Framing the Issues: Housing Finance, Economic Development, and Policy Innovation

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Housing and Economic Development

A key motivation for the conference was to confirm and highlight the important role housing can play in economic development and as a platform for improvement of housing conditions for the broader population.

Improved delivery of housing can reduce the incidence and impact of squatter settlements, increase labor and social mobility and reduce the negative externalities of congestion and traffic pollution. Better functioning housing markets can serve as an important vehicle for savings, wealth creation and entrepreneurial business development. Better functioning housing markets lead to improved cities and can contribute to broader economic development and macroeconomic stability.

Further, shelter strategies are also effective economic development strategies. Building construction creates jobs and is a powerful local economic stimulus. Better housing attracts aspirant households, increases neighborhood wealth and leverages retail, commercial, and other businesses. Also, it provides for stable real estate markets that facilitate macroeconomic stability.

Well functioning housing markets must be able to address housing needs for a wide variety of users, adapting to demand and supply pressures, while preserving affordability and quality, produce long run, sustainable outcomes and, importantly, display diversity in tenure, quality, and cost choices. A properly functioning housing market includes a vibrant resale market, facilitating mobility and the unlocking of housing wealth. A functional rental market is also important both as an affordable shelter alternative and as a facilitator of labor and social mobility.

Conversely, the failure to improve housing conditions and markets can impede economic development, contribute to poverty and social isolation, create negative externalities in development, and de-stabilize the economy.

Clear property rights and titles play a crucial role in a well functioning housing market. It secures mortgages and provides liquidity by allowing homeowners to "monetize" their equity. In this way, low-income borrowers who have few prospects for borrowing in the formal financial sector can pledge their property as collateral to raise money for other purpose, including businesses.

A well functioning housing market with an effective housing finance system can provide large external benefits to the national economy:

- Better overall living conditions for families who can access a home and, thus, improve their housing quarters.
- Improved urban infrastructure (housing demand stimulates utilities, schools, transportation).
- Enhanced economic and social mobility both within metropolitan markets and regionally within a country;
- Improved labor market mobility, diversity, and accessibility;
- Increased savings (by giving households an increased motivation to save);
- Increased consumer spending and investment financed by homeowners borrowing against the value of their homes;
- More capital for entrepreneurs;

International experience suggests that there is a causal link between housing demand, housing finance, financial sector development, and economic growth. In urbanizing countries, where the development process generates sharp increases in mobility and relocation, housing investment increases as a share of GDP. Increased financial sector institutional development and macroeconomic stability in developing countries is conducive to a rapid rate of growth in the supply of housing finance. Experience from developed countries also suggests that the process of financial liberalization and shift from directed credit to market allocation provides significant impetus to the growth of housing finance.

Over the past decade, substantial progress has been made to improve the functioning of housing markets in the subject countries, and beyond, spearheaded by the delivery of formal housing finance. A starting point for the conference was to draw on this rich experience to improve the understanding of the necessary pre-requisites for a robust and sustainable housing finance system and the effective government policies that underpin it.

Housing Finance: A Basic Tool for an Efficient Housing Market

International experience has shown that housing finance plays an important role in improving the housing conditions and markets of a country. An effective housing finance system channels resources to support housing demand, allowing households to accelerate purchase and construction of housing and facilitates a better allocation of resources between housing, other goods and savings over the life cycle. Access to finance can liquefy the wealth of inhabitants, facilitating upgrading of the housing stock and improved spatial distribution of households and business. Affordable housing can have a beneficial effect on the quality of housing, housing related infrastructure and the shape of urbanization.

Formal housing finance is a key enabler for improved functioning of the housing market and economic development. Cities are built the way they are financed. Formal (commercial) housing finance can produce a diversified supply of housing units, completed by professional developers in relatively short periods of time. Formal housing finance works in conjunction with an organized real estate industry to facilitate the distribution of finished product, and with local governments to create planned communities with adequate infrastructure.

Under the appropriate legal environment, because of housing's strength as collateral, housing finance affords the lowest cost debt available to most small borrowers. As a result, the availability of housing finance permits more than housing to be purchased. It is also a tool for small businesses and households to rearrange their portfolios so that they can make use of some of the highly illiquid savings they have accumulated in housing. For example, in the US where housing finance is highly developed, it is estimated that up to 80% of new business creation is financed from housing.

The availability of affordable mortgages may enhance savings, contributing to financial sector development and macro-economic stability. New housing finance instruments, such as mortgage-backed bonds, can provide a relatively safe alternative investment, stimulating investment in housing from non-traditional sources (e.g., domestic pension funds, international capital providers).

By contrast, the lack of finance (or informal finance) produces slow incremental housing based on retained savings which is more costly to the end user. "Self-development" by owners using small craftsmen results in high real resource cost reflecting inflation, a lack of economies of scale and organization. Spontaneous communities (informal settlements) are accompanied by problems of overcrowding, crime, disease and family dysfunction that in turn are exported to the larger metropolitan area.

An effective housing finance system will make housing loans available to qualified borrowers without excessive wait, provides loans whose relative cost is in line with the cost of credit in the economy generally and reflect the risks of the investment. The system will be able to withstand moderate exogenous shocks. An effective housing finance system should be diverse, with loan types and providers consistent with the economic environment and able to meet diverse consumer needs. Loan losses should be at least partially predictable based on property, borrower and transaction characteristics and fair where liens are enforceable but borrowers receive due process.

The Building Blocks for Housing Finance in Emerging Economies

In developed countries, housing markets and finance systems are broadly capable of producing successful outcomes. Although problems with slums, unequal access to credit and affordability remain, they are small in relation to the problems experienced in emerging economies. There are a number of key pre-requisites for an effective and robust housing finance system:

1. Macroeconomic stability which enhances affordability through lower and more stable mortgage interest rates and the adoption of consumer friendly instruments like fixed rate mortgages.

2. Adequate laws, titling systems, and judicial processes that allow households to establish ownership or pledge collateral. The enforceability of the lender's security interest is a major determinant of the attractiveness of mortgage lending. If liens are not enforceable, there is little to distinguish mortgage loans from unsecured debt. Lack of enforceability causes mortgage lending to not be perceived as safe a field of activity in many developing countries.

3. Robust markets for new and existing housing. The presence of numerous buyers and sellers, adequate information on prices and characteristics, an accurate and timely title registration system and the lack of discriminatory or onerous taxes (e.g., stamp duties, property taxes) foster housing markets and make houses safer collateral for finance.

4. Adequate supply levels of housing units, both in volume and in price range, consistent with the distribution of household income. Such supply characteristics implies having an efficient production process capable of generating: land with infrastructure and services, quick license and permit approval mechanisms, short production cycles and ample acquisition finance (both credit and, if needed, subsidy).

5. Competitive and efficient primary mortgage markets. Competition stimulates innovation and the adoption of cost-saving processes and technology. As markets expand and deepen, greater efficiencies in lending can offset the higher costs of small loan size for affordable housing. The ability to price for risk and the development of risk-sharing mechanisms like mortgage insurance can expand the supply of credit to low and moderate income households.

6. Products that meet the needs of borrowers and lenders. A robust housing finance system generates a wide range of products to meet consumer needs and protects consumers against rogue lenders or products incompatible with their ability to repay. In addition, finance is available for housing construction and renovation, increasing the efficiency of the building process.

7. An infrastructure for information for assessing collateral and credit risk. This is particularly important to address the complexities of underwriting and servicing small loans to individuals with typically undocumented and potentially unstable sources of income. The lack or high costs, of obtaining information, vetting it for credibility, and fitting it into established value chains, delivery channels, and financial forms is a substantial impediment to lending.

8. Adequate levels of household domestic savings relative to the size of the economy providing a pool of resources that can support the credit needs (formal or informal) of households. Long term savings stimulated by pension and insurance reform is an important source of funds for housing.

9. The development of mortgage capital markets. The ability to access long term funding through issuance of mortgage securities can enhance the supply of funds and facilitate improved risk management by lenders. However, mortgage capital markets are likely to be an incremental source of funding in emerging markets and develop only after a robust primary market is in place.

The countries that were invited to this conference have all reached a take-off stage in housing market and housing finance system development. They have achieved macroeconomic stability, have taken steps to liberalize their financial systems and are experiencing economic growth. They all, however, face significant challenges in improving the functioning of the housing market and the housing finance system, in particular expanding the system to meet the needs of a broader segment of the population. The goal of the conference was to introduce strategies that address the weaknesses in existing markets and systems and can produce successful and effective housing markets and housing finance systems to increase societal welfare and economic progress.

The Complementary Roles of the Public and Private Sectors

For housing to fulfill its potential in social and economic development several preconditions must be met. Each nation's government must commit to make housing a priority sector. The finance system needs to stimulate creation and improvement of ownership housing in both the formal and informal sectors. And markets must be buttressed by a regulatory and tax system that does not discourage the formal purchase and sale of homes and a finance system that encourages it. Both government and the private sector thus have essential roles in extending housing markets and housing finance. Furthermore, rental opportunities must also be fostered.

First, each nation's government requires a deliberate and embracing strategy to mobilize private capital for mortgage finance. That strategy must use public funds to leverage private capital and to extend its reach to markets that might otherwise go underserved.

Second, government must provide resources to improve the housing conditions for low income households. While a robust housing finance system is an extremely important element of housing and economic development, it is not realistic to expect the private market to provide affordable finance for all households. In the subject countries, a large portion of the population is currently unbankable and will remain so for the foreseeable future. Governments should undertake policies to stimulate savings for housing (equity as opposed to debt finance) and provide intelligent subsidies that improve the housing solutions for lower income households within their domestic budget constraint.

Third, each nation must have a legal and regulatory framework that supports property rights and finance, including property rights law, titling, foreclosure and eviction laws and judicial process, consistently practiced urban development regulations, disclosures and consumer protection laws, and in some cases land reforms. Attention must be given bolstering the market for existing housing as well as rental and intermediate forms of tenure.

Fourth, each nation needs an information infrastructure that enables accurate housing finance risk assessment. Lenders and insurers must be able to assess and quantify the risk of mortgage lending. Here again, governments can act as a catalyst for private sector collection and provision of this information or undertake these functions in whole or in part by itself for some period of time.

Fifth, financial institutions and financial instruments, both for debt and equity, must exist that serve demand at all levels, from the wealthy to low and moderate income individuals employed in the formal sector to those engaged in informal sector work and/or housing. Competition among lenders must exist to encourage innovation and efficiency in loan origination and servicing.

How do countries build the proper enabling environment? What strategies, policies and innovations are effective in creating an atmosphere where housing markets are successful and housing finance can flourish? How can governments work more effectively, both internally (i.e., better policy coordination across agencies and jurisdictions) and externally (with the private sector) to achieve successful policy outcomes?

Three of the four participating countries – Mexico, South Africa, and Thailand – have recently made significant progress in improving the delivery of housing and housing finance. The country contexts differ and so do the approaches. But there is a common theme of macroeconomic stability, strengthening the legal and regulatory environment and encouraging investment by traditional lenders and non-traditional investors. Importantly, there has been an emerging partnership between the public and private sectors that has facilitated change.

Kenya represents the next tier of challenges; a country facing the same needs, and with a broad stakeholder consensus for change, but lacking the established platform of a proven enabling environment. Yet even if the environment is not yet receptive, household formation, urbanization, and housing demand are rising rapidly in Kenya – the need is there. Including Kenya as representative of aspiring countries provides a perspective to examine what strategies require enabling environment as a precondition, versus those that can work in less-enabled environments.

Experience in numerous nations and over many decades has shown that both the pure-private and pure-public approaches to affordable housing creation lead, ultimately, to the same unsuccessful end: a disadvantaged and disenfranchised community that seems only to warehouse the poor with little prospect that either they as individuals or the neighborhood as a community will improve. The public sector has neither the resources nor the organization to deliver successful large scale housing outcomes. The private sector may not have the vision or the risk appetite for expanding the delivery of housing services and finance. Instead, a public-private model is essential, because it fuses public sector policy motivation and willingness to provide subsidy, infrastructure, risk-sharing and supportive regulatory environment with private sector innovation, capital, accountability, efficiency and responsiveness.

Public-private partnerships have worked well in numerous developed countries. Government provision of mortgage insurance for example can be a catalyst for increasing lending, particularly down market. Investments in information infrastructure through rating agencies, credit bureaus, and valuation companies can accelerate lending by improving the capabilities of lenders to assess risk. Risk sharing programs where government fosters the development of new private sector institutions through guarantees or seed capital can speed development of mortgage capital markets. Subsidy designs that encourage participant savings can create additional capital that can be leveraged to provide finished houses.

Public-private partnerships are being developed in the target countries. In Mexico, the Sociedad Hipotecaria Federal provides guarantees on private sector security issues to broaden the capital market finance for social housing. In Thailand, the Government Housing Bank has funded the creation of a credit bureau and a real estate information provider. In South Africa, following the unsuccessful earlier piloting of low-income securitization through Gateway Home Loans in South Africa, government and banking sector are again in discussions surrounding risk sharing mechanisms to encourage sustainable mortgage lending, all driven by the landmark Financial Sector Charter signed last October.

Government can play a critical role in creating public-private partnerships through providing leadership, establishing the vision, coordinating private and public sector initiatives and assembling resources. Government must establish the proper enabling environment through law, regulations, and administration that creates a capital-enabling environment hospitable to public-private programs. Government can also be a capital facilitator by providing the proper regulatory infrastructure and risk mitigation approach that allows both private and public entities to better manage risk, as well as monitoring the performance and activities of the private sector.

Government participation is fundamental in areas where investment risk/return profiles are difficult to assess. Nowhere is this characteristic more important than in infrastructure investment for land development, particularly in affordable housing for the lowest income earning households. Governments can choose how to best subsidize housing solutions for the poorest families: either in the form of land investment, with infrastructure and services, where to build housing solutions (ie progressive housing), or with upfront acquisition subsidy that can pay for the investment provided by third parties.

The private sector must recognize the profit opportunities inherent in expanding housing development and finance. Some businesses already recognize these opportunities, most notably building material suppliers and builders. Others, often formal sector lenders, have not because they lack the information, products, laws and regulations, and systems to serve the markets effectively. This may require new institutional players (specialized lenders), instruments (alternatives to standard mortgages), distribution approaches and risk management techniques. Working together with the government, given the proper incentives, the private sector can mobilize and deploy the resources necessary to create a successful housing market and effective housing finance system.

The political economy of creating successful public-private partnerships is daunting. Obtaining co-operation across ministries with overlapping or competing objectives - finance, housing, commerce, health, environment, labor etc - as well as between national, regional and local governments is essential, as is the creation of an environment where the public and private sectors are engaged in constructive dialog. Successful models in both emerging and developed countries are highlighted in the articles that follow.