Creating a housing finance strategy in developing countries

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In the past few years there has been a distinct shift in policy direction in the housing sector within the donor community and in several developing countries. The adjustment has been from a situation in which government was a developer of housing for low and moderate income households to one in which government acts to enable the private sector to produce a high volume of minimally acceptable housing.

Housing finance, as a key input into housing production and a natural entry point into sector level policy-making, is being given increasing attention in this new context. Because of housing’s capital intensive nature, creation of effective housing demand generally requires the ability of the household or investor to borrow funds to finance development.

In most developing countries, mortgage financing available through regulated institutions has accounted for only 10-20% of housing production, and has typically been limited to families at the top of the income distribution scale. Lower income households have been forced to rely on “informal” financial sources, especially friends and the extended family; sometimes they turned to much higher cost, unregulated money lenders for shorter term financing. Hence, an expanded volume of financing is needed to fuel housing demand, particularly among lower income households.

According housing finance a priority as an input is also attractive for another reason. Mobilising more financial resources will typically require reforms in the financial sector as a whole which will make the sector more efficient and probably reduce implicit subsidies (Hanson, 1976). This makes such reforms of interest to the country’s monetary authorities and economic planners, and expands the political support for reform.

The purpose of the process described in this article is to develop a strategy for a country to mobilise additional financial resources for the housing sector and to target these incremental funds for lending to lower income households. It is important to remember that both parts are critical: you must mobilise the additional funds before they can be on-lent; but, it does little good to have generated these funds if they are simply lent to households who would have been living in perfectly acceptable housing even if they had not received loans. It is for this reason that the procedure deals both with the mobilisation of funds and their deployment.

If the steps described below are applied successfully, the products will include a concrete strategy for increasing the financial resources in the housing sector. It might call, for example, for integrating housing finance with broader financial markets by paying market rates for deposits and charging corresponding market rates for mortgages. Alternatively, it might address the same objective by recommending the sale of market rate debentures by housing
finance institutions to major institutional investors.

The balance of this article outlines six analytic steps in formulating a housing finance strategy, which are summarised in Figure 1. These steps were developed in the course of designing housing finance strategies for Sri Lanka and Honduras (Rourke et al, Stuyt et al, 1985). In practice, these steps may not be as distinctly separate as they seem in the discussion and they may not be executed in this particular sequence.

Nevertheless, the content of each must be accomplished somewhere in the overall process. Also, beyond these analytical steps it is necessary to engage in coalition building and other actions to gain acceptance for the strategy among a country's key public and private sector decision makers.

Step 1. Assessing Financial Markets

IN THE past there has been a strong tendency to consider housing finance in isolation from the balance of a country's financial markets. As described below, this has often resulted in an extremely narrow set of possibilities for increasing the volume of finance in the housing sector. A central thesis of the Housing Finance Strategy Method is that the housing finance system must be shaped in the context of broader financial markets. Hence the first step in the method is a careful look at a country's financial markets.

Three related aspects of financial markets need to be considered to form a reasonably complete picture of the financial market environment for housing: (a) the depth of financial markets; (b) the degree to which saving is being done in financial form; and (c) the degree of government interference in these markets.

The first point concerns the maturity and depth of the financial market. A number of indicators of these characteristics are available. One set are ratios of various monetary indicators to GNP. These include, for example, the ratio of money, broadly defined, to GNP, the ratio of commercial bank assets to GNP, and the ratio of deposit institution assets to GNP. There is a general relationship between higher levels of per capita GNP and higher values of these ratios. These ratios offer a quick way to place a country in a broad perspective relative to other countries (see Stuyt-Turner, 1987.)

Other general indicators of depth and maturity of financial markets are readily available. Does the country have an active equity market? Is there a stock exchange, and, if so, what is the number of firms listed and the volume of turnover? Are debentures being publicly sold or even privately placed in any significant volume? Another good indicator is the presence or absence of any secondary market operations. Typically a market in government securities will be the first to develop; has this occurred yet?

A further way to approach this question is to inquire about the vitality of the informal market. To what degree do commercial enterprises obtain operating capital from commercial banks or from informal circuits operating in isolation from broader markets or more fully integrated,

— extent of government control on funding sources and lending patterns.

3. Determine the possibilities for generating additional resources.

— formal finance: tapping institutional investors, possibly via secondary markets; expanding deposit base of depository institutions,

— informal: bringing informal lenders and other entities into the broader system,

— government: generally a very efficient borrower whose powers may have to be employed to generate long term capital.

4. Develop several "packages" of possible combinations for increasing the volume of finance in the sector.

— define strategies emphasizing different sources,

— consider both short and longer-term possibilities,

— link mobilisation of resources to their deployment.

5. Analyse the impacts of implementing each package on: a. for alternative spending plans estimate the number of additional households in different income groups living in minimally acceptable housing using Housing Quality Model; efficiency measures,

b. the balance of the economy, especially the anticipated size of multiplier effects and effects on financial markets.

6. For recommended course of action, detail the institutional changes needed immediately and sketch those needed over the longer term to execute the package selected.
sources? The ratio of commercial banks’ loans to total investment is a rough indicator. Are large enterprises obtaining financing for expansion from regulated sources or from private equity placements or informal borrowing?

The second consideration for judging financial markets concerns the possibilities for savings in financial form. The key distinction is between total savings, which might be in any form including gold, jewels, or durables, and savings in financial form, which means in cash or financial instruments including savings accounts. The less savings in financial form, the greater the possibility for transforming household savings in real form into financial form to finance additional investment in the housing sector.

In some countries, like India and Sri Lanka, there has been an extraordinary expansion in the number of branch banks as part of a government policy to move savings into financial form so that these funds can flow to productive investments. In other countries, such as Honduras, comparatively little branch banking has occurred and the opportunities for financial savings are limited for many households. Beyond simply providing more branches, the quality of services is important — especially the possibility of obtaining loans as well as making deposits (Vogel and Burkett, 1986).

In addition, the real rate of return (i.e., roughly the nominal rate less the rate of inflation [Khatkathe, 1986]) paid by formal institutions on savings is a critical determinant of the attractiveness to households of this form of savings. In many countries this rate has been consistently negative for a number of years because of repressive government interest rate policies, thereby sharply discouraging savings in this form.

A final point to consider in assessing the possibilities for expanded financial savings is the amount of “forced savings” already occurring through payroll taxes for social insurance schemes.

Lastly, and possibly most importantly, is the extent of government’s intervention in capital markets. There are numerous ways in which governments intrude in these markets, quite beyond their legitimate regulatory and macroeconomic functions. In general, the greater these intrusions the greater the loss in the efficiency with which investable funds are collected and allocated throughout the economy.

Governments in many developing countries run large budget deficits and, to keep the cost of servicing their outstanding debt to a minimum, they force major financial institutions to purchase government debt, generally at below market interest rates. Such “captive institutions” often include government savings institutions (such as postal savings systems), government pension funds and insurance companies.

In terms of interest rate policies, governments often set interest rates by fiat, and do not adjust them with changing market conditions. As suggested above, this can lead to negative interest rates on deposits and thereby discourage financial savings. Similarly, governments sometimes set maximum lending rates, even differentiating the rates that can be charged to different sectors.

The interest rate structure set by Government in India, which features this kind of fine-tuning, is possibly the most elaborate in the world (Morris, 1985). There are generally two clear consequences of such policies, one intended and one unintended. The intended effect is to allocate funds to sectors with higher lending rate ceilings; the unintended effect is for the unfavoured sectors to resort to borrowing from unregulated sources. Governments also use a whole series of credit allocation schemes in addition to interest rate policies. A prominent example is the lending of government development banks which make long term loans to favoured industries at subsidised rates — often causing the rates on long term loans to be less than the short term rates of commercial banks. Parastatals typically rank high among borrowers. In addition, some governments resort to direct credit allocations, ordering commercial banks to devote some share of their lending to favoured sectors. More commonly however, the central bank will offer to rediscount loans to some sectors or bank reserve requirements will be increased and the extra funds lent to favoured sectors. Often these practices lead to higher lending rates to unfavoured industries (Hanson & Rocha, 1986).

**Step 2: Housing finance in relation to financial markets**

ARMED with the results of the first step, one can address this step quite efficiently. The main question is the degree to which housing finance is integrated into broader financial markets. In many countries, housing finance has been supported by Government through a “special circuit” — an arrangement under which funds from particular sources are earmarked for housing, and thus for which the housing sector does not have to compete. One example is an earmarked payroll tax, which is used in the Philippines and many other countries. In Sri Lanka, the current system is even easier: government simply lends funds to the government parastatal institution.

Almost always the funds made available for mortgage lending under these arrangements carry below market interest rates, and they are on-lent at rates which are also below market (frequently to higher income families). Thus the special circuit isolates housing finance from the rest of the financial markets, since depositors want higher returns and other lenders will not compete to lend at the below market rates of the parastatal. So the major impediment to expanded housing finance is often the very arrangements which were set up previously to establish some
minimum lending in the sector.

Knowing the current sources of funds mobilised by housing finance institutions, aside from those locked into special circuits, helps define the possibilities for raising additional funds and for assessing the extent of interest rate and term risk these lenders face. Are they primarily depositary institutions or are they more like mortgage bankers, borrowing from other institutions? Generally, they are depositary institutions, as is the case, for example, in Honduras and Kenya.

The quality of the specialised housing institutions themselves is also an important factor for system expansion. The weaker their balance sheets—for example, the greater their problems with mortgage payment collections and the greater their interest rate and (related) maturity risks—the more difficult it will be for them to sell mortgage-backed debentures to investors. Hence, a clear first step in any system expansion will be to strengthen the key housing finance institutions if they need it, or even replace them if this is warranted.

A related factor is the degree of innovation shown by the existing institutions lending for housing. Have they explored the use of alternative mortgage instruments? Have they been aggressive in looking for new sources of funds? Have they tried innovative underwriting procedures to reach lower income households? Often, officials in institutions drawing funds from special circuits have little incentive to be innovative, but institutions with other incentives sometimes show great entrepreneurship: a prime example is the senior staff at the Housing Development Finance Corporation in India (Buckley, Khadduri, and Struyk, 1985).

Finally, as in the case of financial markets overall, one must know the extent of government interference. Are mortgage interest rates set by government? If so, are they adjusted with adequate frequency? Are there restrictions on the types of liabilities (e.g., deposits) for which specialised housing institutions can compete? Are there restrictions on the type of lending they can do?

Combing all of the above information should provide a good starting point for identifying impediments to the expansion of housing finance and for exploring possible innovations.

Step 3: Possibilities for generating additional resources

It is essential to begin the search for additional funds for the housing sector by examining the full range of options. Such an examination will include discussions with decision makers at a range of private institutions—banks, insurance companies, pension funds—as well as officials at similar public sector agencies and the central bank and ministries of finance and housing.

Such discussions would determine current investment patterns and constraints and explore possibilities for shifts in these practices. As always, the more concrete the description of possible new modalities offered, the clearer the response is likely to be. The results of such meetings and analysis of current investment patterns, beyond ideas for specific alternatives, should be some central themes for reform.

Typically, the most obvious candidates for expansion will be the formal sector specialist housing finance institutions. As suggested, there are two broad—not necessarily mutually exclusive—routes that can be chosen for expansion. One model is the deposit-based model, in which the source of funds is primarily deposits from households. There are a number of cases in which this model has worked very well. An outstanding example is the Jordan Housing Bank, the country’s largest depository institution (Gardner, 1986) and the almost exclusive source of housing finance.

A tool often advocated as giving housing finance institutions a comparative advantage is the contract savings scheme, under which a depositor is assured of a mortgage loan up to a predetermined multiple of its savings, if it successfully completes a savings contract (Chretien, 1986). Other possibilities are arrangements with large firms, unions and cooperatives for access to housing loans (for improvements as well as purchase) tied to savings.

Opportunities also exist for serving what have been neglected parts of the savings markets, such as low income urban areas and rural areas. One startlingly successful example of a co-operative bank is the Grameen Bank in Bangladesh which has gathered funds from low income families and lent them out on the basis of group repayment responsibility; it may soon begin originating and servicing housing loans for other banks (Madeley, 1987).

As suggested earlier, the wisdom of pursuing deposits will depend on the degree of competition for deposits already present in the country. Expansion of deposits was, for example, the central thrust of the strategy developed for Honduras.

The alternative route is for housing finance institutions to tap large institutional investors either by obtaining term loans or by selling them mortgages or mortgage-backed debentures. This might be called the “mortgage banker” model. The most lucrative targets for such investments are often pension funds (both public and private) and insurance companies. These investors prefer long-term investments which both match their liabilities and minimise the active management of the investment portfolio. If mortgage or long term debentures can be sold, it is particularly advantageous to the housing institutions since it reduces their exposure to term and interest rate risk.

Generally, investors will prefer to hold mortgage-backed securities rather than purchase whole mortgages, since the latter require much less administrative effort than the former. In particular, investment in
whole mortgages is complicated by loan prepayment which generally cannot be well anticipated. When prepayment occurs, investment officers must deal with the reinvestment of these funds. This contrasts with some mortgage-backed instruments which generally provide a scheduled flow of income.

Normally, the sale of mortgage-backed securities to other investors begins with individual placements. This may eventually mature into a genuine secondary market for mortgages. Some countries have tried to move more aggressively toward establishing a secondary market — the Philippines being a notable example. But these initiatives have not always gone well. The housing finance strategy developed for Sri Lanka recommended placements of debentures with a few very large institutions as the first phase in raising additional funds for housing (Boleet, 1987).

In terms of tapping informal financial sources, the most obvious strategy is to create housing opportunities which cause households to access assistance from their extended family, friends, and unregulated lenders and to invest more of their own savings in housing. It is commonplace in developing countries that there is a scarcity of units built to minimum standards and affordable to lower-income households. Expansion of the supply of such units will induce households which still may not have access to formal finance to tap their traditional financing sources.

An approach that might be preferred to permitting some lower income households to obtain high loan-to-value ratio loans at reasonable interest rates from formal institutions, while most obtain no loan from these sources, might be to keep loan-to-value ratios in the range of 0.6 to 0.7 to encourage all borrowers to use informal sources to some extent or to rely heavily on savings. (A potential problem with this strategy is that some borrowers will obtain high cost, supplemental loans from moneylenders. Given the higher interest rates on these loans, the borrowers will be sure to make payments on these first. If the borrower has any problems making payments on both loans, the formal sector loan will be the first to go into delinquency.)

Another avenue for tapping informal sources is for formal institutions to use informal sector actors as their agents. Small scale lenders could be contracted with to be deposit points and loan servicers. More expansively, community groups can provide loan security for individual members through the collateral of deposits by the group held at the formal institution; the loans can be originated and serviced by representatives of the community. Use of community groups was recommended in the Honduras finance strategy. Examples of other arrangements have also been catalogued (UNCHS, 1984, 1984a).

A final important source of additional financing for housing is government. As discussed earlier, government is very important in establishing the “ground rules” for the competition for funds and the allocation of credit. Governments can and should also serve a role in promoting innovation in housing finance, generally by reducing the risk associated with certain innovations. Clear examples are for government to provide guarantees for the first sales of mortgage-backed securities by a secondary mortgage institution or to establish a self-financing mortgage default insurance agency.

Our particular interest here is in government as an actual generator of additional housing finance. Explicit subsidies for housing are often thought of as the primary form of financing provided by government. While these can be important, payroll taxes and “off budget” loans (frequently at below market interest rates) by the central bank to financial institutions can easily be of greater magnitude.

In thinking about a proper role for government in mobilising funds, it is useful to begin with the idea that it can be a very efficient generator of long term funds. In countries with relatively primitive financial markets, only government may be able to mobilise long term funds, in the sense that only it can bear the interest rate risk over a long period.

In addition, of course, the government’s guarantee of interest payments and the large scale of its borrowing operations lowers the price of borrowed funds compared to the prices paid by other borrowers. One must use considerable judgment as to when to exploit the advantages of government in the capital market. Since reliance on government is easy compared to other solutions, there is a natural tendency to move in this direction.

Our view is that much reliance on government should be avoided, since it will slow down the development of efficient private financial markets. Certainly, there are countries where this dictum cannot be followed. If borrowing or other forms of financing by government is necessary, then the emphasis should be on on-lending these funds to housing institutions at market rates. This practice will encourage the creation of private alternative sources and dodge problems of misallocation of resources.

A concluding note to this section concerns the role of donor provided financing for housing. External financing has the advantage of reducing pressure on financial markets to provide the funding for various competing purposes. And it often permits a rapid expansion of housing lending, probably more rapid than could otherwise be achieved. However, large infusions of external funds to individual institutions can have the effect of reducing their efforts to generate funds domestically.

This problem can be accentuated if donors permit their funds to be onlent at below market interest rates, which will discourage other lenders from making loans in the sector. In
general donors must exercise extreme care in setting the terms for their loans, including the rate at which funds are released to the institutions — slower rates of dispersal will maintain pressure on the institution to seek funds from other sources.

**Step 4: Develop alternative packages**

IN THIS step the analyst puts together various possibilities for expanding the amount of financing in the housing sector identified in Step 3 into internally consistent and reinforcing packages. One wants to be certain, for example, that the housing finance needs of various groups are addressed in each package and that each initiative supports others which are included.

For each element in the package several parameters must be defined:

— the amount of funds that might be generated,
— the terms on which the funds could be obtained,
— regulatory or legislative changes needed to permit raising the funds in this way,
— terms on which funds would be on-lent,
— the target group for the funds, both location (urban/rural) and income group.

Alternative packages can be defined in different ways. One way is to vary the elements included in the package: so, for example, selling debentures in one package might be exchanged for a greater emphasis on expanding deposits in another. Another way to vary the packages is to alter the amount of funds that might be generated from different sources, the terms on which they are obtained, and the targeting of the lending.

In general, some packages should be defined at the outset that contain a good deal of innovation and fairly sharp changes, so as to provoke a proper airing of a wide range of options.

It is at this stage in the process that the explicit link between the sources of funds and their uses is made. Many of these linkages are quite natural. For example, a simple expansion in the deposits taken by a group of housing finance institutions would presumably result in a continuation of current lending patterns. Likewise, additional government lending would be tied to its own assistance programmes.

But there is also room for change and innovation. Deposits might be expanded through establishing contract savings schemes through unions or large employers; this would probably result in a shift of lending to somewhat lower income families than is standard practice. Alternatively, in exchange for being able to sell market rate debentures to the government pension fund, lenders could be required to on-lend the funds to home purchasers with incomes at or below the 70th percentile of the income distribution.

Lastly, lending to small investors in rental housing should be considered. In some countries, like Kenya, most housing is produced by this group and being able to obtain medium term financing could sharply increase supply.

The objective in this step is to establish a range of feasible options which can be further explored along several lines. One line is acceptability to the principal actors in the sector. Such exploration takes place through a series of bilateral meetings or through a meeting of an advisory panel set up as part of the strategy development process. Another line to be followed is an estimate of the impact of pursuing the policies contained in that set of a few packages that looks most promising.

**Step 5: Analysing impacts**

TWO distinct types of impact resulting from implementation of the policy reform packages formulated in Step 4 are of interest: impact on the quality of housing occupied by different income groups, and impact on the balance of the economy.

As indicated earlier, a primary objective of increasing the volume of housing finance available is to improve the quality of housing occupied by lower income families. Thus, a primary analytic question concerns the number of lower income households which are likely to occupy minimally adequate housing beyond the number occupying such housing in the absence of the policy reforms. Moreover, one should also answer questions of the efficiency with which various policy packages are able to accomplish such improvements: what is the cost per additional low income household occupying minimally adequate housing? What is the subsidy cost per additional household? Subsidies should include both explicit government expenditures as well as tax expenditures, in-kind grants of land, etc.

Answering these questions is both exceedingly complex and important. To address them the Urban Institute developed the Housing Quality Simulation Model, which is described elsewhere (Struyk & Turner, 1987a; Turner, 1987). Suffice it to say that this model was explicitly designed to address exactly these issues and is flexible enough to deal with almost any conceivable government housing programme or private lending operation for housing.

Note also that the Housing Quality Model can be used to analyse policy initiatives quite separate from those involving housing finance reforms.

There are several impacts on the balance of the economy of increasing the financing available for housing which will be of interest, especially to those at the central bank and ministries of planning and finance:

**Balance of payment effects.** How would a surge in housing investment affect the country's balance of payments? This question is best addressed through a careful analysis of the direct and indirect (ie, inputs for production of building materials) import content of
housing for low income families. If detailed analyses are not available, general discussions and experience from other countries would have to be relied upon (see Katsura [1984] for a good review of the record in import content). Employment and investment multipliers. In the short run an increase in housing investment can be expected to have economy-wide impacts of about double the amount invested, with considerable variation among countries and the type of housing produced. More precise estimates might be obtained for a country if an input-output analysis has been done or if the housing sector has been included in economy-wide econometric models — both more the exception than the rule.

The longer term effects of housing — which stem from housing as an input into the production of a healthier and more productive labour force (through improved sanitation and health conditions) and a better educated population (through reduced absenteeism at school) — have been much more difficult to measure and are probably best left as qualitative statements (Katsura, 1984).

Efficiency of financial markets. Clearly, changes of the type outlined above which result in genuine innovation or reform of financial markets can significantly improve the efficiency with which these markets operate. A good sign that this will be the case is whenever the prices for capital — paid to savers or by borrowers — are moved closer to market rates or when additional credit is being allocated by competition rather than government directives.

While measuring the gain in market efficiency directly is difficult, one should be able readily to compute the reduction in subsidies in the system from raising interest rates from their below market levels.

Financial savings. In many countries increasing the share of savings held in financial form is an important policy objective, since savings in this form can be allocated to productive investments whereas savings in real form, like gold, are generally hoarded. Hence, it is possible for a country to increase its investable resources without affecting its total savings rate. To the extent that actions called for in the reform packages increases financial savings, this will be a major plus to officials concerned with overall economic growth.

The econometric evidence on the sensitivity of financial savings in developing countries to interest rates paid and the transactions costs associated with this form of savings is far from definitive. The final action in this step is the selection of the preferred policy package. This recommendation is based on a weighing of the impacts on the degree of improvement in the quality of housing occupied by lower income households and the broader effects on the economy. Where there is a conflict between these impacts, the choice will be determined in part by the extent to which support for the reforms will be needed outside of the housing community.

Step 6: Detailing the initial changes

HAVING selected the recommended course of action — and discussed its acceptability with key public and private sector participants — now is the time to detail the concrete action for implementing the recommended package of reforms. Most attention should be devoted to action required in the short term, but other changes needed over a period of several years should be sketched so that the full range of developments is clear. Note that these are all actions following a decision to go forward with the reforms; they are not a "game plan" for obtaining those decisions.

Many of the required actions will fall within the purview of various government agencies. For example, in Sri Lanka the Ministry of Finance would have to signal the National Savings Bank that buying housing-backed debentures would be acceptable, instead of the NSB using all of its deposits to purchase government debt.

Similarly, central banks would have to take action to permit the interest rates on deposits and mortgages of housing finance institutions to move to market levels and move with the market thereafter. Central banks also control the types of deposit accounts institutions can offer and the types of loans finance institutions can make. In Honduras, action by the central bank to realign the powers of commercial banks and S&Ls was a critical element in the programme of change. On the other hand, it will be the ministry of housing that typically would have to implement policies to increase interest rates charged to beneficiaries.

Some changes requiring legislation might also be necessary. One example of this type in Sri Lanka was a change in the law governing the type of investments that could be made with funds from the civil servants' pension fund — a major potential customer for housing debentures.

Beyond the kind of actions just outlined, the analysts should also indicate the type of technical assistance and other actions by the donor community that will be instrumental in achieving the reforms. Technical assistance is one avenue. In Kenya a key element in achieving the goal of attracting more capital to the housing sector is the creation of a limited secondary mortgage market; substantial outside expert assistance is needed to formulate a concrete plan that will be acceptable to housing finance institutions and potential purchasers.

Another avenue is seed money to support particular innovation. In Honduras the analysis team recommended that AID fund the initial reserves of a privately operated mort-
gage insurance fund, which would enhance the saleability of mortgage-backed securities to a broad range of investors.

In short, the final part of the housing strategy developed by the analysts should be an outline of a concrete plan of initial essential actions to implement the recommendations. It should be a kind of blueprint for what to do when consensus is achieved.

Conclusion

Two significant changes are combining to increase the value of systematic analysis of housing finance in developing countries. First, "sector lending" is being favoured by the major players in the donor community, such as the World Bank and USAID’s Housing Guaranty Program. Very large loans have recently been made to housing finance institutions in India and Indonesia, for example to promote increased housing construction by private developers.

Loans of this type would not be possible, however, without the second change: the shift in host government policies toward supporting housing production by the private sector. In this new environment, analysis linking housing finance with broader financial markets and focusing on alternative ways to lend to lower income households of the type outlined above is a necessity.

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