Housing Finance, Enabling Strategies and Economic Development

by Timothy T. Thahane

INTRODUCTION[1]

Recent changes in the context within which the housing sector operates, and a few dramatic policy failures in both developed and developing countries have focused new attention on the role of the housing sector throughout the world. It is increasingly recognized that when housing policies fail to work well, the performance of the housing sector suffers, and when the performance of the housing sector suffers, broader economic performance suffers. Moreover, the consequences of housing policy failure are almost always borne most heavily by the poor, indicating that both economic justice and economic efficiency are reduced when policies are not well-conceived and implemented. Creating a well-functioning housing sector, therefore, presents both one of the greatest challenges and one of the greatest opportunities for policy-makers in developing and developed countries.

Governments can improve policies by moving from policies of direct production and manipulation of the pricing and distribution of housing toward enabling strategies for housing. Such policies, which emphasize a strong and constructive role for governments to stimulate demand for housing and to facilitate its supply, are necessary if policies are to have an effect at a scale necessary to address the housing concerns of all citizens, and for the housing sector to contribute toward achievement of other economic goals of society.

The design of policies affecting housing finance are particularly important among the elements of an enabling strategy. Just as it is possible to conceive of a well-functioning housing sector, it is possible to conceive of a well-functioning housing finance sector - one that addresses both housing needs and contributes more broadly toward social and economic goals of society.

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The high stakes of good policy

The stakes of adopting appropriate enabling strategies for the housing sector are becoming increasingly better known on the basis of comparative research on housing policy effects around the world. Housing investment typically accounts for 2 to 8 percent of GNP, and the flow of housing services for an additional 5 to 10 percent of GNP. Annual spending on housing, therefore, accounts for between 7 and 18 percent of GNP. Such magnitudes, however, fail to convey fully the many ways in which the performance of the housing sector is intertwined with that of the broader economy through real, financial, and fiscal circuits. Government housing policies have an important impact on the performance of the housing sector, and thus a significant effect on the economy as a whole. At the same time, government macroeconomic policies often affect the performance of the housing sector in more powerful ways than direct housing actions by government.

Moreover, there are strong links between housing policy reform and concerns with the reduction of poverty and with reversing the deterioration of the urban environment. Policies that affect the performance of the housing sector as a whole tend to affect the housing conditions of the poor in a more pronounced fashion. In broad terms, when housing policies are designed to enable housing markets to function well, limited resources are effectively translated into housing improvements. When markets are not functioning well, access to good quality, affordable housing and infrastructure will be in short supply, with the inevitable result that better-off households will capture most of the benefits of housing and infrastructure improvements. In such cases, subsidies, which are sometimes instituted with the stated objective of improving the housing conditions of the poor, will often also be captured by better-off households. The targeting of housing subsidies appears to be considerably worse in countries with the worst housing conditions. Moreover, when land and housing are in short supply, housing prices are high and subsidies to help house the poor are much higher than they need to be.

Almost all developing countries have considerable scope for improving policies focused on providing better housing conditions for the poor - policies that encourage the marketplace to provide more, better, and cheaper housing; enable the poor to house themselves; and improve the effectiveness of subsidy systems. The principal task of housing policy regarding the poor is to ensure that resources are translated as effectively as possible into improvements in their housing conditions, and that improved housing conditions, in turn, contribute to the extent possible to real improvements in the well-being of the poor.

The changing context of the housing sector

When the World Bank made its first housing loan in 1972, a $7 million loan to the government of Senegal for a sites-and-services project, the economic climate within which housing policies were being formulated throughout the world was in general favourable, with positive real growth and low inflation. As a rule, economic growth was good for the housing sector, with housing investment increasing and housing conditions in physical terms improving at rates in excess of the rate of economic growth. The principal challenges for housing policy in the developing world in the 1970s were seen by governments largely in terms of physical objectives - build more housing and provide more services for growing urban populations. Housing policy was defined largely in terms of governments' direct activities to provide housing and related infrastructure, and, in a number of countries, by actions to control the price of housing or its key inputs.

In contrast to the early 1970s, the past two decades have seen the housing sector placed under the same stresses experienced by the macroeconomies of many countries with the result that overall sectoral performance has declined in many countries and, major flaws have been exposed in housing policies and institutions. The costs to both the housing sector and the broader economy of inflexible and inappropriate policy have proven to be surprisingly high. The nature of the challenges to the housing sector have been far from uniform among countries, but virtually no country has escaped stress and the pain of dealing with it.

Demographic pressure

An overarching source of pressure on housing markets throughout the developing world has come from the continuing rapid urbanization of the Third World's population. Since 1950, the urban population of developing countries has more than quadrupled, growing from 300 million to 1.3 billion people in 1990. Two billion people are expected to be living in urban areas by the end of the decade, 2.7 billion by 2010, and 3.5 billion by 2020. Each year, some 12 to 15 million new households, requiring an equivalent number of dwellings, are added to the cities of the developing world.

Economic recession

In some countries, this demographic stress has been heightened by the global economic crises precipitated by the oil shocks. The ensuing high and volatile inflation raised real interest rates and choked off credit, particularly long-term credit, in many countries (especially in Africa and Latin America), depressing demand for housing and lowering housing investment. Structural adjustment policies have directed credit toward the export sector and away from non-tradeables such as infrastructure and housing.

Inability to accommodate to economic success

In other countries, stress on the housing sector has been caused by economic success. Some Asian countries have simultaneously experienced rapid urban population growth and economic expansion in collision with stiff and inflexible land and building regulations. The result has been housing prices escalating far more rapidly than incomes, leading to cramped living conditions, the persistence of slum and squatter settlements, and a variety of macroeconomic distortions. In Korea, Malaysia, and even Japan, rapid economic progress has not been well translated into improvements in housing conditions, causing increased social tensions and excessive diversion of investment into the housing sector without much to show for it.

The transition from socialism

Finally, in formerly socialist countries, the legacy of past failures in housing policy has become most evident, with citizens placing great emphasis on improved housing in their new set of economic and political priorities. The forces unleashed by the transition to a market economy have highlighted the social costs of insufficient housing. But, more importantly, housing has constrained overall economic reform as well, as evidenced by macroeconomic costs associated with labor force immobility, resulting from endemic housing shortages. Past prohibitions on private ownership of property has also reduced savings rates and domestic resource mobilization.

Policy failures in the industrialized countries

In the United States, the highly visible Savings and Loan crisis is estimated to be likely to impose costs of some $300 billion on American taxpayers during a time when budgetary deficits have drastically hampered the policy options of economic policy makers. In Japan, the long and dramatic rise in land and real estate prices which collateralized a considerable part of recent Japanese economic expansion has been reversed, leaving in its wake tens of thousands of personal and business bankruptcies.

Responding to the changing context

This changing context and its implication for the performance of both the housing sector and broader economy of countries around the world led, in part, to the unanimous endorsement in 1988 by the United Nations General Assembly of a document prepared by its Center for Human Settlements entitled *A Global Shelter Strategy fo* *the Year 2000.* This document both represented a statement of the critical importance of the housing sector in the social and economic affairs of nations and suggested a potentially massive turn in the driving philosophy of housing policies throughout the world. Simply put, the *Global Shelter Strategy* (GSS) noted that the economic importance of the housing sector is far greater than is commonly recognized by most governments, that the effects of good housing policy far transcend their direct effects on better housing conditions (and, correspondingly, that the costs of housing policy failures are felt well beyond the sector), and that past government policies, which in most countries have relied on direct government production of housing, and which have usually failed, need to be replaced with so-called enabling strategies that leverage the government's limited resources to call forth a vigorous private housing delivery system. The GSS called on all member governments of the UN to initiate policy reforms and programs aimed at making enabling strategies a reality.

Subsequently the World Bank endorsed the concept of enabling strategies in a Housing Policy Paper entitled *Housing: Enabling Markets to Work.* As set out in that document, governments have at their disposal seven key broad instruments which together constitute an enabling framework for housing.

THE INSTRUMENTS OF AN ENABLING HOUSING POLICY

Of the seven major enabling instruments, three address demand-side constraints, three address supply-side constraints, and one addresses the management of the housing sector as a whole. The three demand-side instruments are:

- developing property rights: ensuring that rights to own and freely exchange housing are established by law and enforced, and administering programs of land and house registration and regularization of insecure tenure;
- developing mortgage finance: creating healthy and competitive mortgage lending institutions, and fostering innovative arrangements for providing greater access to housing finance by the poor; and
- rationalizing subsidies: ensuring that subsidy programs are of an appropriate and affordable scale, well-targeted, measurable, and transparent, and avoid distorting housing markets.

The three supply-side instruments are:

- providing infrastructure for residential land development: coordinating the agencies responsible for provision of residential infrastructure (roads, drainage, water, sewerage, and electricity) to focus on servicing existing and undeveloped urban land for efficient residential development;
- regulating land and housing development: balancing the costs and the benefits of regulations that influence urban land and housing markets, especially land use and building, and removing regulations which unnecessarily hinder housing supply; and
- organizing the building industry: creating greater competition in the building industry, removing constraints to the development and use of local building materials, and reducing trade barriers that apply to housing inputs.

These instruments are to be supported and guided by:

- developing the institutional framework for managing the housing sector: strengthening institutions which can oversee and manage the performance of the sector as a whole; bringing together all the major public agencies, private sector and NGO representatives and community-based organizations; and ensuring that policies and programs benefit the poor and elicit their participation.

In designing effective enabling strategies, it is essential that governments have a clear understanding of how the housing sector operates, and of how different policy instruments impinge on the functioning of the sector, and on the markets that comprise it.

THE ROLE OF HOUSING FINANCE

The role of housing finance in the housing sector may be described both at the level of individual households and at the level of the economy. Good policy must be based on an understanding of the role of housing finance from each of these perspectives.

Mortgage finance as a critical factor in generating housing demand [2]

Because a housing unit normally costs a multiple of annual household income, mortgage financing is essential for purchase. Yet mortgage financing in developing countries is extremely limited. In many cities the total volume of formal mortgage loans issued in a given year accounts for no more than 10 to 20 percent of the annual value of housing investment. Other loans for housing usually come from relatives, employers, and money-lenders, but savings and current income finance the volume of construction. When current income is used, construction often occurs incrementally as funds become available over time. Multitudes of urban dwellers living for years in what amounts to a building site demonstrates the lack of an efficient housing finance system. In many such cases, construction is also highly inefficient; in the absence of complementary inputs, materials languish and of-

Box 1: Housing Finance Innovation and Financial Sector Development in Colombia

In 1972, the Government of Colombia established new housing finance institutions, the *Cajas Ahorra de Vivienda* (CAV's) which paid positive, real interest rates on deposits, indexed to the rate of inflation. Depositor response to these indexed instruments was immediate and positive, and led to rapid growth of deposits in the housing finance system. In commercial banks, by contrast, real interest rates paid on certificates of deposit had averaged negative 6.5 percent over the preceding 14 years. In order to compete for deposits, commercial banks were forced to pay more competitive deposit rates, with the result that from 1972 to 1984, their certificates of deposit paid an average, positive real return of 2.5 percent, allowing them to maintain and subsequently increase their deposit bases.

The direct benefit of this process for Colombia was increased financial depth. Credit outstanding as a share of GDP increased from an average of 15 percent in the five year period leading up to 1970, to 36 percent after 1980. During this same period most other Latin American countries experienced significant reductions in monetary assets as a share of GDP. Colombia's ability to maintain and increase its financial depth during this period has been cited as a major cause for its favorable economic growth relative to that of other Latin American countries. This illustrates the productive contribution that well-structured housing finance systems can make toward both financial sector and overall economic development.

Sources : Buckley and Dokeniya (1989).

ten deteriorate.

When housing finance is available, however, ready capital transforms the construction process. Professional developers become active more rapidly and the building industry becomes more efficient. Households can build or buy housing they could not otherwise afford. Citizens of developing countries view the ability to accelerate the construction or acquisition of housing by assuming mortgage debt as highly desirable. Mortgage loans permit households to distribute patterns of saving, investment, and consumption in a more efficient way.

Housing finance and financial development

Recent research on connections between financial development and economic growth suggests that an economy's financial depth may have an important independent contribution to growth. Housing finance is important to the financial system, therefore properly structured housing finance policies are important to the stability of the financial sector and thus to the stability of the economy (see Box 1). Conversely, failures in housing finance policies can lead to broader financial failures (see Box 2).

As economic development proceeds, it is generally accompanied by increased monetization of the economy, by an increase in the depth and breadth of financial institutions, and by increasingly integrated capital markets. At the lowest levels of economic development, long-term loans through the formal financial system are rare, as is any form of mortgage finance. As development proceeds, financial institutions seek to diversify their portfolios to mitigate risk and to achieve a match in the term structure of assets and liabilities. A consequence of this is that formal lending for housing purchases begins to occur, often in the form of overdraft loans or loans that are rolled over annually. Household savings are encouraged and are sometimes linked to the possibility of receiving housing loans. Further development of the financial system leads to increasing maturities of loans for housing and sometimes to the development of specialized housing finance institutions, some of which may constitute secondary markets in mortgage loans.

Quantitative evidence on the growing importance of mortgage lending is imprecise, but it appears that the relative importance of residential mortgage loans in the portfolios of the financial system grows from next to nothing to more than 25 percent at moderate levels of economic development. Mortgage loans may constitute 40 percent of the portfolios of the financial system of developed countries.

Box 2: The Collapse of BNH in Brazil

The Banco Nacional de Habitacao (BNH) was created in 1964 to serve as the primary regulator of and a channel for funds to the Brazilian housing finance system. The major sources of funds for the system were a compulsory workers' savings system and deposits in savings and loan associations. By law, all deposits were indexed to inflation on a quarterly basis.

To protect loan balances and maintain the system's solvency, mortgage loan contracts were also indexed. Originally, both payments and loan balances were indexed on the same basis as deposits. However, over time new indexation systems were mandated for payments which caused them to lag behind the general price level, and the government agreed to cover any outstanding balances remaining at the end of the loan term. By 1985, inflation was running at an annual rate of 240 percent while loan payments were increased by only 112 percent. The growing imbalance jeopardized the solvency of BNH and in 1987 it was closed.

However, the basic structure of the mortgage finance system was not reformed. One study of implicit subsidies in the financial system estimates that the annual subsidy to borrowers on mortgage loan contracts taken out through 1987 could eventually exceed 2 percent of GDP. As these contracts mature, the Brazilian government must fulfill its obligation to cover the shortfall, with almost certain inflationary consequences.

Sources : Pinto Lima (1990); Silveira (1990).

How rapidly mortgage lending develops depends on both the overall pace of financial development and on policies within the housing sector. High and variable inflation rates impede development of the financial sector and long-term lending, especially for housing, suffers. Financial systems characterized by positive real interest rates for both deposits and loans and by lack of directed credit or subsidies are more favorable for the development of mortgage finance. In addition, systems of property registration and titling and workable systems of foreclosure and eviction are necessary to ensure the collateral security of mortgage loans. Finally, the design of mortgage lending instruments, and particularly the design of mortgage index provisions, can make a critical difference. Recent innovations in mortgage instrument design, such as the "dual-indexed mortgage" now employed in Mexico and proposed for Turkey, for example, have permitted mortgage lending to expand even during inflationary periods (See Box 3).

Box 3: Reforming Housing Finance in Mexico

From the mid 1970s to the mid 1980s the government of Mexico required commercial banks to lend a set percentage of their portfolio equal to 3 percent of deposits for mortgages to low to middle-income households. For many years this was sustainable. However, in 1982, inflation increased to nearly 100 percent annually while the mandatory housing portfolio had a mandated interest rate of 11-14 percent; banks were thus forced to absorb an implicit subsidy equal to $400 million annually and at that point, raising interest rates to market levels would have made traditional fixed payment or adjustable rate mortgages unaffordable to all but the highest income groups. As an alternative, the Central Bank of Mexico devised a form of mortgage instrument to serve the interests of both borrowers and lenders. This instrument, known as the dual-indexed mortgage (DIM), had the following characteristics:

- indexing to cover inflation. In the standard design of a DIM, a real interest rate is applied to the indexed balance, yielding a positive rate of return;
- indexing to maintain affordability. Payments are typically established as a maximum percentage of household income. If payments are indexed to the trend in wages, payments can be increased to pay down the loan while never exceeding the defined maximum portion household income;
- adjustable repayment period. If the required monthly payment exceeds the maximum percentage of household income, the difference can be capitalized and the term of the mortgage extended beyond its original 15 years. To put an upper limit on the term, the central bank agreed to cover all balances not paid at the end of a twenty year term.

The new instrument was an immediate success. With the elimination of the implicit interest rate subsidy, banks expanded their discretionary lending for housing; the mandatory lending requirements ceased to be binding and were eliminated in 1988. Today, commercial banks lend an amount equal to 8% of their deposit level - a substantial increase over the earlier requirements - for housing. This process continues today, as the banks continue to adapt the structure of the instrument to their own particular portfolios; presently, all banks use a variation on the DIM in their own portfolios.

Housing finance and subsidy reform

Economic conditions in many developing countries during the 1980s focused attention on the need for fiscal reform. Major attention was focused on public expenditures and on the need to reduce government budget deficits to reduce inflationary pressure. In many cases, fiscal reforms related to the housing sector were intimately related to reform of the housing finance system, which have served as a major conduit for housing subsidies.

Of the major subsidies granted in developing countries, housing subsidies represent an appropriate candidate for reduction. On-budget housing subsidies have been a particularly prominent feature in centrally planned economies such as Poland, where, in the late 1980s, housing subsidies comprised some 34 percent of all government budgetary subsidies, 13 percent of the government budget, and about 3 percent of GNP.[3] At that time, high inflation was aggravated by persistent budget deficits, reduction of which has since become a major reform target. Reduction of housing subsidies is a major element of the overall reform.

In other countries, budgetary subsidies are less important, but off-budget subsidies in the form of below-market interest rates and after-the-fact loan forgiveness can have no less important impacts on domestic inflation rates. In Malaysia, interest rate subsidies to civil servants during the late 1970s put considerable upward pressure on housing prices, with consequences for the general inflation rate. In Argentina, poorly indexed systems of housing finance have created a subsidy system that has been referred to by some as an "automatic fiscal destabilizer",[4] and which has been estimated to have exerted significant pressure on Argentina's inflation rate and to have imposed welfare costs estimated to equal some 4 to 5 percent of GNP. Thus reform of the housing subsidy system is important in order to rationalize both the fiscal and financial linkages of the housing sector to the broader economy.

Housing policies and personal savings

Another way in which housing finance is linked to the performance of the economy is through the connection between housing finance, other housing policies, and personal savings. The housing sector may have major effects on savings rates in a number of countries. Centrally planned economies, which for ideological reasons have restricted private property rights, show many signs of chronic under-investment in housing - long waiting lists, low turnover and mobility rates, and high black-market premia. In effect, state saving for housing has been insufficient to accommodate housing demand, and economic disincentives or prohibitions have discouraged households from saving for, and investing in, housing. Household budget surveys in such countries confirm powerful distortions in patterns of both consumption and savings that result from rigid control of housing prices and limitations on ownership of many forms of property. In Poland during the 1970s, typical urban households spent only about 3 to 4 percent of income on housing but from 11 to 15 percent on alcohol and tobacco; at the same time, personal savings rates were extremely low.

Recent analysis in a number of countries has focused on the link between housing price appreciation and personal savings, and has examined the premise that during periods of rapid housing price appreciation households are likely to decrease their financial savings, content to save in the form of accrued capital gains on their property. The most careful examination of this thesis has been done in the United Kingdom (see Box 4). The rapid house price appreciation in the southeast of England during the 1970s apparently initiated a decline in the personal savings rate from 18 to 4 percent in a decade, with significant implications for interest rates, inflation, and the balance of payments. Prices evidently rose because of the combination of increasing housing demand, fuelled in part by liberalization of the housing finance system and an unresponsive system of land and housing supply. Similar investigations in other industrialized countries have tended to produce similar, though somewhat more conjectural findings.[5]

The applicability of these findings to developing countries is not yet known. One institutional feature of industrialized countries that creates the possibility of such a strong link between house price appreciation and savings is their well-developed mortgage finance sytems, which permit the withdrawal of accrued equity in the form of second (junior) mortgages or home equity loans. Thus while the behavioral link between house price appreciation and personal savings is likely to be the same in developed and developing countries, the institutional prerequisites are likely to be less accommodating.

DEVELOPING MORTGAGE FINANCE AS AN ELEMENT OF AN ENABLING STRATEGY

Despite the importance of good policy regarding housing finance for both individuals and broader economic performance, a number of common problems are found with the housing finance systems of both developing and developed countries. These problems must be addressed if an effective enabling strategy for housing finance is to be put in place.

Common problems associated with housing finance

The great majority of urban households in developing countries do not have access to mortgage finance; in most developing countries, less than 10 to 20 percent of the annual investment in housing is covered by mortgage finance. The development of housing finance institutions is strongly tied to overall financial sector development, but policy decisions often tend to limit their ability to engage in mortgage lending. Such policies include forcing such institutions to give subsidized loans, often at negative interest rates, and to forgive loans. Such actions are, in effect, off-budget subsidies which entice politicians because they escape budgetary allocations, instead creating unmeasured and unseen contingent liabilities. However, the costs of such programs often far exceed those of direct housing subsidies. Hidden subsidies delivered through the financial system (such as interest rate subsidies) impede financial development, are often regressive, and can im-

Box 4 : Housing Policy Distortions and Macroeconomic Performance in the United Kingdom

Housing policies in the United Kingdom have been predicated on heavy state intervention in private land and housing markets, emphasizing public construction and ownership of Council Housing, control of private rents, stringent town and country planning regulations, and the establishment and protection of greenbelts around cities. Together, these policies have created a somewhat rigid and unresponsive system of housing supply - one that during the 1980s was unable to accommodate increases in demand, particularly in the greater London area, without rapid escalation in housing prices.

Recent research has suggested that a number of aspects of the U.K.'s macroeconomic performance have been affected by increasing house prices. One impact has been on the personal savings of households, which declined dramatically during the 1980s. Increases in perceived wealth by households, coupled with financial liberalization which permitted households to withdraw portions of their increasing home equity in the form of mortgage refinancing, apparently reduced incentives to save using financial instruments. Falling personal savings rates led, in turn, to decreased availability of financing for the business sector. As in most countries, the business sector in the U.K. is a net borrower while the household sector is typically a net saver, so that when household savings decline, upward pressures are put on interest rates. These pressures lead eventually to increased inflows of foreign capital and deterioration in the balance of payments capital account. At the same time, it was suggested, the current account of the balance of payments was put under pressure, since households which withdrew home equity often purchased imported commodities.

At the same time, the higher housing prices in the Greater London area tended to discourage migration from areas of labor surplus, in the North of England and in Scotland, thereby keeping unemployment rates higher than would have been the case had housing markets been able to adjust more freely. It is estimated that this increased the overall unemployment rate in the U.K. by some 2 percentage points.

Sources : Muellbauer, (1989); Minford (1988).

pose significant hidden costs and risks.

In the early stages of financial sector development, the sector tends to accumulate extremely short-term assets and liabilities, and thus tends to avoid financing long-term investments, in industry and infrastructure as well as housing. In the absence of well-designed indexation, long-term lending in inflation-prone countries is perceived to be of high risk. Similarly, in countries with weak mechanisms for foreclosure on defaulters, the risk of default on repayments tends to be high.

Partly as a way of overcoming shortages in housing finance, governments in a number of countries have instituted directed credit schemes for housing. These have taken the form either of government-sponsored housing finance institutions, often supported by direct budgetary transfers, or specified lending targets for housing (often also at below-market interest rates) by commercial lending institutions. In either case, directed credit lowers incentives for resource mobilization by lending institutions. The result may sometimes be that lending volumes for housing are actually smaller than they would have been under a more neutral financial regime which permitted lending for housing to seek its own level based on market conditions.

In developed countries, the failure of prudential regulation of housing finance institutions has sometimes been catastrophic, as evidenced by the fact that failures of savings and loan (housing finance) institutions in the United States will necessitate some US$300 billion in taxpayer subsidies to compensate depositors in the failed institutions, whose deposits were insured by a federal government agency. Such failures underline the importance of sound prudential regulation and enforcement.

Regulations governing mortgage lending are usually biased towards completed owner-occupied housing, making it unattractive or impossible for financial institutions to lend for rental housing, condominium housing, for house improvements or for unfinished core houses on serviced sites. The development of a broad set of instruments for mortgage financing is a key component of an enabling housing strategy, and can increase the demand and hence the quality of housing.

Box 5 : Successful Housing Finance Institutions in India and South Africa

Several housing finance organizations in developing countries have successfully created sustainable lending programs for the poor by adapting local cultural norms to overcome the risks caused by inadequate legal systems. Reputation-based mutual financial institutions have been able to mobilize savings of the poor and provide them low-cost access to credit.

Founded in 1978 in India, and supported in part by equity financing by the International Finance Corporation, the Housing Development Finance Corporation (HDFC) provides mortgage loans to low and moderate income households. HDFC operates in a constrained regulatory environment where strong tenant protection discourages lenders from entering the market, stamp duties make mortgage registration prohibitively expensive, and loan applicants' incomes are impossible to verify. In response, HDFC has developed a range of responses for low income lending, including higher loan-to-value ratios, step-up loan repayment plans, innovative collection techniques, and third party guarantees.

In South Africa, one fourth of black families live in informal dwellings; two thirds have no access to housing loans from financial institutions. Founded in 1990, the Group Credit Corporation makes small, short-term loans to "savings clubs" - 70 percent of whose members are women - to build and upgrade low-income housing. The excellent repayment experience parallels the longer-term experience of the Grameen Bank in Bangladesh in making group loans to low-income households.

Sources : Shah (1988), N. Munjee, *et al* (1990), The Urban Foundation (1990).

The well-functioning housing finance system

In order for the housing sector to function well, the housing finance system should also function well. Among the principles that help to define a well-functioning housing finance system are the following:

- A well-functioning housing finance system should be able to compete for deposits on equal terms with other financial institutions without the need for directed credit toward the sector. Housing finance institutions should not be forced to lend at negative or subsidized interest rates, and subsidized parastatal lenders should be avoided. Lending should be at positive, real interest rates with a sufficient margin to allow positive rates to be paid on deposits and, in so doing, permit expanded resource mobilization. There should be sufficient deposits of an appropriate term structure for long-term mortgage lending. Where there are insufficient long-term deposits, housing finance institutions should be permitted to borrow from international sources. Such borrowing should be encouraged, even in highly-indebted countries, when housing investment has higher internal rates of return than export-producing industries and when the demand for mortgages is high.

- Mortgage lending instruments which are in demand by households, and which provide adequate protection for the institution, should be permitted. In countries prone to inflation, mortgages should be protected by appropriate indexation and variable-rate mortgages should be permitted (see Box 2, which describes the dual-indexed mortgage used in Mexico, an attractive option in many developing countries). Systems of property rights, tenure security, and foreclosure should be such that the financial interests of lenders can be protected without compromising the legal rights of households. Where foreclosure procedures are weak, personal or group guarantees should supplement the use of the house and land as collateral (see Box 5).

- Governments should also act to improve the efficiency of financial intermediation in the housing sector. The spread between mortgage and deposit interest rates in many developing countries is often exceedingly high, sometimes 10 to 15 percent, rather than the 1 to 2 percent typical of well-functioning mortgage lending institutions. To reduce this spread, governments should encourage the entry of new institutions into the housing lending market. For example, commercial banks, despite their efficient networks of branches and their interest in mortgage lending, are often prevented from lending for housing. Governments should remove the bureaucratic impediments associated with mortgage lending and reduce the risks associated with such lending (for example, by promoting titling, foreclosure, and eviction procedures that improve the security of collateral).

- Development of housing finance institutions should proceed hand in hand with the overall development of the banking sector. Government should act to ensure that such institutions make prudent investments and maintain the capital requirements appropriate to risks associated with housing investments.

Mortgage finance and the poor

Special considerations are necessary to ensure that the poor benefit adequately from housing finance reforms. The record of mortgage lending to poor households in most of the sites-and-services projects assisted by the World Bank and other international donors has, for example, been less than satisfactory. Defaults have been common and have tended to spread rapidly throughout projects when mechanisms for addressing defaults were lacking.[6] Specific attention should be directed at designing and implementing mortgage instruments that can assist low-income families. Such instruments may require collecting payments at the source, or increasing the frequency of collection for families with irregular incomes.

Small-scale mutual credit institutions and alternative lending instruments attuned to the needs of households undertaking incremental house-building should be encouraged. Mutual institutions can mobilize savings, can lend competitively to appropriate borrowers, and can rely on a high level of member supervision through peer pressure. Such institutions, which adapt existing informal systems and cultural norms, have been effective in Bangladesh, India, Mexico, Sri Lanka, and South Africa (See Box 5).

In addition, foreclosure procedures need to be applied promptly to contain defaults. When such procedures have been applied, as was the case in the Community Development program in Hyderabad, India, default rates were kept to a minimum, enabling the program to expand and to assist very low-income households.[7] In other cases, special funds and a special team of social workers have been assigned to deal with households that have difficulties in meeting mortgage payments, again keeping defaults to a minimum. This was the approach taken in the Bank-assisted sites-and-services projects of the Foundation for Minimum Housing and Development in El Salvador.

Housing finance institutions should be regulated in a manner which renders them neutral to lending to all income groups, to lending for complete houses as well as for house improvements, core houses on serviced sites, and condominium as well as rental housing, all of which are usually in high demand by low-income households.

The role of international institutions

The task of creating effective enabling strategies for housing and, particularly, for housing finance is one that requires the creative energies of all levels of government and of associations of the many stakeholders in the housing sector. International organizations such as the bilateral donors, the Regional Development Banks, the United Nations Centre for Human Settlements, and the World Bank can and will support local and national reform efforts through programs of grants, loans, and technical assistance. Indeed, compared to earlier periods, when the policy objectives and programs of these many organizations were often at cross purposes, the emerging consensus concerning the need for enabling strategies and the framework for their implementation that has been provided by the Global Shelter Strategy has created a more favorable environment for coordinated policy reform efforts than has ever existed.

Despite this emerging consensus among governments and international organizations, the fundamental task of policy reform nevertheless remains the responsibility of local and national governments. In terms of resources alone, the potential role of international transfers in contributing towards housing policy objectives in developing countries is limited. For example, in recent years, the World Bank's annual lending for housing and related residential infrastructure in cities has been roughly between US$ 1 and 2 billion. In comparison, the annual urban housing investment in developing countries is of the order of US$ 150 billion, and the aggregate value of the housing stock in developing country cities is of the order of some US$ 3 trillion - roughly twice the gross national product of all developing countries. Even modest decisions made by local and national governments that affect the productivity of housing and infrastructure investments, and that affect the value of the housing stock and the ease with which it can be effectively collateralized and used as a source of funds for either housing improvements or other productive investments will each year have a far greater impact on the well-being of consumers, producers, financiers, and investors than will all of the lending by international agencies. And while the benefits of better policy on the functioning of housing markets are often less visible than those associated with the many ribbon-cutting ceremonies associated with past government housing policies, it is apparent that *the lasting benefits of cutting red tape generally far exceed those of cutting red ribbons.*

CONCLUSION

In conclusion, it is apparent from any perspective that the performance of the housing sector is critically important not only in its own right, but also because of its links to the broader economy through real, fiscal, and financial circuits. The benefits of a well-functioning housing sector are becoming increasingly apparent, as are the high stakes of good policy within the sector. Policies regarding housing finance are particularly important, but it is clear that for the housing finance sector to work well, not only must financial policies be well designed, but other complementary policies regarding property rights, the regulatory framework, and subsidies, among others must also be carefully thought through and implemented. And in designing the policy framework, it must be remembered that those most disadvantaged by bad policies are the poor, and it is they that stand to gain the most if policies are rationalized. Finally, while the many international institutions that are active in the housing sector stand ready to help, the responsibility of designing and implementing good housing policy is fundamentally that of local and national governments. In exercising this responsibility, governments will need all the help and constructive guidance that they can get. This represents both the promise and the challenge for all of us here today. ■

NOTES

[1] This paper draws heavily on the World Bank's Housing Policy Paper, which is entitled *Housing : Enabling Markets to Work,* which was published in 1993.

[2] For a comprehensive discussion of housing finance as an integral part of financial development see Renaud, *The Role of Housing Finance in Development: Issues and Policies.* World Bank, July 1989.

[3] Direct subsidies have taken the form of capital grants for housing and operating subsidies.

[4] Buckley (1988).

[5] Loikkanen (1991).

[6] Swan, Wegelin and Panchee (1983).

[7] Kumar (1980).

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