World Development Report 1989

This article summarises the World Development Report 1989, concentrating on those issues of most relevance to housing finance.

Why does finance matter?
Chapter 2 introduces the main body of the report and examines the role of finance in development. It argues that finance matters in more ways than might be immediately apparent. Efficient financial systems help to allocate resources to their best uses and are indispensable in complex modern economies. In many developing countries the financial sector is in urgent need of reform.

The role of savings is particularly important. On average the more rapidly growing developing countries have had higher savings rates than the slower growing countries. Many factors influence the saving rate including the rate of income growth, the age composition of the population, attitudes to thrift, and the services provided by the government. Interest rates have an uncertain effect on the amount people save, but they do affect the form in which people save. High interest rates favour financial over non-financial forms of saving.

Financial sector issues in developing countries
Developing country governments have played a large role in credit allocation. For example, in Pakistan in 1986, 70% of new lending by the national banks was targeted by government. In Yugoslavia in 1986, 58% of short-term loans were directed credits. Many such regimes have been very complicated. At one point Korea had 221 formal directed credit programmes. These programmes usually have targeted industry, state-owned enterprises, agriculture, small and medium scale firms, and to a lesser extent housing and exports. In under-developed countries, interventions have largely comprised lending requirements imposed on banks, refinance schemes, loans at preferential interest rates, and loans by development finance institutions.

Individual sectors have benefited from directed credit, but the overall effect on growth is hard to gauge. Credit programmes can be useful when used to tackle inadequacies of the market. However, even well designed controls tend to lose effectiveness if maintained too long.

'Reform needed urgently'
Directed credit programmes have often been used not to correct the inadequacies of the financial markets but to channel funds to priority sectors, regardless of whether these were the more productive investments.

The interest rates charged on directed credits have deviated substantially from market rates. Subsidised credit often failed to reach its intended beneficiaries.

It is clear that directed credit programmes have damaged financial systems. Many directed credits have become non-performing loans. In a sample of 18 industrial development finance institutions, on average nearly 50% of their loans by value were in arrears and accumulated unpaid interest. Restructuring the financial system is providing a unique opportunity to consider the sorts of institutions which will be best suited to the economic environment of the 1990s. Greater emphasis than in the past should be placed on ensuring the availability of a broader array of financial services. It is specifically suggested that contractual saving systems should be developed.

Institutions insolvent
In 1981 the Chilean Government liquidated three commercial banks, four finance companies and a development bank, which together accounted for more than a third of all loans made by financial institutions. Fourteen months later the authorities placed eight institutions which accounted for nearly half of all loans under central bank management and extended financial support to all but one of the remaining commercial banks. In the USA more than a thousand saving and loan associations were closed or merged between 1980 and 1988. By early 1989 600 savings and loans were still thought to be insolvent and the loss to the insurance fund was expected to be at least $120 billion.

Explanations of firms’ financial difficulties can be grouped under three headings — macroeconomic conditions, industrial and financial policy, and debtor and creditor behaviour. The importance of macroeconomic factors is clearest in the countries with large external debt burdens. Mismanagement and speculative behaviour persist because prudential regulation and supervision are inadequate in many countries. Four types of mismanagement commonly occur in the absence of effective regulation and supervision:

(a) Technical mismanagement. Poor lending policies are the most common form of technical mismanagement and are usually a consequence of deficient internal controls, inadequate credit analysis or political pressures. Poor lending policies often lead to excessive risk concentration. Mismatching assets and liabilities in terms of currencies, interest rates or maturities is another form of technical mismanagement.

(b) Cosmetic mismanagement. Strong supervision with a good board of directors should ensure that losses are reported and corrective measures taken. Without these bankers may try to hide the past and current losses, for example, by keeping dividends up in spite of poorer earnings or resorting to accounting measures that increase net profits on paper, even if more tax can be paid as a result.

(c) Desperate management. When losses are too large to be concealed bankers may adopt more desperate strategies including lending to risky projects at higher loan rates and speculating in stock and real estate markets.

(d) Fraud. This sometimes causes the initial losses, but once illiquidity appears inevitable fraud becomes common. Bankers are tempted to grant themselves loans which they are unlikely to repay.

The case of the United States savings and loan associations is given as an example of moral hazard and is shown in the box on the following page.

**Foundations of financial systems**

If financial systems are to be efficient and robust they must be set within a suitable legal and regulatory framework. Lenders must have appropriate assurances of repayment. Lenders have traditionally made extensive use of collateral (mortgages, floating charges, liens and so forth) and personal guarantees to reduce the probability and cost of default. Consequently, annual loan losses of commercial banks in industrial countries have typically been less than 1% of outstanding balances and in turn this helps to keep total intermediation costs at less than 4%. Non-performing loans in many developing countries are now 20% of total loans. Profitable lending becomes
The US savings and loan crisis: the lessons of moral hazard

MORE than 500 of the 3,000 savings and loan associations in the United States were insolvent at the beginning of 1989. The cost to the Federal Savings and Loan Insurance Corporation (FSLIC) of restructur- ing the S&L industry through liquidations, consolidations and assisted mergers, was, as of early 1988, estimated to be roughly $80 billion in terms of present value. Because its own assets were insufficient to meet the potential obligations, FSLIC had been unable to close or otherwise dispose of many insolvent institutions, and so loss-sharing S&Ls were allowed to remain in operation. In early 1989 the US government announced its intention to cover the FSLIC shortfall through a combination of government funding and higher deposit insurance premiums to be paid by S&Ls.

The difficulties of the S&L industry began in the late 1970s. S&Ls had traditionally lent funds on 20- to 30-year mortgages at fixed rates and funded themselves with short-term deposits. Higher inflation rates in the late 1970s and early 1980s and the correspondingly higher interest rates that S&Ls had to pay on deposits sharply depressed earnings.

The response of the US Congress and several state legislatures was to authorise S&Ls to take on a wider range of lending and borrowing. Ceilings on deposit rates were phased out, and the maximum size of an insured deposit went up from $40,000 to $100,000. Unfortunately, lawmakers paid less attention to strengthening the system of prudential regulation and supervision. Increased lending and borrowing powers gave S&Ls new opportunities for loss as well as profit. They were required to risk little of their own capital; any losses beyond those amounts would be absorbed by FSLIC. This gave them strong incentives to take greater risks, since they would enjoy all the gains but suffer only some of the losses. In addition, deposit insurance premiums were levied at a flat rate per dollar of deposit; so the premium structure did not discourage risk taking. Insurance experts and economists use the term "moral hazard" to describe this situation of distorted incentives.

Although only a minority of S&Ls fell prey to moral hazard, they did so with gusto. Their losses were compounded by changes in the tax law that made real estate (in which many of these S&Ls had invested) a less attractive investment; by a severe economic downturn in oil-producing areas, particularly Texas; by delays in the imposition of remedial prudential regulations; by delays in the closure of insolvent S&Ls; and by an accounting system that used historical cost-based values rather than current market values to determine income and solvency.

Valuable (albeit costly) lessons have been learned from this experience. Appropriate prudential regulation must accompany the economic deregulation of deposit-taking institutions that are explicitly or implicitly insured by the government. Adequate capital levels, preferably related to risks undertaken, are vital. Risk-related insurance premiums can help. Strong supervisory and examination powers, enforced by well-trained and well-paid personnel, are important. Market value accounting systems are indispensable. Finally, if an institution falters towards insolvency, early regulatory intervention is necessary to prevent small problems from exploding into costly horrors.

The development of legal rules governing the economic rights and obligations of different agents should go hand-in-hand with economic and financial development. Most developing countries have legal systems which were imposed during colonial rule which were often at odds with local custom. This has happened in India and Indonesia. By contrast Korea and Thailand have imported and adapted foreign legal systems on their own initiative. The legal recognition of property rights, that is, rights of exclusive use and control over particular resources, gives owners an incentive to use resources efficiently. For example, without the right to exclude others from their land, farmers have no incentive to plough, sow, weed, and harvest. China's recent economic reforms consisted mainly of restoring land tenure to households.

The assignment and transferability of property rights promotes economic efficiency by directly creating new incentives, but it also assists by making financial intermediation possible by allowing borrowers to offer security in the form of mortgages over real estate or other collateral. Immobile assets such as real estate have very desirable properties as they cannot easily be misappropriated and can be quickly sold for an amount close to the purchase price.

When taking collateral the lender is mainly interested in the efficient transfer of property rights because the security is invoked only in the case of default and may deteriorate or disappear if too much time elapses before he can take possession. In most countries real estate accounts for between half and three-quarters of national wealth and if ownership is widely dispersed, tenure is secure and title transfer is easy, real estate can be a good collateral for any type of lending. The
accompanying box shows the position in Thailand.

However, in developing countries the land distribution is often skewed, tenure (if any) insecure and title transfer cumbersome. A key to smoothly functioning systems of land tenure is land registers supported by cadastral surveys. In many countries these are inadequate or missing altogether.

Often real estate is used as collateral for commercial ventures. However, if an entrepreneur has no suitable collateral the risks to the lender increase dramatically.

Legal systems in developing countries often favour the borrower by making it hard for the lender to foreclose on collateral. Originally, the intention was to protect small borrowers against unscrupulous money lenders, but today such laws may adversely affect the ability of state-owned commercial banks to collect on loans. This raises the cost of intermediation and weakens bank portfolios. In many countries in Southern Asia creditors have to sue the defaulting debtor for payment which can take several years. Cumbersonsome recovery procedure has led to new lending arrangements but redresses the balance to favour the creditor, for example, hire purchase and leasing.

Prudential supervision by government authorities is needed for banks and other financial institutions and markets. In many countries bank supervisors concentrate on compliance with monetary policy regulations, foreign exchange controls, and economic policy regulations, rather than prudential aspects of financial monitoring. The goal of bank supervision should be to promote safe, stable and efficient financial system.

Among the points that need examination are:

(a) Organisation. Off-site supervision cannot assess risk adequately. Off-site supervisors should analyse reports periodically submitted by banks and on-site inspectors should verify their accuracy.

(b) Licensing. The purpose of licensing should be to ensure adequate capitalisation and sound management, not to limit entry or restrict competition.

(c) Capital adequacy. Banks need capital to absorb unusual losses. Standards of capital adequacy can take account of different degrees of risk. The recent agreement among major industrial countries on standards of capital adequacy uses risk weights and might serve as a model for others.

(d) Asset classification and provisioning. Banks should be required to make appropriate provisions for loan losses, to write off uncollectible assets and to suspend interest on non-performing loans.

(e) Liquidity. Liquidity ratio requirements are more often used for monetary policy purposes than as a prudential measure. Liquidity risk arises because banks borrow money at short maturities and lend it long-term.

(f) Portfolio concentration. Limits on lending as a percentage of a bank’s capital are necessary to prevent concentration of risk in a single borrower, a group of

Financial and economic effects of land tenure in Thailand

THAILAND has a relatively efficient system of land tenure, title transfer and use of collateral. In 1901 the government introduced the Torrens system in which land titles are based on cadastral land surveys and registered with central land record offices. The use of land as collateral increased significantly, but land registration was concentrated in the more heavily populated areas. In the early 1960s half of the land area of Thailand was designated as national forest reserve, including land that was already being farmed. Most farmers in the forest reserve have no transferable title to their land, but the government has enforced the forest reserve policy flexibly and has not evicted farmers. About one-fifth of the farmed land does not have secure and transferable title.

Although uncertainty about continued possession does not seem to worry untitled farmers, lack of titled ownership affects their access to institutional credit. Untitled farmers cannot provide collateral and are limited to borrowing on the basis of personal or group guarantees or from money lenders. (Money lenders charge interest rates of 40-50%, compared with about 15% for loans from financial institutions.) In a sample study of matched groups of titled and untitled farmers, titled farmers were able to borrow on average three times more per acre of land. Secure land title not only affected the ability to obtain mortgage credit (which accounted for half of all credit among titled farmers) but also doubled access to unsecured credit.

Thanks to easier access to credit, titled farmers made significantly more land improvements and used significantly more machinery and other inputs. As a result they enjoyed 12-20% higher farm revenues and 12-17% higher productivity than untitled farmers in similar regions. The government has recently taken steps to improve land tenure for untitled farmers.
related borrowers or a particular industry.

(g) Enforcement powers. In many countries supervisors can do little to address unsafe and unsound banking practices.

(h) Restructuring. If supervisors are to dispose of insolvent banks quickly they must have authority to close a bank, to replace its management and directors, to dissolve existing shareholders' interest, to sell or transfer bad assets, and to merge, restructure or liquidate as necessary.

(i) Audits. Minimum audit standards should be set and the form and content of the related financial disclosure should be prescribed.

(l) Policy priorities and political will. Prudential regulation must be backed by a political commitment to supervision and enforcement.

(k) Developing financial systems. There are pressures that are leading most developing countries to rethink the shape of their financial systems. These include the effort to apply some of the lessons learnt from past intervention and the need to adapt to the decline in foreign capital inflows. A third factor is rapid changes in financial technology and banking practice. The net flow of foreign capital to most developing countries is likely to be relatively small in the years immediately ahead. Developing countries will therefore have to rely primarily on domestic savings. Unless countries develop their financial systems, potential investors will have to rely primarily on retained earnings.

Demographic trends will affect the financial systems of developing countries. As the share of the population living in urban areas increases and as incomes rise, more people will live apart from the rest of their family. This combines with the fact that in urban areas people are required to buy or build a house, whereas in rural areas, typically, the owner builds his own house.

Some governments provide concessional finance for housing to preferred borrowers, often civil servants. But others discourage mortgage lending so as to free resources for investment in industry. As urbanisation increases it will be important for governments to recognise the scale of housing investment, to improve laws concerning using housing as collateral, and to integrate housing finance on a non-preferential basis with the remainder of the financial system (see the accompanying box).

As more people will wish to make provision for retirement there should be an opportunity to develop contractual savings institutions such as life assurance companies and pension funds.

Commercial banks hold between 50% and 90% of the assets of all financial intermediaries in most developing countries and will continue to be at the heart of their financial markets for the foreseeable future. Often markets are dominated by a few large banks as a result of restrictions on interest rates, product

Housing finance

THE formal financial sector in most developing countries finances only a small share of housing investment. Mortgage credit from the formal sector was 28% of all housing investment in a sample of eleven developing countries, compared with more than 60% in OECD countries. The difference partly reflects the shallowness of financial systems in developing countries. Years of financial repression not only have minimised the role of the formal sector in housing finance, but have raised housing prices because negative real interest rates favoured investments in real assets. In another sample of eleven developing countries the average ratio of house value to annual household income was 5.5, compared with 3.0 in five high-income countries.

Several other factors explain the lack of smoothly functioning markets for housing finance in developing countries. Countries have often given little priority to housing finance. Because housing is a large investment, it requires long-term finance and in many countries inflation, interest rate controls and the instability of financial markets have deterred long-term lending of any kind. Inadequate legal systems diminish the value of housing as collateral and hence also diminish lenders' willingness to provide mortgage finance. And policymakers have been concerned that increased finance for housing might drive the cost of housing even higher.

Shelter is a basic human need. Secure ownership of a house can raise the welfare of the household that lives in it. Moreover, when a house is purchased through a mortgage, the buyer becomes, in effect, a contractual saver: the buyer is paying the lender for the right to live in the house while saving for its purchase. And when the title to a house can be easily transferred, the household gains a relatively riskless form of collateral. Furthermore, a housing loan, which is fungible with other household resources, may provide the funds that would permit the household to undertake a productive investment.
innovation, branching and the entry of new institutions. Greater freedom for banks to respond to market signals, to choose their own customers, to set interest rates, and to determine the location of branches will stimulate greater competition. The creation of new banks and other institutions should be stimulated by prudential requirements.

In small economies it may not be possible to ensure a competitive market for every financial product. A few commercial banks, supplemented by a postal savings bank, may be all a small economy can support.

Poor management has contributed to banks' difficulties in many countries. Improvements must be made in the skills of management and the banks' internal systems.

**Issues in informal finance**

The non-corporate sector accounts for between 30% and 70% of the labour force in some developing countries. A formal financial arrangement is not often well suited for the needs of the non-corporate sector, partly because of the sums of money involved. Also, non-corporate borrowers rarely have the collateral acceptable to banks.

The popular view of informal finance is that of powerful money lenders who exploit the poor through usurious interest and unfair seizure of collateral. In fact, informal finance is both extensive and diverse. Informal financial arrangement reduce transaction costs and risks in ways denied to formal institutions. Money lenders, for example, can operate out of their own homes and the services they provide are outside the control of the monetary authorities. Freedom from regulation allows informal agents greater flexibility and they must rely on local knowledge.

Not much long-term finance is provided through informal arrangements and where it does exist it is generally for housing finance. One example is key money as in Korea. A home buyer can lease his house in exchange for payment; after an agreed period the house and the money are re-exchanged. The interest that could have been earned on the money is the rental value of the house. The recipient of the key money may use it to finance a business venture or the purchase of the house, thus circumventing the lack of conventional mortgage finance.

Informal financial arrangements are limited. They do not move funds

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**The Grameen Bank: an alternative approach to noncorporate finance in Bangladesh**

While the government struggled to create a viable rural banking system in Bangladesh, a small private initiative was started in 1976 to help the landless without normal bank collateral to obtain credit. This programme has become the Grameen (Rural) Bank. The unique operating procedures of the Grameen Bank grew out of several earlier attempts to reach the rural poor and were a sharp departure from traditional banking. The bank’s customers, who are restricted to the very poor, are organised into five-person groups, and each group member must establish a regular pattern of weekly saving before seeking a loan. The first two borrowers in a group must make several regular weekly payments on their loans before other group members can borrow. Most loans are to finance trading and the purchase of livestock.

By February 1987 the Grameen Bank was operating 300 branches covering 5,400 villages. Nearly 250,000 persons were participating, among them an increasing number of women, who accounted for about 75% of the total. The membership included about 13% of households with less than half an acre of land in the areas in which the bank was operating. Loans were small — on average, about 3,000 taka ($100) in 1985. By the end of 1986 about Tk1.5 billion had been disbursed, of which almost Tk1.2 billion had been recovered. Outstanding loans were thus about Tk300 million, with almost 70% held by women borrowers.

In sharp contrast to the Bangladesh commercial banking system, the Grameen Bank has experienced excellent loan recovery. As of February 1987 about 97% of loans had been recovered within one year after disbursement and almost 99% within two years. This good performance is reportedly attributable to a combination of factors: close supervision of field operations, dedicated service by bank staff, borrowing for purposes that generate regular income, solvability within groups, and repayment in weekly installments. Another factor which encourages repayment is the borrower's knowledge that the availability of future loans depends on the repayment of borrowed funds.

Bank staff meet weekly with groups to disburse loans, collect savings deposits and loan payments, and provide training in financial responsibility. This means high operating costs. The ratio of expenses to loans rose from 9% in 1984 to 18% in 1986. These high costs have been partially offset by low-cost funds from international agencies.
over large distances and they segment local from national markets. However, the limitations do not call for completely new institutions. Indeed, formal intermediaries have often failed where informal arrangements have prospered. Formal institutions and policy makers might learn about the markets by studying informal arrangements more closely. The essential facts are that transaction costs are undertaken by mutual consent, transaction costs are kept to a minimum, and lenders are able to reduce risk by using knowledge that they have already gathered from other social or business dealings.

Group lending schemes and co-operative finance try to overcome the limitations of informal finance for the non-corporate sector.

There are various ways in which finance for the non-corporate sector can be improved:

(a) Improving the legal environment. Legal reforms could make it easier for small enterprises with relatively large financial needs to use formal services; such reforms include better definition and enforcement of property rights. Squatters and small farmers with clear land titles would then have an acceptable form of collateral. Laws meant to protect borrowers have often made loan contracts harder to enforce and have therefore raised the risk of lending.

(b) Links between informal and formal finance. This is becoming increasingly common in Africa.

(c) Formal intermediation for the non-corporate sector. Formal institutions can be encouraged to serve the non-corporate sector by various means including low cost rediscount facilities for targeted lending through commercial banks, mandatory lending targets and state supported lending institutions. These policies have created weak institutions and have retarded the development of an efficient financial sector. However, government supported credit programmes for the non-corporate sector can work.

Towards more liberal and open financial systems

A number of countries have taken steps to liberalise their financial systems. Interest rates have been liberalised in Argentina, Indonesia, Korea, Malaysia, Nigeria, the Philippines, Sri Lanka, Turkey and Uruguay. In other countries, such as Thailand and Yugoslavia, interest rate ceilings have been managed more flexibly. Several countries, such as Korea and Chile, have privatised commercial banks. Directed credit programmes have been reduced in Argentina, Chile, Pakistan and Turkey, and interest rate subsidies have been reduced or abolished in Korea and the Philippines.

Success of informal finance

Commercial banks privatised

have been able to avoid the pitfalls of high real interest rates, fluctuations in the real exchange rate, and insolvency among firms and banks. A second lesson is that where prices are distorted owing to protection or price controls, financial liberalisation may not improve the allocation of resources. The third lesson is that direct intervention in finance must be replaced by an adequate if less rigorous system of laws and regulations. A fourth lesson is that the authorities must anticipate how reforms will change relative prices and how these changes will affect different groups. Many developing countries will be unable to liberalise as extensively as some of the high income countries.

Reforms should start by getting the fiscal deficit under control and establishing macroeconomic stability. Directed credit programmes can then be scaled down and the level and pattern of interest rates adjusted to bring them in line with inflation and other market forces. The foundations of finance, that is the accounting and legal systems, procedures for the enforcement of contracts, disclosure requirements, and the structure of prudential regulation and supervision should also be improved. In the next stage financial reforms should seek to promote the development of a greater variety of markets and institutions and to foster competition. The government can then move to the final stage, full liberalisation of interest rates, the elimination of the remaining credit programmes, the relaxation of capital controls, and the removal of restrictions on foreign institutions.

‘Liberalisation of interest rates’