Development of viable housing finance systems

By David Painter

THE developing countries of Asia, as in the rest of the world, are experiencing rapid urbanisation and the accompanying demands for urban services. It has been estimated that by the end of this century an additional one billion more people will be living in the cities of the developing world. This rate of urban growth has implications for every segment of the economy. Increasingly scarce financial resources will need to be more efficiently utilised, food production and marketing systems will need to be improved, jobs will need to be created, and the shelter delivery systems will need to be expanded. The ability to provide even the most basic services will require greater resource mobilisation and efficiency.

The important role that shelter plays in coping with and managing this urbanisation process was emphasised at the Second International Shelter Conference held in Vienna in 1986. As stated in the recommendations from Vienna:

> "Housing and urban infrastructure are prerequisite components of efficient urbanisation and direct contributors to economic growth through capital formation, employment generation, and their strong forward and backward linkages to the national economy."

Housing finance is a key component in the overall shelter delivery system, and it is on the topic of developing a viable housing finance system that this article concentrates. At the same time, it is important to recognise that finance institutions do not operate in a vacuum, and the

availability of credit by itself cannot ensure the provision of shelter. Other aspects of the entire system must also be considered.

The shortage of suitable land is a major constraint to housing production in many countries. Land markets must become more equitable, and the procedures for land transfer, titling and registration more efficient. Security of tenure needs to be guaranteed for all income groups. Appropriate building codes need to be adopted so that affordable units can be built for lower income families. Adequate infrastructure needs to be developed, and the building materials and construction industries need to improve their productivity. Finally, public policies and regulations need to be supportive of the shelter delivery system as a whole.

The magnitude of the urbanisation process in the developing world underscores the need for a systems approach to shelter delivery. Housing production on a project-by-project basis cannot possibly keep pace with demand. Moreover, changing global economic circumstances provide additional impetus to developing a housing finance system, which by its very definition involves resource mobilisation.

High foreign debt burdens, falling commodity prices, and low or even negative rates of economic growth have resulted in a scarcity of investment resources in developing countries. It is no longer feasible for these countries to rely primarily on foreign borrowing or donor assistance to fill the gap between capital needs and available resources.

Increasingly, financial resources for investment must be mobilised locally. A viable housing finance system can contribute significantly to this process. Capital formation and economic growth are dependent on savings. Savings can be generated by business and government, and from international transfers, but by far the most important and consistent source of national savings is the household sector, which can account for some 40% to 60% of a country's total savings.

Households contribute to capital formation. Naturally some of this capital is returned to households through shelter investments, but fears that shelter will crowd out other investments are simply unfounded. In fact, the opposite is true: effective housing finance systems result in higher rates of savings and expand the amount of available capital for investment in other sectors.

Universally, home ownership is a

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high priority for which families are willing to save. In some cases, the opportunity to save for the purchase of a home has resulted in monetising and bringing into the finance system for the first time such unproductive assets as gold and jewellery.

Even more significant, however, is that homeowners increase their rate of savings above and beyond mortgage payments after purchasing a home. One study in India showed that lower income borrowers had increased their savings from zero to over 6% of their monthly income, despite the fact that their housing payment had increased more than three-fold. Similar trends have been observed in Morocco, El Salvador and the United States, suggesting that the same process occurs at all stages of national economic development.

Thus, a viable housing finance system serves to meet shelter needs and contributes to national economic development — not only in terms of resource mobilisation but also by furthering the development of a country's finance system. Many countries, however, have failed to recognise this link between housing and economic growth, and have adopted policies which either prevent a housing finance system from emerging or severely constrain its growth.

A housing finance system cannot succeed in a policy environment which unfairly constrains its operations, makes it uncompetitive in mobilising resources, or establishes standards which prevent private lending for all income groups. In some countries, credit is allocated by sector, often to the disadvantage of housing, which is believed to be less productive than other sectors.

In other instances, a cap on the deposit and lending rates of mortgage institutions reduces their ability to mobilise resources. These rate ceilings are simply another mechanism for allocating credit, and they are based on fears that long-term housing finance will crowd out other important investments. Moreover, they tend to make the overall finance sector less efficient by reducing the ability of capital to seek the highest return. These types of policies tend to "marginalise" housing finance institutions by not incorporating them into the larger capital markets, and, in turn, their ability to contribute to economic growth or provide essential services is lessened.

The debate over what should be the appropriate governmental role in low-income housing is another area in which inappropriate policies have hindered the development of housing finance. In much of the developing world, housing has been commonly regarded as a social sector, not as an economic one. While this attitude is changing it is still prevalent in many countries. As a result, governments have felt compelled to provide low-income housing as a social service, rather than relying on finance institutions and developers.

'Need for partnership between public and private sectors'

Often, public agencies themselves have acted as builders, marketing agents and retailers of mortgages. This approach assumes that the private sector is unwilling to address low-income shelter needs. But by their very involvement in the shelter sector, governments have, in a sense, created a self-fulfilling prophecy. Private institutions are both unwilling and unable to compete with government agencies which subsidise costs, have priority for land acquisition, or are allowed to operate according to different rules and regulations.

Where government has inhibited the emergence of a private sector housing system, the result is that shelter — particularly for lower income households — has grown only to the extent that it can be supported by the national budget. Unfortunately, the project-by-project approach of government agencies has fallen far short of needs, and has failed to achieve an acceptable level of cost recovery. Public housing tends to be over-designed, expensive and heavily subsidised.

The agencies themselves are often inefficient, which adds to project costs, and the uncertainty of annual budgetary funding merely compounds their management problems. Even the more successful sites and services and slum upgrading projects, such as in the Philippines and Indonesia, have not overcome all of these problems.

What needs to occur in the process of developing a housing finance system is the emergence of a working partnership between the public and private sectors, a partnership in which each understands and carries out its appropriate role. This was a major focus of the Vienna Recommendations on Shelter and Urban Development which state:

> "The basis for effective public/private co-operation rests with the understanding and fulfillment of the responsibility incumbent on each sector."

In the experience of the US Agency for International Development, the public sector plays two essential roles in developing the housing finance system. First, government establishes the policy and regulatory environment for housing finance. Second, government performs those tasks which individuals and the private sector cannot do for themselves.

Government policies should allow shelter finance institutions to compete for resources by utilising market interest rates on both deposits and loans, thus enabling them to become active players in the country's financial community and capital markets.

Markets should be supervised to assure fair access and competition. Institutions should be monitored to discourage reckless or illegal business practices. However, until such time that the governments recognise the important contribution that housing makes to the national economy, it is unlikely that a supportive policy and regulatory environment will be created.

I have discussed in general terms the contribution of housing to economic growth, but let me take the opportunity to be a little more specific:

- Housing has strong backward linkages to the construction and building materials industries, and forward linkages to furniture, fixtures and equipment manufacturers. Malaysia's Ministry of Housing and Local Government estimates that 108 industries directly or indirectly benefit from housing investments.
- Housing provides both direct and indirect employment, and it is particularly important in providing entry level jobs for unskilled labour.
- Housing investment can be counter-cyclical and can be used to stimulate sluggish economies. In the past few years, Sri Lanka has emphasised shelter activities during its period of political turmoil and economic downturn.
- Housing contributes to national economic development. Malaysian officials estimate that every $400 million invested in housing adds 1% to GNP growth.
- Housing is a major component of national wealth, forms a major part of a country's total tangible assets, and represents the main form of wealth accumulation for most households. For lower income families, housing is frequently a source of equity to leverage other resources, an income generating asset through the use of rental rooms, and a location for micro-enterprises.

The public sector's second role can best be described as doing what individuals or the private sector cannot do for themselves. Providing major infrastructure is a good example. While neighbourhood infrastructure can be included in the sales price of land, major off-site infrastructure serving the city generally must be financed by public agencies.

By comparison, the construction of housing units is something that the private sector can do, and thus it should be considered that sector's responsibility. Making such distinctions will have the additional benefit of reducing or eliminating many of the demands now placed on the national budget, thus freeing up scarce public resources that can be targeted to other more critical public investments.

Other activities which cannot be performed by private institutions include land titling, planning, zoning and similar tasks. These activities rightfully fall under the purview of local or national authorities. In order to support the housing finance system, governments need to look at how they carry out these essential functions, and whether such services are provided in a timely, co-ordinated fashion to complement private initiatives.

'Housing a major component of national wealth'

To summarise, the public sector plays two essential roles in terms of housing finance: creating a supportive policy and regulatory environment, and efficiently providing services which individual households or private institutions cannot provide themselves. The actual financing and production of shelter should be left to the private sector.

The only caveat to this general definition of roles is that the truly needy — the poorest of the poor — often cannot be served by formal, private sector mechanisms alone, and governments must take the lead in assisting these households. The trick here is to identify correctly, and target assistance to, these families, perhaps no more than the lowest one-quarter to one-third of the income scale. In too many countries, well-intended programmes for the poor have been appropriated by much higher income groups, and impoverished households continue to suffer from a lack of adequate shelter or essential services.

Some public officials may feel that playing only a supportive role within the housing finance system is too limited in scope. I suggest that quite the opposite is true. Identifying and implementing policies which enhance private resource mobilisation, and designing strategies for developing efficient financial markets, are sensitive, intellectually challenging and far-reaching activities.

In terms of providing infrastructure, how easy is it for city officials to design a drainage system for Bangkok which floods each year; or to develop land titling records for the sprawling cities of Calcutta and Manila? These are the types of activity which create the context for housing development, and, by extension, which must be undertaken in support of the housing finance system. They are limited in neither scope nor impact.

I have already mentioned that the private sector's responsibilities include housing construction, finance and resource mobilisation. But private institutions also have a developmental role to play in shelter. The private sector needs to respect the government's legitimate concerns for the poor, and needs to find creative means to balance profit motivation with a responsiveness to the needs of all income groups.

The private sector also needs to identify and encourage policy changes which will assist in the development of housing finance institutions and a more efficient shelter system. In doing so, the private sector should not be protectionist, nor encourage monopolistic systems. In fact, the private sector should encourage competition precisely for the reason that competition

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will strengthen the entire system. The emergence of many private housing finance institutions will provide strength in numbers when advocating policy changes.

Finally, if the public sector does move to create a supportive policy environment, then the private sector must be willing to accept prudent business risks, operate according to competitive principles and live with the market results, resisting the temptation to seek government subsidies.

Experience has proved that the private sector is willing to finance low income housing, provided it is not excluded from this market by unfair government competition or regulations. A good example comes from India. In 1978, India's first private mortgage company, the Housing Development Finance Corporation (HDFC), was established with paid-in capital coming from both the public and private sectors. However, from the start, the management was private. In 1986, only eight years after its start-up, HDFC had nearly US$300 million in deposits. This remarkable growth has been accomplished while serving lower income households. In 1986, HDFC approved close to 41,000 loans at an average value of under US$3,900.

India has a highly regulated economy in which shelter has traditionally been given much lower priority than other sectors. Thus, the establishment of HDFC required both legislative and policy changes. These changes, however, were not particularly far reaching, nor did they give HDFC favourable treatment; rather, they simply permitted it to go into business. As a result of HDFC's success, some two dozen other private firms have been encouraged to enter the housing finance market.

'Addressing low-income shelter needs'

HDFC is not only an example of the willingness of finance institutions to extend mortgage credit to lower income families, it also serves as a good example of a private sector institution assuming a much fuller role in this public/private relationship to which I referred earlier. HDFC has mobilised resources for shelter investment; analysed public policies and advocated changes to facilitate development of a housing finance system; balanced its profitability with responsiveness to India's poor; and accepted prudent business risks to achieve profitable growth.

What we are witnessing in India is the emergence of a viable housing finance system, operating with a market orientation while still addressing low-income shelter needs. I might add that we at AID have used the HDFC experience as a model for institutional development in other countries throughout the world, and we believe that other Asian institutions should talk to HDFC to learn from its experience in developing their own housing finance systems. Asia in particular can draw upon private initiatives. While other regions of the world have only weak or newly-emerging private institutions, Asian countries in general are characterised by a strong, broad-based, entrepreneurial private sector.

Development is not a static process. In the course of development, our ideas about how to solve problems can — and should — change with experience. Over the years, our approach at AID to housing and urban problems has evolved from a project focus to a systems approach, and from emphasising public intervention to encouraging private initiative.

At AID, the Office of Housing and Urban Programs has the lead responsibility for addressing shelter issues. We have seven regional offices worldwide, and our regional office in Bangkok administers AID's shelter and urban programmes for Asia. For nearly 25 years, the Office of Housing has been providing assistance in shelter and related urban concerns through our Housing Guaranty loan programme. Last year, our total loan guarantees authorised surpassed the US$2 billion mark, making us the largest bilateral donor in the housing sector. To date in Asia, we have guaranteed US$220 million in loans.

The Housing Guaranty programme is a mechanism for channelling private commercial loans from the United States into shelter and related urban services in developing countries. AID provides a US Government guaranty to the American private lender. Usually the direct borrower is a central bank, finance ministry or other governmental entity that provides AID with a host country guarantee to repay. In effect, the borrower is able to use the dollars and absorbs the exchange rate risk. An equivalent amount of local currency is then made available by the borrower to finance shelter or urban services through intermediary lenders.

'Encouragement of private initiative'

Sometimes these intermediaries are national housing institutions, but increasingly we have been working to bring private banks, building societies and savings and loan associations into our projects.

In addition, we use grant funds to support our country programmes. This support takes the form of training, providing technical assistance, and conducting research and development activities. Many of our projects are also enhanced by our leveraging of other donor resources for both technical assistance and capital investment. ■

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