The World Bank & Housing Finance: Its Role in Financial Reform

By Robert Buckley

IN the last five years the World Bank has over US$ 2 billion for housing finance projects. I hope to suggest that a review of the Bank's experience with these projects can offer some perspective and insights on when and how such projects might be effective contributors to broader economic policies and the financial deregulation process.

The Bank's experience is sufficiently complicated and varied that it is important to get the details of the experience clear before conjecturing a possible role for housing finance policies in financial liberalization. One maxim, however, remains valid : correctly-structured housing finance systems can be expected to make significant contributions to the ability to mobilize financial resources, target subsidies effectively, and develop the sector so that the social concerns generated by poor housing conditions can be obviated.

A. An Overview of the World Bank's Housing Finance Portfolio

The Role of Housing

Housing is a major economic sector in all developing countries. Housing investments typically amount to 3 to 8 percent of GNP and 15 to 25 percent of gross capital formation. Housing is usually the largest single form of household wealth and accounts for between one-quarter and one-half of the capital stock in developing countries. It is therefore clear that the manner in which resources are mobilized for housing, how well they are invested and how efficiently they are utilized have a major impact on the prospect for economic adjustment and resumed growth.

However, housing is not only an economic good, it is also a basic human need. The link between health and housing conditions, for example, is well established (although hard to quantify). Slums and squatter housing tend to be the most visible signs of poverty in developed and developing countries alike. Thus, housing plays a central role in the social policies of virtually all governments. The sector receives a significant share of government transfers that go far beyond those measured in traditional budget documents.

Housing is also the main user of urban land. This has placed housing in the center of government interventions aimed at managing urban growth and creating a "healthy" and "liveable" urban environment. A plethora of laws, codes, and regulations define the rights to build, use, sell and rent houses. This regulatory framework often determines how different actors on the housing market—builders, real estate agents, owner-occupiers, renters and landlords—respond to various social, fiscal and financial sector policies.

Finally, housing is a long-lived and costly asset which is heavily dependent on people's ability to borrow. During the last decade, higher and more volatile inflation and real interest rates and increasing integration of financial markets have increased the risks of making long-term loans. This has also reduced the ability of many financial systems to mobilize the resources needed to finance long-term investments such as housing. Thus, of all the social sectors, it is the capital-intensive housing sector that has been at the intersection of social policy and financial policy, often with adverse consequences for both sectors. The rapid expansion of Bank lending for housing finance is largely a reflection of a desire to create a greater interface between not only social and financial sector issues, but also with urban development and fiscal concerns.

For Bank policy, these characteristics of the housing sector represent both a strategic opportunity, as well as a cause for very basic concern. It is an opportunity because housing is one of the simplest—and safest—assets in the economy, and it is ubiquitously and increasingly demanded as economies expand. In this respect, market-rate housing finance can be a very basic part of the Bank's effort to encourage private savings and support a process of financial deepening in the economy since it will help improve the ability of financial systems to mobilize and allocate resources. If mortgage instruments are well designed, a functioning, competitive housing finance system can also reduce the need for government subsidies to all but, perhaps, the very lowest-income groups.

On the other hand, such assistance is also a cause for basic concern because as the Bank *Housing Sector Policy Paper* (1975) stated:

"It is clear from the record that...(housing finance) assistance is fraught with many dangers...the failure to evaluate housing finance institutions in the context of housing markets and the financial environment has led to heavy subsidies for housing for middle- and upper-income groups... outdated financial policies frequently result in implicit subsidies...(that) are particularly unfortunate in housing...The Bank Group's contribution to housing finance therefore, has to be carefully formulated and executed if it is to avoid such pitfalls." (page 48)

When these institutions provide transfers rather than access to market-rate credit, they do not contribute to the development process and in fact can undermine this process. Hence, a key aspect of the Bank's strategy in the sector is a well defined understanding of how the sector and the institutions and regulations that govern it interact with the economy.

Today, after 16 years of Bank experience and 99 shelter projects in 50 countries, it is fair to say that squatter upgrading and sites-and-services programs have been a considerable improvement over the public shelter programs that preceded them. Most importantly, they have provided unquestionable evidence that production of affordable and adequate housing for the poor is possible. However, their achievements notwithstanding, it is clear that neither approach by itself can provide a long-term answer to the problems of accommodating the growing numbers of urban dwellers. Much more fundamental change in policies, institutions, and incentives are necessary if urban conditions are not to deteriorate further.

Evolution of the Housing Finance Portfolio

In the seven years since the Bank's first housing finance project, 21 projects focusing on housing finance, or including major free standing components have been approved totaling over US$2.0 billion. The volume of Bank lending for housing finance in the six years from 1985 to 1988 already exceeds the total 16 year volume of sites-and-services lending since the first such project in 1972. In addition, as shown in Table 1, over the last three years, the number of projects and the amounts lent for housing finance have increased sharply, totaling almost US$1.5 billion - almost half of all urban lending of the Bank in FY89 and FY90. In both these years, large operations in Latin America dominated the volume of lending. However, FY89 and 90 also witnessed follow up projects in Morocco and Zimbabwe, as well as new projects in Ghana and Tunisia.

In terms of regional variation in projects, Latin America and Asia have the largest dollar share of housing finance lending, but measured in terms of number of projects, the Africa region has a similar level of activity as LAC and Asia. The EMENA region lags in both volume of housing finance lending and number of projects. (Based on the pipeline of projects it is likely that this situation will change over the next few years.) In terms of project size, the 13 loans made over the FY86-88 period were on average almost three times as large as the four loans made over FY83-85.

Table 1: HOUSING FINANCE LENDING WITHIN REGIONS

REGION	FY83	FY84	FY85	FY86	FY87	FY88	FY89	FY90	TOTAL
EMENA*	60	0	0	25	0	0	58	80.5	224
AFRICA	0	5	10	16	39	30	20	20	140
LAC**	0	0	80	150	0	320	500	350	1400
ASIA	0	0	0	275	160	330	0	16.2	791
TOTAL	60	50	90	466	199	680	578	467	2555
% of Urban Lending	11	1	23	30	15	34	40	47	31
Average Loan Size	60	5	45	116	66	112	145	117	102
No. of Operations	1	1	2	4	3	6	4	4	25

*EMENA refers to Europe & Middle East ; **LAC refers to Latin America and the Carribean.

Selection of Intermediaries

Sixteen of the 21 housing finance projects were channelled to financial intermediaries rather than to non-financial public sector housing authorities. In addition, in the cases in which projects relied on government housing programs—Korea, Thailand, Chile, and Mexico I - a central objective of the projects was a refocusing of the public housing sector authorities so that the financial sector could more actively participate in the mortgage market. While this refocusing of the public sector took a number of different forms, the central objectives have been to reduce the overall level of subsidies and to better target them on lower-income families. In Mexico, Chile, Morocco, Zimbabwe, and Indonesia prospective housing finance projects are carrying this disengagement of the public sector from lending a step further.

Most of the institutions that received housing finance loans have either been created in the past 11 years or considerably refocused. Cumulatively, these figures suggest that the borrowing institutions for shelter projects are now more likely to be financial intermediaries than public housing entities, and they are likely to be newly-created or recently restructured institutions.

Objectives of the Housing Finance Operations

Most of these loans have a number of policy objectives - and impacts - that go far beyond the benefits they would provide for the housing sector. Typically, Bank involvement is motivated by the impact on the economy that could be achieved through a better functioning housing finance and housing delivery system. Table 2 lists three broad motivating rationales given for the projects. They are the financial concerns associated with improved domestic resource mobilization and allocation, broader fiscal policy concerns (associated both with subsidy transparency and targeting, and with reducing what might be termed the regulatory taxes placed on the financial system), and housing sector concerns (associated with the institutions and regulatory environment that affect the efficiency of the housing market and the access of the poor to adequate housing). Obviously these concerns are by no means mutually exclusive. For example, the major objective of Mexico II was a reduction in the regulatory taxes placed on the commercial banking system. Similarly, a feature of the loans in Cote d'Ivoire and Lesotho was the privatization of housing production and mortgage credit supply, respectively. Nevertheless, this categorization scheme provides a basis both for evaluating the wide range of housing finance projects and for showing the relationship of the projects to various Bank strategies.

The early housing finance projects were primarily concerned with increasing the access to adequate housing for the poor while controlling or reducing and better targeting housing subsidies. As the macro-economic role of housing finance has become better understood, these projects are increasingly aimed at supporting financial sector reform. Quite appropriately, sectoral housing concerns, rather than the broad economy-wide effects, remain the prime rationale for these projects. However, as the next sections emphasize, an important determinant of the success of housing finance projects is the degree to which they are consistent with both the Bank strategy for financial development, and the Bank's approach to sub sidies.

Table 2: CHIEF RATIONALE FOR HOUSING FINANCE PROJECTS

Financial Sector Reforms		Broader Fiscal Policy Objectives		Housing Sector Concerns	
PORTUGAL	86	MALAWI	85	MOROCCO	83
COTE D'IVOIRE	87	CHILE	85	ZIMBABWE	84
SENEGAL	88	MEXICO I	86	NIGERIA	86
ECUADOR	88			INDONESIA	86
INDIA	88			KOREA	87
MEXICO II	88			THAILAND	87
				PHILLIPINES	88
				LESOTHO	88

B. An Assessment of the Effectiveness of Housing Finance Operations

A Framework for Evaluation

An assessment of housing finance interventions on the overall development strategy of the Bank will depend on several key factors. This section will focus on how well the lending operations of the Bank have responded to three different areas of policy concern in an attempt to answer the following questions:

- First, is there a clear strategy for the reform and development of the housing finance sector that is consistent with broader financial sector objectives?

- Second, is the strategy consistent with the objective of restoring fiscal balance and controlling and targeting subsidies along the principles?

- Finally, does the strategy promote a well functioning housing market and help low-income families get access to adequate housing?

In evaluating the financial sector implications of projects, emphasis is placed on the project's performance with respect to domestic resource mobilization efforts. The statistics presented are therefore similar to those presented in other Bank evaluations of financial intermediaries. Attention is given to the effects the projects have on borrowers' interest rate policies, on their efforts to mobilize domestic financial resources, and the response to loan arrears. In addition, the effect on the government's contingent liabilities is also examined. For fiscal policy concerns, attention is given to the level, transparency and targeting of subsidies and the government's contingent liabilities. Finally, for housing sector concerns, the focus is on institution building, the regulatory environment and the unit costs of the houses financed by the program. These concerns are less quantifiable than are the financial or fiscal policy measures, but no less important.

Financial Sector Objectives.

- Resource Mobilization. Sixteen of the 21 projects attempt to promote savings mobilization; more than 40 percent of the housing finance institutions that have received Bank loans have been able to mobilize most of their resources domestically (ten of 21). This result is in sharp contrast to the less than 10 percent of Bank-supported development finance institutions that do so. The latter result is also in contrast to the results of the sample of agricultural credit loans. The sample indicated that only three of the 24 agricultural projects surveyed (12 percent) attempted to promote savings mobilization. The inflation-adjusted interest rates paid for funds mobilized at the time of the Staff Appraisal Report were in most cases (75 percent) non-negative. These results are important for institutions that are financing assets that yield non-tradeable services. The long-term resource base of such lenders must be domestic financial assets, and these can be mobilized only by inducing savers to place their savings in these institutions. Whether these funds are mobilized directly, or by other intermediaries and then on-lent to the housing finance lender depends upon the type of financial infrastructure that exists. But, regardless of the type of system, positive interest rates are essential to provide long-term financial integrity to the intermediation process.

- Risk Exposure and Contingent Liabilities. Another perspective on how projects affect government presence and risk-taking in mobilizing financial resources is whether the project changes the government domestic risk-exposure implied by a particular type of financial intermediation. Such risks are of particular concern in longer-term lending, such as housing finance, because the risk to the government is, of course, affected if it is a depositor in the housing finance institution, or if it guarantees other depositors. Moreover, in practice, it also assumes contingent liabilities - or "moral obligations" to make up losses - if it sets lending interest rates or regulations which undermine the viability of the housing finance institution.

Fifteen of the twenty one housing finance projects reduce the borrowing government's contingent liability, and only two of the projects increase the government's exposure in this regard. In addition, in one of the projects which does increase the government's domestic contingent liabilities, other desirable objectives were achieved. This loan, in effect, replaced a financing mechanism that ultimately conferred large credit subsidies with a mechanism that provides much smaller liabilities whose cost may be realized. Eighty percent of the projects that do not improve the government's position were projects that were motivated primarily by housing sector concerns.

- Arrears. Before discussing the arrears rate experienced by Bank funded housing finance institutions, it is worth emphasizing that definitional and measurement issues in this area limit the strength of the conclusions that can be drawn. With this caveat in mind, a number of features nevertheless appear to be noteworthy:

  (i) The average percent of portfolio arrears reported for housing finance institutions identified for Bank projects is on the order of 12 percent. This figure is similar to the 16 percent rate realized by development finance institutions.

  (ii) Almost half of the projects appeared to have portfolios of commercial quality, i.e. arrears of less than 6 percent of the portfolio.

In addition, (i) the average expected spread for all projects was about 3.0 percent, and according to simple measures of expected inflation, the real interest rate charged for 13 of the 16 projects was on the order of 3.6 percent; (ii) the apparent commercial level borrowing rate on so many of the projects stands in sharp contrast to the results reported in Mayo and Gross (1987) for Bank-financed shelter projects in the 1970's.[1] Their analysis shows that the average on-lending rate for shelter projects was negative 3 percent for the 1972-81 period.

An obvious implication of moving to market-rate lending—as the housing finance projects appear to be doing—is concern for the target audience of beneficiaries. That is, as borrowing costs increase, the poor are no longer able to afford to participate in housing programs. This result, in turn, raises the issue of how subsidy targeting or fiscal policy concerns are addressed in housing finance projects.

Fiscal Policy Concerns

As noted in Table 2, fiscal policy concerns were the primary objective of four of the housing finance projects. These projects were concerned largely with the broader effects of housing subsidies on government expenditures and transfers. For example, the Malawi project was initiated by earlier structural adjustment discussions. Similarly, both the Chilean project and the Mexican loans were components of broader fiscal policy dialogues between the Bank and the borrower.

While both of these projects were directed at the fiscal aspects of subsidy targeting, an equally important dimension was their reduction in the implicit taxes on financial institutions that were asked to finance these subsidies. In Mexico, commercial banks were required to allocate an amount on the order of US$400-700 million per year. The Bank loan financed a time slice of commercial bank mortgage lending that eliminated much of this implicit tax on the banks. The elimination of this implicit tax was the product of a dialogue between the Bank and the Government of Mexico. High quality studies of this issue were produced by the Mexicans which provided a key input into policy discussion.

Subsidizing Target Beneficiaries. A number of the fiscal features of the projects were prominent:

(i) The target beneficiaries of housing finance projects are "below the-median income" households, rather than the very poor. However, this does not imply that such projects neglect or ignore the poor. More than half of the projects provide cross subsidies to lower income borrowers. In addition, if lower and middle-income households can be accommodated by debt at commercial rates, subsidies that were going to them can now be redirected to those who truly need them. Finally, and perhaps most importantly, because of the relatively recent nature of the Bank's housing finance projects, these projects can avoid the earlier errors of other sectors, and build on lessons learned within the sector. The Bank's experience in the agriculture sector has shown the ineffectiveness of attempting to help the poor through credit policies.[2] In addition, the lesson learned from the Bank's sites-and-services projects is that the production of low-cost affordable housing is possible. If the right housing standards are in place, it is access to credit, rather than concessional lending terms, that can best improve housing conditions.

(ii) A number of institutions that have been supported by housing finance projects provide access to concessional finance for very expensive housing, even if the projects themselves do not. In some countries, projects finance mortgages of up to US$17,000. However, the institutions which receive Bank loans can finance mortgages of up to US$50,000 at preferential interest rates. There is no obvious rationale for these institutions to provide credit at preferential interest rates, even if the interest rates are set by a regional monetary board that sets financial policies across a number of countries. It is exactly this concern that the Bank's Housing Sector Policy Paper (1975) warned against.

(iii) In five of the six projects in which the average borrowing rate is implicitly subsidized by the lender, the per unit subsidy was reduced. However, in only three of the six cases was the subsidy's transparency improved by replacing implicit subsidies with explicit subsidies.

Besides the subsidy targeting concerns associated with housing finance projects, an equally important concern is the efficiency with which housing transfers are mobilized. For example, forcing financial institutions to invest in the below-market-interest rate securities which ultimately finance housing loans - as is done in many countries - is a reliance on a very inefficient transfer mechanism. Such devices can in the long run seriously erode the ability of financial systems to mobilize resources. Greater subsidy transparency not only yields a better measure of who is the subsidy beneficiary, it also yields a better sense of how government policy is adversely affecting financial development. It helps give a sense of whether the borrower's subsidy is borne by the government, other borrowers (through higher interest rates) or deposits (through negative interest rates).

Foreign Exchange Risk. In only one case was the foreign exchange risk imposed on the borrowing intermediary, and that in five cases the borrowing agency was charged a fee for the government's bearing of this risk. In almost 60 percent of the projects the government took the foreign exchange risk without fee. This risk-bearing arrangement appears to impose more uncompensated riskbearing on the government than do the arrangements made for industrial finance loans through financial intermediaries. In the latter type of project the government took the foreign exchange risk without fee in only 49 percent of the cases. On the other hand, the figure for housing finance projects is similar to the figure for the sample of agricultural credit loans, i.e. 64 percent of the projects with clear definitions.

Housing investments produce either no pecuniary income or rental income denominated in local currency. In addition, mortgage payments can make up as much as 25-30 percent of household income that is earned in local currency. Consequently, in the case of housing it is not possible for the ultimate borrower to carry the foreign exchange risk and over the longer term projects should clearly encourage domestic resource mobilization to finance housing. In this regard, the projects in Zimbabwe and Lesotho which aim for 100 percent domestically-based resource mobilization are particularly noteworthy. Nevertheless, in the short run, because housing finance institutions finance domestic assets they are not able to effectively and directly bear foreign exchange risk. Thus, normally, the government should be willing to assume this risk for a fee. However, if the housing finance institutions - and, by implication, the final borrower - do not pay a fee for the transfer of this risk or pay a fee that is lower than the expected cost of this risk, the subsidy element should be recognized.

Housing Sector Concerns

Table 2 indicates that the most frequent rationale for housing finance projects was sectoral policy concerns. These concerns arise because of the inability of most housing production delivery mechanisms to accommodate the large and growing demand for housing. For example, in many countries, and particularly in sub-Saharan Africa, the informal sector plays the dominant role not only in the provision of housing services, but also in providing the inputs into housing production, the financing that is used to purchase the housing, and even the titling of the property itself. Obviously, in such environments housing sector concerns cut across Bank concerns with financial policy, employment policy, fiscal policy, local administrative policy as well as, ultimately, sectoral policy. Consequently, the characterization of rationales in Table 2 understates the importance of sectoral concerns in generating such projects. In almost every instance in which financial or fiscal policy concerns were the basic policy objective, these broader concerns were generated by side-effects of the functioning of the housing and housing finance delivery mechanisms. Only in the case of Malawi was the project developed without prior housing sector work or extensive technical assistance studies.

Table 3 disaggregates those projects in which sectoral policy oriented objectives were identified as the foremost rationale for the project into two sub-objectives:

(i) Efforts to demonstrate that many lower and moderate income households can afford to repay market rate finance. These efforts, in many respects, involve giving greater attention to the design and implementation of both effective mortgage and building practices.

(ii) Efforts to give greater emphasis to the private sector in providing both housing and housing finance services. These efforts often seek to disengage the public sector from functions that the private sector can perform.

Evaluating the sectoral performance of housing finance projects against these kinds of objectives is more difficult than is the evaluation of their financial or fiscal performance for two reasons. First, because the constraints on the development of more effective housing finance systems vary so widely depending on characteristics of the economy, and second, because these kinds of constraints are difficult to quantify in simple summary statistics. Nevertheless, even though these kinds of characteristics may be difficult to measure they are important, if not fundamental, to the development of successful housing finance projects.

C. Implementing Policy Change: the Lessons Learned

Linkages with Broader Financial Sector Strategies

The evolution of the housing finance projects in Morocco provides a good example of how the implementation of Bank

Table 3: HOUSING SECTOR RATIONALES FOR HOUSING FINANCE PROJECTS

Encouragement of greater Private Sector Role	Encouragement of Resource Mobilisation for Lower Income Households
INDONESIA	MOROCCO
PHILIPPINES	ZIMBABWE
KOREA	PHILIPPINES
THAILAND	LESOTHO
NIGERIA	
ZIMBABWE	
LESOTHO	

housing finance projects is changing both as the Bank's financial policy perspective changes, and as problems of implementation affect project design. The 1983 housing finance project in Morocco was very much in the image of the traditional development bank operation that preceded the "Financial Intermediation Policy Paper." It closely followed the directed credit paradigm that had been applied in virtually all Bank lending to financial institutions. Little emphasis was given to the specialized housing bank's (Credit Immobilier et Hotelier, CIH) ability to mobilize resources directly from households. Instead, CIH remained as a residual borrower, financed by the earmarked investments of other financial intermediaries. The implementation experience—the project disbursed slowly—also clearly demonstrated that a number of land management-related bottlenecks were major factors limiting the access of the poor to adequate housing. Lack of clear titles, cumbersome zoning and building regulations, lagging infrastructure provisions, all interacted to reduce the supply of low-income housing.

The focus of the recent appraisal report for a follow-up housing finance project in Morocco moves beyond the directed credit paradigm. Although the project does not address directly questions of financial liberalization and deregulation, it is designed to "fit" the housing finance system into what will eventually be a market-determined financial system. It focuses explicitly on improving CIH's competitiveness and ability to mobilize resources so that it can ultimately operate without any government assistance in a fully liberalized financial system. In particular, the project has permitted the Bank to engage in a discussion of what types of deposit instruments can best serve these purposes. (Other Bank interventions are aimed at resolving the land management related bottlenecks).

Broader discussion of financial policy issues and their implication on the housing finance sector are also planned in the context of a financial sector reform to be supported by a specific financial sector loan. These issues include an assessment of the macro-economic implication of expanding credit to the housing sector, the establishment of an appropriate liberalized framework for housing finance and the mobilization of related savings, the development of Central Bank rediscounting facilities and/or a secondary market for mortgages, and the introduction of variable interest rates. The reform of the financial sector is expected to lead to future lending operations involving both CIH and the commercial bank system.

This kind of broader discussion of financial policy issues was not possible under the Bank approaches that supported the status quo of uncompetitive, highly regulated financial systems. However, while it is now possible to engage in such discussions, it is equally important to stress that housing finance reforms are only one part of a changing financial policy environment. Equally important, these reforms are only one component of housing sector policy. As such, housing finance reforms need to be evaluated in the context of an evolving financial system and sectoral policy. The evolution of housing policy in Mexico is another example of a sustained dialogue between the Bank and the borrowing country in which both parties cooperated in a joint effort to build a sustainable system of financial resource mobilization for housing.

As the data indicate, housing finance loans can be made at positive real rates, with reasonable expectation for satisfactory cost recovery and through reliance on domestic resources. However, it should be recognized that the development of more competitive, sound financial practices are long-term objectives. They may not be achievable in one project, particularly when housing sector and financial sector policies either are at odds with each other or have been carried on through fragmented policies for a number of years. In many countries, lasting improvements in the functioning of these sectors will require an incremental approach as has been pursued in Morocco. As a result, follow-up housing finance projects are under preparation in Zimbabwe, Chile, Mexico and Indonesia.

Another example of a housing finance project that fosters the Bank's financial intermediation strategy is the recent loan to Ghana. This project provides for a new mortgage instrument that permits household debt to replace large implicit credit subsidies in a heavily indebted country. It provides for the indexation of mortgage repayments to wages, and recognizes that in an economy such as Ghana's, real wage decreases may well imply temporary repayment problems for borrowers, but they do not necessarily imply a reduced long-term ability to repay. As a result, under the project, if real wages behave in such a way that repayments are not sufficient to amortize the loan, the shortfall is capitalized into the outstanding loan balance. Simulations of various future real wage scenarios indicate that even with very pessimistic assumptions the indexation scheme reduces subsidies substantially. In addition, with only slightly more optimistic assumptions, subsidies can be eliminated.

If this instrument becomes fully operative, it is likely to be a striking example of a Bank-induced financial innovation that helps both the sector and the financial system. It shows how the development of mortgage instruments that are in tune with macro-economic conditions can help ensure that lending institutions have competitive access to resources. These resources can be mobilized in reaction to the demand and they can help keep the need for subsidies to a minimum.

Housing Finance Projects and Subsidies

In every country in the world, the housing sector receives a significant share of government transfers that go well beyond those measured in traditional budget documents. Credit policies and regulatory controls generate large and unmeasured transfers to the sector, and as the scale of these transfers increases, this aspect of housing finance policy should be given more emphasis. As *"The Bank's Approach to Subsidies"* paper has argued and the housing finance projects in Mexico and Chile have shown, transfers to the sector need to be and can be reduced by better-targeted, more transparent transfers. Over the near-term, measurement and control of these subsidies will be important components of both the Bank's policy dialogue in this area and the Bank's research efforts.

Developing housing finance institutions that minimize these subsidies will be central to this agenda. An important element will be the demonstration of how the newer analytical tools that are emerging to deal with these credit subsidies in developed countries can be applied to developing countries.

It is clear that the Bank's understanding of the broader effects of the implicit subsidies due to financial policies has increased significantly. For example, evidence of the Bank's enhanced ability to assess sector performance is provided by a comparison of the Bank's first housing finance study in the Philippines (1982), with the most recent shelter study of Pakistan (1988). The latter study attempts to identify and rank the factors that hinder the effective and more spontaneous development of the housing market. It attempts to deal with the basic questions posed in the Bank's subsidy paper that need to be addressed in any evaluation of government transfers. It shows that in Pakistan many of these impediments are in the regulation of the housing and land markets; others are in the housing finance system. In this respect, it suggests that while Pakistani housing finance policies are an important source of implicit subsidies to upper-income borrowers, they are nevertheless of less importance than basic land management issues: only by expanding the total supply of serviced land, can the broad masses of urban poor gain access to adequate housing at affordable prices. Simultaneously, it also recognizes that in the move to expand finance for housing, the poor can not be forgotten, particularly given the study's documentation of how the current financial system provides more subsidies to upper-income families than do the measured government expenditures for the poor.

The Philippines study, on the other hand, did not give explicit recognition to the economic costs of providing subsidies to the sector. The Report never mentioned that the government's interest rate policies were indicated by "social" considerations and were often negative in real terms. The conclusions of the project completion reports for the two first shelter projects in the Philippines (issued in 1986 and 1987), however, accurately summed up the situation: "... Negative financial returns represent a serious constraint to the replicability of the projects.....and the high-level of inflation has decapitalized the institution." Not surprisingly, it went on to say that "there has been .... lack of an effective dialogue between the Borrower and the Bank on several important sector issues such as housing finance..." during the late 1970's and early 1980's.

Housing Finance Projects and Housing Sector Objectives

The Bank is still in a transition from a traditional housing sector analysis - which looked at the demand side in terms of "housing needs" and which emphasized the role of government as "the" provider of shelter services, especially for the poor - to a broader analysis that puts housing and the government's housing policies in a broader macro-economic perspective. This shift in perception has been followed by a shift in lending approach. However, the transition away from sites-and-services and upgrading projects to housing finance operations will not occur rapidly, nor, in many countries, should it occur at all in the near term. Most of the Bank's early shelter loans were made to lower-income African countries that were urbanizing rapidly, had very basic financial systems, and often had severe land rights problems. The average per capita income level of countries receiving a sites-and-services project was 40 percent less than that of the countries receiving housing finance loans. In most of the lowest income countries, the sites-and-services approach was the appropriate strategy then, and in many of these countries it remains the appropriate strategy today.

Almost every housing finance project was preceded by other kinds of shelter projects to build up the basic institutional infrastructure, and in most of the borrowing countries new or refocused institutions are the borrowing agency. In many respects, then, housing finance projects represent a "second generation" approach that should not be of the foremost priority for many of the Bank's borrowers.

However, just as the major rationale for the Bank's early sites-and services was to demonstrate that the building standards of developed economies were inappropriate for developing nations, a broader rationale exists for the housing finance agenda in these countries. In countries with little sectoral or financial infrastructure, it is important to demonstrate:

(i) the inappropriateness of specialized, continually and implicitly subsidized mortgage lenders; and

(ii) the ability of moderate income house

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BUILDING SOCIETIES ...
⟶ 11

11 This chart uses the average deposit rate as the cost of retail funding. It is often argued that the appropriate rate for measuring the marginal cost of retail funds is the maximum retail deposit rate. If this is used then wholesale funding has been cheaper than retail for most of the 1980s. See Drake L. and Llewellyn D., *"Building Society Profitability Analysis: A Pilot Study of the Halifax Building Society 1970-86"*, Loughborough University Banking Centre Research Monograph No.2.

12 Moody's rate senior debt offered by the Halifax as Aa1; other societies listed are at Aa3.

13 The liquidity ratio is defined as liquid assets (excluding holdings of building society CDs) as a proportion of total assets (excluding holdings of building society CDs).

14 Under the 1986 Act, there is no minimum requirement on societies' holdings of liquid assets (although there is a maximum of 331/3% of total assets), but they must keep sufficient liquidity to be able to meet liabilities as they arise. Discussions are held between the Building Societies Commission and the individual societies to determine appropriate holdings.

15 These are classified as Miscellaneous Financial Institutions (MFIs) in the official statistics (see, for example, Table 9.4 in *Financial Statistics*).

16 Since both of the new groups of lenders can be characterised as intermittent participants who enter the market when profit opportunities arise, it could be argued that the mortgage market is now close to being perfectly contestable (see Baumol, W, Panzar, J and Willig, R, *Contestable markets and the theory of industry structure*, Harcourt Brace Jovanovich 1982). In the pure form of such a market there are no barriers to entry and prices are held down to the levels of marginal cost by the threat of potential entry.

17 The limits on class 2 and class 3 lending are to be further raised so that by the beginning of 1993 they will be able to account for 25% of commercial assets, with a limit on class 3 assets of 15%. These changes have allowed societies to diversify away from traditional mortgage business in response to market conditions and have enabled them to plan these new business ventures in advance.

18 Equity extraction can be defined as the difference between the net increase in the stock of house purchase loans and the private sector's net expenditure on housing. It arises mainly from the actions of last-time sellers leaving the housing market but also from those of existing owner occupiers borrowing in order to run down their housing equity or trading down. See Holmans, A, E, (1986), *"Flow of funds associated with house purchase for owner-occupation in the United Kingdom 1977-84 and equity withdrawal from house purchase finance."*, Government Economic Service Working Paper No.92. Also *"The housing finance market: recent growth in perspective"* in the March 1985 *Bulletin*, pages 80-91.

19 Defined as net interest income as percentage of average total assets.

20 A benefit arising from the existence of zero interest current accounts which can be deployed at market rates exceeding the costs of running such accounts.

21 There are obviously problems with this assumption. Large societies are likely to be able to obtain funds at a lower rate than smaller ones and in some cases at below Libor. Swaps can also be used to reduce funding costs. Also, fixed-rate issues are likely to be above or below Libor depending on the recent history of interest rates.

22 See Drake and Llewellyn, *"Building Society Profitability Analysis"*, for a similar pattern in the spread of the Halifax Building Society up to 1986.

23 Annual Report of the Building Societies Commission 1989-90.

24 An alternative view is that the movement to conversion has only been attenuated by poor market conditions. When these improve conversions could again be pursued.

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holds to repay market rate loans.

Attempting to copy financial approaches from developed economies without first sorting out basic regulatory issues in the housing market is bound to bring significant problems for the sector, for government transfers, and for financial development. Such institutions need to have longer-term strategies that demonstrate how they eventually will be able to mobilize resources.

In summary, it appears that some regional specialization of basic housing finance strategies will almost inevitably occur. The same type of housing project that is appropriate or even essential in one type of country will be inappropriate, or of much lower priority in another. For example, in many higher inflation countries better mortgage indexation may be essential to make housing affordable, to reduce transfers, and to help mobilize financial resources. In such an economy, housing finance interventions should be of relatively high priority. On the other hand, if a high inflation country also has a low level of economic and financial development, declining real income and a weak land cadastral systems, there are almost certainly many more important sectoral policy issues to be addressed before indexation is introduced or discussed. Stopping the leakage of resources through negative ex ante interest rates is essential in all high inflation countries. But whether mortgage indexation is the appropriate means of doing this is another question. ■

NOTES

1 Stephen K. Mayo and David J. Gross,