.

### Discussions with borrowers

#### Case Study 1

*X is a 34 year old man who resides in Kottawa. After three years of his marriage he started to construct a house for his family with financial assistance from a mortgage loan. The plot of land was bought previously with a mortgage arranged by the same organization. By this time there were three members in the family including their child. At the beginning of the second mortgage agreement he had to pay 30% of monthly salary earned for the first mortgage installment and the interest rate on the mortgage was 19.5%. However, after 5 years he was paying 80% of his salary on loan installments while he has not been able to complete construction works on the house as he had planned previously. He disclosed that he had submitted some documents to show extra income though actually he did not have such income at the time of applying for the mortgage loan. While he was shouldering these commitments a second child came into the family. By now he had lost the capacity to meet both his family needs and to meet the payments on his mortgage loan. As a result he had entered several informal financial arrangements with known third parties in the course of making an effort to manage. All these efforts had increased his difficulties but he had not discussed his inability to meet payments on his mortgage loan with the mortgage supplier.*

This case illustrates the need for increased financial capability to enable individuals to handle their income and expenditure. If this person had received guidance and explanation on how to overcome his issues, the level of risk he could afford, and what options were available to him, he might have overcome his problems. For instance, he could have obtained advice on

loan rescheduling, on how to gain a grace period on payments, the danger of informal financial arrangements etc.

### Case Study 2

*Y is a 38 year old unmarried woman who works as a nurse at a government hospital located far away from the capital city. She was dreaming of a house and bought a plot of land with 6 perches (1 acre = 160 perches) for 400,000 LKR out of a 1,000,000 LKR loan obtained from a bank to construct a house. In the process of purchasing the plot of land she looked for guidance and help with the legal and administrative requirements from a number of third parties known to her but she had to go to a lawyer a number of times because of errors in the legal documentations. After obtaining the loan, she started construction work with verbal guidance from third parties known to her, trusting their words. Construction work was carried out by individuals living close to the area. After completing some work she was uncertain about the accuracy of measurements, the mix of materials, and so on. She questioned the workers about her doubts and this created a tense situation among them while she feared that they had committed misconduct. Finally, the work stopped as she could not continue. Then, she approached some other workers and requested them to carry out the balance of works. They informed her that the previous workers had committed some serious mistakes which they would have to rectify. Since then she has been stuck for more than two years without completing the walls of the house. She has said that she has not the financial capacity to complete the balance of works as she had to bear unexpected costs for rectification. Further, current prices of construction materials are much higher than at the time she planned and started the work.*

She frankly explained the difficulties faced by her because of her lack of technical/engineering knowledge on house construction. More importantly she referred to her inability to supervise construction works as she is not confident in this area. She had consulted many individuals but they had no formal and systematic knowledge on those areas and she failed to gain access to services from formal and trustable professionals. This had resulted in unexpected issues such as quarrels with workers and the extra cost of rectification.

### Case Study 3

*Y is an unmarried 49 year old woman residing in Miriswatta. She worked as a music teacher for a government school. She spent the last 30 years*

*with her sister but when some issues arose she had to leave the place. Thereafter, she had made a temporary shelter on land belonging to her which had been bought with her savings about 7 years previously. She started to construct a house for herself with financial assistance under a mortgage on her land four years back. While implementing construction works she was cheated by a number of people. One person/contractor had promised to start works and obtained money in advance for materials and other expenses but did not come to do the work. Then, she tried with another contractor but she realized that he was over-charging her halfway through the work. Following that experience she tried to continue construction of the house by assigning part of the work to individuals under her supervision. She retired early from her job as she was unable to manage this with her job responsibilities. However, only the walls of the house have been completed over the last three years and she has no financial capacity to pay for the balance of the work to complete her house. As a result she has become disillusioned and has advertised to sell the land with a half-constructed house. She referred to the pressure of loan repayments and her inability to cover the cost of construction work even though land has been sold.*

Usually, a music teacher does not have the necessary capability and knowledge of construction and engineering. She was facing the difficulty of finding a good service provider for construction works. If she had had a good builder, she would have been able to manage her job and the completion of the construction work even though she had financial difficulties.

Knowledge and awareness about financial arrangements, or the financial ability to deal with lenders are both crucial elements. Out of the total of respondents the majority did not know how to decide or calculate loan repayment installments or what information is used to calculate them while only very few respondents had gained financial management education or training. Further, 91% of them did not know whether early settlement of a loan would be economically advantageous or disadvantageous for them in their current situation other than saying if they had money they would settle the loan and get relief from the liability. More importantly 68% of respondents had not evaluated market interest rates before selecting the lender. They had selected the lender on the recommendation of known third parties or because the lenders were government establishments. It was indicated that 34% of respondents had not been able to meet the completion of works as they planned with the amount they received from the

mortgage loan. All the above indicates that mortgage customers have insufficient awareness and knowledge in relation to financial management or financial capability.

The documents containing the legal requirements are drawn up by the loan supplier and it is the customer's responsibility to complete and submit them. Out of the 30 interviews, 65% claimed that all legal documents were submitted by them as per the requirement and all of them were completed at their own cost and using their own legal arrangements. The balance of 35% mentioned that the loan provider gave guidance on how to obtain these legal arrangements but the total cost and effort was their own. Further, 41% of respondents did not have awareness of the terms and consequences of those legal documents and they had not even read them before the loan agreement was approved and signed. Some respondents (32%) knew what the documents were by name but had not clearly understood why those were needed and the content of them before signing the mortgage agreement. Further, 89% of respondents did not know that there is a mortgage law covering the country.

The loan supplier will make a requirement that the borrower must submit a house plan approved by the relevant government administrative body (local government) as a condition of obtaining a housing loan. In relation to the technical or engineering support rendered by the loan provider, the majority of respondents discussed an overall limitation to the bill of quantity [BOQ] and housing plan. Out of the mortgage loan holders surveyed 79% had not received any technical or engineering advice on their construction works from the mortgage loan supplier. Some of the respondents stated that technical and engineering support was limited to a BOQ and after getting the approval for BOQ, all discussion in relation to the construction work was over. 82% of respondents had paid for professional consultancy on technical and engineering work services prior to the commencement of their house construction work. 27% of respondents mentioned that there were no such professionals to get technical or engineering consultancy from in the mortgage loan supplying office.

## 6. Findings and conclusions

If the mortgage loan supplier does not meet the service requirements of customers it can cause a failure to fulfill expectations. Customers have to bear additional costs and there may be dissatisfaction over many issues. Finally default on the mortgage loan may occur. Many

interviewed borrowers in default did not have a clear awareness of mortgage procedure and their long term commitments and responsibilities. The majority of respondents took on the responsibility of construction of their home or they built it themselves even though they did not have minimum technical and engineering knowhow on house construction. More than half of the sample had contacted separate individuals for each piece of work such as one for the foundations, one for concreting, one for masonry works on walls, another for plastering, another mason for tiling, one for doors and windows, one for roofing etc. As a result they spent more than the average time on construction of a house. They expressed their dissatisfaction with organizing and arranging these works, with the unnecessary cost they incurred and with the poor quality of work.

None of the respondents claimed that they defaulted on their mortgage loan intentionally or defaulted because the default option was financially advantageous. They had not been able to cope with changes in costs and additional items of expense including increases in construction costs, restitution, and unexpected experiences. These indicate the need for all related services to be obtained from one service provider who they can trust and who is convenient for them to use. All the above indicates the need for a well arranged counseling and support service for borrowers before and after signing the mortgage agreement. This should include a property construction inspection service. Mostly lenders can overcome those issues by arranging along with housing loans multi service (complementary - inclusive of financial, legal, and engineering/construction) counseling instead of simply granting loans and letting borrowers make their arrangements for the rest of the works and meet the responsibility of repaying the loan.

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