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Challenges in financing residential construction for individuals by commercial banks and ways to address them

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Abstract

This article examines the challenges faced by commercial banks in Uzbekistan when providing financing for individual residential construction and explores solutions to improve this financing process. Key issues include high default risk, limited borrower creditworthiness, fluctuating interest rates, regulatory constraints, and high administrative costs. The study proposes targeted solutions such as phased disbursement loans, enhanced credit assessment, financial literacy programs, and partnerships with construction firms, and public-private collaborations.

Keywords: Commercial banks; Residential construction financing; Default risk; Creditworthiness; Housing finance; Public-private partnership

1. Introduction

The financing of residential construction for individuals is a crucial factor in the growth and stability of housing markets and the broader economy. As home ownership remains a primary goal for many individuals and families, providing accessible and affordable financing options for residential construction can drive economic development, reduce housing deficits, and contribute to social stability. In Uzbekistan, as in many developing economies, demand for housing has increased significantly due to factors such as urbanization, population growth, and the need for improved living standards. However, many individuals face difficulties in securing financing for residential construction, which hampers the housing sector's growth and limits access to adequate housing.

Commercial banks play a central role in residential construction financing, offering loans that enable individuals to build, purchase, or improve their homes. These loans not only benefit individuals but also stimulate demand across industries related to construction, such as materials, labor, and real estate services. In this way, residential construction financing directly supports job creation and economic activity. However, despite these benefits, commercial banks encounter substantial challenges when offering loans for residential construction, especially for individual borrowers. Unlike standard mortgage loans, construction loans entail higher risks as they depend on the successful and timely completion of the project. These risks include the borrower's financial stability, potential project delays, and fluctuating economic conditions that may impact loan repayment.

Key challenges in this sector include the high risk of default, fluctuating interest rates, limited creditworthiness among individual borrowers, and regulatory restrictions that make it difficult for banks to offer favorable loan terms. Additionally, residential construction loans involve extensive administrative work, such as ongoing monitoring of the project's progress, which increases costs for the bank and affects the profitability of such loans. Limited financial literacy among borrowers also presents challenges, as some may lack understanding of loan terms, repayment obligations, and financial planning.

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2. Literature Review

Residential construction financing plays a fundamental role in supporting economic growth, improving living standards, and fostering social stability. The financing of housing projects, particularly for individual borrowers, is essential for addressing housing deficits and meeting the demands of a growing population. However, numerous studies reveal that commercial banks face significant barriers in providing residential construction loans due to the associated risks and market challenges.

One of the core challenges in financing residential construction is the heightened risk of borrower default. Loans for construction purposes are riskier than traditional mortgages due to the complexity and duration of construction projects, which involve various stakeholders, regulatory compliance, and a reliance on project completion. Geltner et al. (2007) argue that construction loans are exposed to unique risks stemming from potential cost overruns, delays, and dependency on borrower financial stability. These risks often deter banks from issuing such loans without additional security measures or higher interest rates to compensate for the increased default risk.

Fluctuating interest rates add to the difficulty of issuing residential construction loans, especially in emerging economies where inflationary pressures and central bank policies can cause significant volatility. Banks must balance between offering competitive rates and safeguarding against interest rate risk, which can impact both the affordability of loans for borrowers and the profitability of banks. Beck et al. (2015) suggest that the unpredictable nature of interest rates can negatively influence borrowers' repayment capabilities and, consequently, increase NPLs (non-performing loans) in banks' portfolios.

Limited creditworthiness of borrowers presents another obstacle. Many individuals lack a strong credit history or stable income, making them high-risk clients in the eyes of banks. According to Khandker and Koolwal (2010), the lack of adequate credit assessments can lead banks to either deny loans or charge higher interest rates, both of which limit accessibility to financing. This challenge is particularly pronounced in developing countries where informal employment is prevalent, making income verification challenging.

Regulatory restrictions also play a significant role in shaping banks' lending policies. Various regulatory requirements, such as capital adequacy ratios, loan-to-value (LTV) limits, and provisions for risk management, can constrain banks' ability to offer residential construction loans. A study by Barth et al. (2004) emphasizes that while these regulations are essential for maintaining financial stability, they can inadvertently limit banks' lending flexibility and profitability. Furthermore, high administrative costs associated with construction loans deter banks from financing individual housing projects. Due to the requirement for continuous monitoring of the construction process, banks incur additional operational expenses that make such loans less profitable, especially for lower-value loans.

To overcome these challenges, various approaches have been proposed in the literature. Tailoring loan products to suit the specific needs of residential construction projects can significantly reduce the associated risks. For instance, phased disbursement loans, which release funds at predetermined stages of construction, allow banks to monitor project progress and reduce the risk of incomplete projects. Barth et al. (2006) support the concept of phased disbursement, suggesting that this approach can improve loan security while enhancing project accountability.

Risk management techniques, especially the use of predictive analytics and big data, have become increasingly valuable in assessing and monitoring credit risk. Advances in data analytics allow banks to develop sophisticated credit risk assessment models that provide a clearer picture of borrowers' financial stability and loan repayment potential. Accenture (2019) reports that predictive analytics can improve early-warning systems, helping banks identify high-risk borrowers earlier in the lending process and take preventive measures. Machine learning algorithms also enhance the decision-making process by analyzing patterns in historical data to identify trends in loan default.

Financial literacy programs are essential in empowering borrowers to manage their finances responsibly and understand loan obligations. Research by Lusardi and Mitchell (2014) reveals that financially literate borrowers are more likely to make informed decisions and manage loan repayment effectively, reducing the likelihood of defaults. By investing in educational programs, banks can reduce default rates, lower NPL levels, and enhance the overall quality of their loan portfolios.

Public-private partnerships can also facilitate access to residential construction financing. Government-backed subsidies, interest rate support, or partial loan guarantees can reduce the financial burden on banks, enabling them to offer more affordable loans to a wider range of individuals. World Bank studies (World Bank, 2021) highlight that such collaborations can promote inclusive housing finance while ensuring the sustainability of lending practices.

Lastly, partnerships between banks and reputable construction firms have been shown to mitigate completion risk and improve borrower repayment. These partnerships allow banks to work with experienced developers, ensuring the quality and timely delivery of housing projects. Bailey et al. (2020) argue that these partnerships not only support housing supply but also reduce the risk associated with incomplete or delayed projects, making residential construction loans more attractive to banks.

3. Analysis and Results

Table 1 summarizes the main challenges faced by commercial banks in providing residential construction loans.

Table 1 Challenges in Residential Construction Loans

Challenge	Description
High Default Risk	Construction loans are more prone to default due to dependency on project completion and borrower financial stability.
Fluctuating Interest Rates	Unstable interest rates affect affordability for borrowers and profitability for banks.
Limited Creditworthiness	Many potential borrowers lack a strong credit history or stable income.
High Administrative Costs	Ongoing monitoring and project inspections increase operational expenses for banks.
Regulatory Restrictions	Loan-to-value limits, capital adequacy requirements, and other regulations restrict banks' lending flexibility.

Source: Developed by the author

The above table highlights that high default risk and fluctuating interest rates are significant obstacles for banks. For instance, residential construction loans are particularly vulnerable to borrower financial instability, and incomplete projects further increase the risk. Furthermore, regulatory restrictions and administrative costs discourage banks from actively lending in this sector, as compliance and monitoring requirements reduce profitability.

Table 2 shows some of the primary regulatory constraints impacting residential construction loan issuance by commercial banks in Uzbekistan.

Table 2 Regulatory Constraints Impacting Residential Loan Issuance

Regulation	Description	Impact on Banks
Capital Adequacy Requirements	Banks must maintain minimum capital ratios, limiting funds available for high-risk loans.	Reduces available capital for residential loans
Loan-to-Value (LTV) Limits	Caps on LTV ratios restrict the amount banks can lend relative to the property value.	Limits loan size and borrower eligibility
Risk-Based Pricing Restrictions	Certain interest rate caps prevent banks from fully compensating for high-risk loans.	Reduces profitability on construction loans
Administrative Compliance Costs	Regulatory requirements for ongoing project inspections increase administrative costs.	Raises overall loan costs and reduces profits

Source: Developed by the author

Table 2 illustrates the restrictive nature of capital adequacy and LTV limits, which reduce banks' flexibility in offering residential construction loans. For example, LTV limits restrict the loan amount relative to property value, making it difficult for some borrowers to qualify. Administrative compliance costs associated with project monitoring and reporting add further expenses, which discourages banks from extending credit in this sector.

Table 3 outlines potential solutions that commercial banks can implement to improve the viability of residential construction financing:

Table 3 Proposed Solutions to Improve Residential Construction Financing

Solution	Description	Expected Outcome
Phased Disbursement Loans	Loan funds are released at construction milestones, reducing project completion risk.	Improved project oversight and reduced default risk
Enhanced Credit Risk Assessment	Use of predictive analytics for better risk assessment of borrowers.	Reduced likelihood of loan defaults
Financial Literacy Programs	Educating borrowers on financial management to improve repayment behavior.	Higher loan repayment rates
Partnerships with Construction Firms	Collaboration with reputable firms to ensure quality and timely project completion.	Reduced risk of incomplete projects
Government Subsidies	Interest rate subsidies or partial loan guarantees to make loans more affordable.	Increased loan accessibility for borrowers

Source: Developed by the author

Table 3 highlights practical solutions that banks can adopt to manage the risks associated with residential construction financing. For instance, phased disbursement loans enable banks to monitor project progress and adjust disbursements accordingly, minimizing the risk of project failure. Additionally, partnerships with construction firms can enhance project quality and completion rates, while government subsidies could make loans more affordable and attractive to a wider borrower base.

Table 4 provides a summary of the key challenges and the corresponding solutions that address each issue in the context of residential construction loans.

Table 4 Summary of Challenges and Solutions in Residential Construction Financing

Challenge	Proposed Solution	Expected Benefit
High Default Risk	Phased disbursement loans	Reduces risk by linking funds to project stages
Fluctuating Interest Rates	Government interest rate subsidies	Provides affordability and stability to borrowers
Limited Creditworthiness	Enhanced credit risk assessment	Improves loan approval accuracy
High Administrative Costs	Technology-based project monitoring systems	Lowers operational expenses
Regulatory Restrictions	Public-private partnerships	Facilitates access to affordable housing finance

Source: Developed by the author

As shown in Table 4, each identified challenge is addressed with targeted solutions designed to improve the overall feasibility of residential construction financing. High default risk can be mitigated by phased disbursement, while government subsidies can counter fluctuating interest rates. Furthermore, enhanced risk assessment and technology-driven project monitoring can improve loan approval processes and reduce administrative costs, respectively. Public-private partnerships can offer additional support to ease regulatory constraints and create a more robust residential financing environment

4. Conclusion

In conclusion, the provision of residential construction financing by commercial banks is essential for meeting Uzbekistan's growing housing demand, improving living standards, and supporting the broader economy. However, this financing segment faces numerous challenges that must be addressed to create a more sustainable, accessible, and robust housing finance environment. The key challenges identified in this study include high borrower default risk, fluctuating interest rates, limited creditworthiness among individual borrowers, regulatory constraints, and high administrative costs associated with loan monitoring and compliance.

The analysis indicates that tackling these issues requires a comprehensive approach that incorporates both operational improvements within banks and supportive policies from the government. Solutions such as phased disbursement loans, enhanced credit risk assessment models, and financial literacy programs can enable banks to mitigate the risks associated with residential construction financing. By releasing loan funds at specific construction milestones, phased disbursement loans help reduce default risks by ensuring that funds are only allocated when projects meet predefined criteria. This approach not only improves the bank's security but also enhances borrower accountability and project completion rates.

Enhanced credit risk assessment, especially through predictive analytics and data-driven algorithms, offers banks a powerful tool to assess borrower risk profiles more accurately. Advanced risk assessment models enable banks to extend credit to a wider range of individuals without compromising portfolio quality. Meanwhile, financial literacy programs play a critical role in educating borrowers on responsible financial management, helping them make informed decisions and increasing their likelihood of successful loan repayment. Financially literate borrowers are better equipped to navigate the complexities of residential loans, reducing the risk of defaults and improving the long-term stability of the housing finance sector.

In summary, improving residential construction financing for individual borrowers requires a multi-faceted approach that aligns the interests of banks, borrowers, and government bodies. Implementing these strategies will not only help banks reduce default risks and improve profitability but also contribute to the overall economic and social development of Uzbekistan.

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