Housing Policy and Financing in Latin America: A Retrospective Analysis and an Alternative Model

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INTRODUCTION

The record of the formal sector meeting housing construction and home financing needs in most Latin American countries has been weak. As a result, a housing deficit exists and continues to grow in most countries of the region.

Traditionally the housing and housing finance policies have been based on partial approaches with predominantly short-term horizons. They have only succeeded in further distorting the housing situation and postponing the achievement of the desired result of a reduction and eventual elimination of housing deficits. In recent years, nevertheless, various analyses and debates on the subject, as well as policy practices in some countries, are making it possible to clarify and flesh out a model that can be the basis for policy in each particular country that can achieve more permanent solutions. In fact, in some countries there has already been a very important policy outcome: the growth of the housing deficit has been halted and is beginning to gradually decline as the annual production of housing exceeds the new needs generated yearly by population growth and the formation of new families.

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The aim of this article is twofold. First, the weaknesses of housing policy and home financing as traditionally applied in Latin America—typically characterized by the existence of the state as a builder of housing and by the limited participation of the private sector—are discussed. Second, based on the practical experience of some countries, the content for an alternative model of housing policy and financing is outlined. This model has as its basic pillar a state which acts as a facilitator and provider of subsidies, with the private sector playing the leading role in the processes of building and financing housing.

THE HOUSING FINANCE PROBLEM

Credit for the construction and purchase of housing has been insufficient compared to Latin America's requirements. According to recent estimates, somewhat more than half a million houses are financed in Latin America each year, while the needs resulting from population growth may be above a million and a half units per year. Thus barely one third of the required financing for new housing is being provided each year on a formal basis.[1]

Furthermore, the financing available for housing often is inadequate compared to the financial terms desired by investors, borrowers and intermediaries. As a result, the limited financing available for housing is concentrated in meeting the needs of upper-middle income and upper income sectors. This explains why a very important portion of the overall housing market (in some countries the figure may be as high as 70 or 80 percent) is made up of housing units built and financed through informal channels for the large sectors of the population with low incomes.

What are the factors preventing a greater flow of resources to the housing sector and greater access to the financing available for housing?

The major factor is the limited role the private sector has been playing in the financing of housing in Latin America. Generally, the private sector has been inhibited by excessive regulation and intervention by the public sector, as well as a limited ability to pay among vast sectors of the population. These factors have prevented the housing sector from being perceived and chosen as a profitable business option by private investors.

Traditionally, countries have lacked integral policies for the housing sector and the state has failed to provide leadership. Public institutions have operated with subsidized interest rates in competition with private institutions and have not pursued coordinated strategies. Housing policy based on the state as builder and regulator was not only inefficient and incapable of meeting the demand for housing, but also inhibited the participation of the private sector.

It also has become clear that the traditional model of housing finance—based on fixed rates, fixed payment schedules and fixed terms—is incapable of meeting the needs of borrowers and lenders. This model collapsed as inflation and the deterioration of the population's purchasing power became commonplace throughout Latin America. In an unstable economy, systems for recovering loans based on nominal interest rates do not work and become obsolete. On the one hand, if interest rates are fixed, financial institutions run the risk of losses during the life of the loan. On the other hand, if mortgage interest rates and payments are allowed to vary, there is the risk that borrowers' ability to pay will be reduced; this in turn results in delays and losses in portfolio recovery undermining the long run viability of home financing.

Three main problems contributed to the reduction and in some cases elimination of funds available for house financing. First, inflation led to the *decapitalization of housing finance institutions.* The instability of the economies created problems for lenders that were financing long-term mortgage loans with short-term deposits (the maturity mismatch *[descalce de plazos]* problem). The lenders began to suffer heavy losses when their cost of borrowing money increased in a context of rising inflation and nominal interest rates, and the rates on their long-term loan portfolios remained fixed. The viability and competitiveness of financial systems were seriously challenged as institutions registered losses. In response to this problem, housing finance institutions began to offer mortgage credits that held the term of the loan constant but had variable rates and payment schedules. This system works as long as there are no major swings in the economy, but in an unstable economy a second problem arises.

This second problem has to do with *losses in mortgage portfolios due to borrowers' inability to pay.* In credit systems with variable rates and payments indexed to a financial indicator, the borrower's ability to pay is affected by the relationship between inflation, interest rates and wages. By indexing credit payments to a financial indicator (interest rates), the former can rise more rapidly than the borrower's income. Over a long period of time, the diver-gence between increases in payments due and increases in wages can lead to a situation in which the debtor cannot pay the mortgage credit, resulting in significant late payment and collection problems. The consequence of significant losses in mortgage portfolios can be open or disguised bankruptcies of financial institutions, which is what happened in a number of Latin American countries.

The third problem is the *abandonment of traditional markets due to borrowers' inability to pay.* The viability of home financing systems within unstable economies has been adversely affected by the reduction in the size of their potential market deriving from their borrowers' inability to pay. Since monthly payments must be increased both in the traditional credit system and in the variable-rate and variable-payment system, financial institutions tend to orient towards market segments that have a greater ability to pay and thus abandon historically served markets, reducing the potential market size.

When the state has tried to "protect" mortgage debtors from the harmful effects of economic instability by resorting to regulation and interest-rate subsidies, the results have been counterproductive in terms of availability and access to home financing. In Mexico, for example, the use of fixed-rate mortgages in the 1970s led to losses equal to the banking system's earnings and the cessation of voluntary lending. Although the offering of credit with variable rates and terms began in 1979, the rise of inflation led to payment problems and the government fixed the rates to low-income borrowers, in effect providing them with a subsidy equal to the difference in rates. The application of such subsidies can be viewed as a situation of controlled loss.[2] In Venezuela, the Mortgage Debtor's Protection Law, passed in 1989, had as its objective the establishment of a fiscal-based subsidy for mortgage debtors with variable-rate loans. The law limited the increases allowed on the loans. While protecting the borrower, it led in practice to a virtual freeze on the granting of new mortgage credits from the private market. The government, moreover, did not pay the subsidies in a timely manner which damaged the housing finance institutions.

In yet another case, the weakest aspect of the successful Chilean model of housing finance is the level of late payments and default in mortgage portfolios. One of the causes of the payment problems is the debtors' lack of liquidity, precipitated at times when the evolution of wages has not kept pace with the inflation-indexed payments. In some circumstances, government authorities have intervened with debt relief mechanisms or other options. There is a proposed law before the Chilean parliament aimed at creating a compensation fund for mortgage loan borrowers. This fund would refinance late payments resulting from the inability of wages to keep pace with prices.

In sum, in Latin America, the state has engaged in construction activities and over-regulated the initiatives and the behavior of agents in the housing sector and offered home financing schemes incapable of satisfying the profitability expectations of investors and financial intermediaries or conditions of accessibility for the bulk of the population, especially those with the least ability to pay. The result has been a situation of limited private investment in the housing sector and a constant increase in the region's housing deficit.

A MODEL FOR AN INTEGRATED POLICY OF HOUSING FINANCE

The present period is marked by change in and transformation of policies used in the area of housing finance. The policy model proposed here, which, of course, must be adapted to the circumstances of each country, is aimed at assuring greater accessibility and permanence in home financing (see Figure 1). This model is the product of an analysis of the evolution of the housing finance systems in various countries of Latin America, focusing on those that took the lead in the application of the new policies, persevered in applying them and are showing significant achievements in terms of a reduction of their accumulated housing deficits.[3]

Figure 1. Policy to Facilitate Housing

BASIC CRITERIA

ROLE OF THE STATE AS FACILITATOR AND SUBSIDIZER

* Policy design: Ministry of Housing
* Creation of payment capacity: subsidies to demand

LEADING ROLE OF THE PRIVATE SECTOR

* Housing construction
* Housing finance

INTEGRATING THE SECTORAL MODEL INTO THE GENERAL ECONOMIC MODEL

* Housing as a factor for economic growth: private investment
* Housing as job generator
* Housing as a factor for social welfare: increases in productivity
* Housing as a factor for the integration of markets
* Housing as a factor for incorporation into the market economy

PROFITABILITY OF OPERATIONS

* Productive investment in housing: profitable construction and development
* Financial savings rewarded with positive real rates
* Recovery of mortgage loans at real values: capitalization of intermediaries and long-term permanence of credit

ACCESSIBILITY OF HOUSING

* Previous savings: individual voluntary effort
* Forced savings: individual capitalization account
* Mortgage loans with payments linked to purchaser's ability to pay
* Leasing of housing
* Supplementing the ability to pay: subsidies to demand

Sector priority and market integration. The fundamental premise is to recognize that housing is an important economic commodity as well as a product that meets a social need. The generation of housing is an important engine of economic development, creating a large number of jobs and multiplier effects throughout the economy. Home financing contributes to a country's long-run capital formation. Furthermore, it strengthens the financial sector in general by increasing the level of savings and creating long-term instruments for investors.

Housing can actually act as a catalyst that stimulates the integration of various markets —the real estate, financial, capital and insurance markets—with the resulting reinforcement of the channels for mobilizing resources in the economy. The state's deregulation initiatives can reinforce the functioning of market mechanisms, increasing the efficiency and the integration of the markets involved.

Generating housing and improving its quality raises the living conditions of the population which in turn has a direct impact on health and education levels, thus reinforcing social welfare and stability. Inadequate housing—that is, housing with high rates of over-crowding, with deficiencies in construction, and/or with a deficit of basic services—contributes to an increase in poverty levels. The improvement of housing, therefore, will help alleviate poverty and protect the environment.

For all of these reasons, governments must place a high political and economic priority on the housing sector. Governments can signal a high political priority for housing by creating a body at the highest level of the executive branch that is in charge of the design and application of policy for the sector. This body can ensure that the model of sectoral development is compatible with the economic model as a whole so that housing becomes a factor in dynamizing the economy and the financial system.

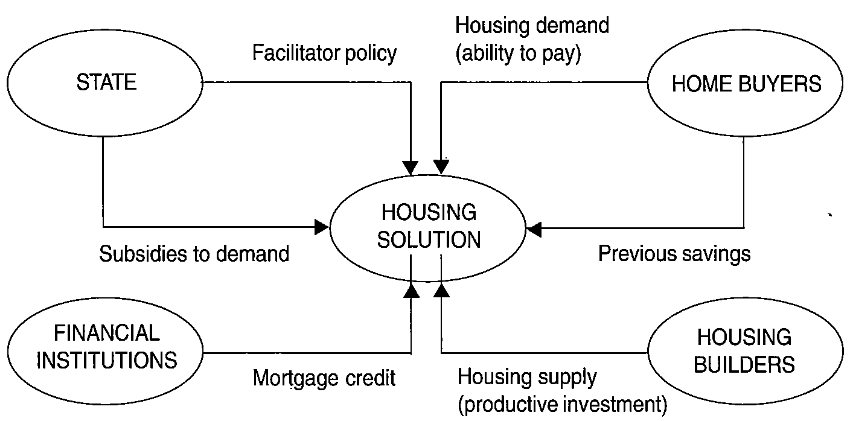
Complementarity of efforts. The complexity of the housing problem demands joint action by all of the agents involved. Clearly the state is incapable on its own of meeting unmet housing demands. Furthermore, it is unrealistic to think that the private sector will become involved if conditions of profitability are not created for the development of housing construction and home financing activities that are comparable to those in other areas of the financial arena.

The policy model requires that the state withdraw from the production and finance of housing and develop a role as a facilitator of housing development and finance. The private sector must carry out and finance the programs and take the market risks inherent in this activity. From this standpoint, the housing finance system can provide families with the opportunity to obtain a home and build equity through a mortgage. The private sector can profitably meet a market need, and the public sector can meet a social need.

The home financing model that is proposed imbues each and every one of the participating agents with a specific and complementary role (see Figure 2). In the first place, the state is called upon to develop a facilitator policy that promotes the participation of the private sector based on the principle of profitability and accessibility to financing opportunities. In order to achieve the latter, the state is also called upon to create an ability to pay among lower income sectors by providing direct subsidies to the demand for housing.

In the second place, builders of housing are called upon to invest in the housing sector to create an adequate supply of housing, an activity which can only be developed on the basis of reasonable conditions of profitability. The state can facilitate by withdrawing from construction and deregulating the industry. In the third place, financial intermediaries are called upon to mobilize resources towards the sector and to grant mortgage credits, also on the basis of reasonable conditions of profitability and accessibility in order to assure the long-term permanence of home financing. The state can facilitate by freeing interest rates and encouraging the use of alternative mortgage instruments.

Figure 2. Housing Policy and Home Financing: The Role of Agents



Finally, buyers of housing are called upon to contribute their previous savings, as meager as they may be, as a sign of their efforts to acquire their own housing, as well as of their ability to pay. Their contribution can improve the conditions of and provide an incentive for them to meet the obligations inherent in obtaining a mortgage. As noted above, the sectors with a limited ability to pay would be able to count on an additional supplement (the housing subsidy provided by the state).

Profitability and competitiveness. The policy model for home financing presented here is based on the application of a free market philosophy, and financial operations related to housing must meet profitability criteria. This will allow several things. First, it will ensure private investment in housing construction as a competitive business option. Second, it will reward savings and therefore create a flow of resources for financial intermediation toward housing. Third, it will allow recovery of loans in real terms and therefore strengthen the lending base. Fourth, it will strengthen financial institutions' equity bases. By ensuring profitability for the participants in the housing finance sector, the permanence, depth and growth of the system is assured and, as a result, so too is the availability of home financing in the long term.

The basis for every financial system is savings, both in order to attract the resources that are necessary to generate mortgages and in order to generate buyers' previous savings. Savers, therefore, must receive adequate returns, which at the very least must ensure the maintenance of real purchasing power. The system must compete for resources in the financial market through instruments that offer attractive rates and provide security to savers.

Thus, mortgage credit schemes must facilitate adequate returns to investors—builders and savers or fund suppliers—compatible with debtors' ability to pay and with the capitalization of the financial intermediaries. All of this leads us to another basic element of the model, which is accessibility.

Accessibility. Systems to recover mortgage loans must be adapted to the income flows of borrowers, in order to broaden the coverage and depth of the financial systems. This must be in harmony with the establishment of home financing operations based on profitability criteria, since the protection of the debtors is not achieved by establishing artificially subsidized financial operations.

Accessibility is a feature that has two aspects: one has to do with accessibility for sectors with an ability to pay, and the other is accessibility for sectors with limited or no ability to pay. In the first case, the scheme of mortgage credits with interest refinancing and payments linked to borrower's income, which has been successfully applied in some countries, can be the bridge to make the long-term profitability of housing finance compatible with the borrower's long-term ability to make payments and can also serve the needs of the traditional segments of the market, thereby taking into account the aspirations of the various participants in the loop.

This scheme, which is called double-indexing because it includes a financial indexing of mortgage obligations based on the market interest rate and an indexing of the client's payments based on the evolution of the purchasing power of wages, has the following features:

- The borrower's payment remains constant as a proportion of his income;
- The rate of interest varies according to the cost of raising funds in order to assure profitability; and
- The maturities are variable in order to absorb differences between the evolution of interest rates and wages.

Schemes of this nature have proved their effectiveness first of all by allowing resources to be obtained at market rates, attracting the public's savings into the financial systems and establishing the basis for growth and stability of investment in housing. In the second place, they have allowed financial institutions to be profitable and adequately capitalized, generating more resources that can be applied to credit for housing and giving continuity to financing programs. For their part, mortgage debtors find that their typical aspirations are met: more accessible credit, a low initial monthly payment, a similar monthly effort to make payments, certainty in terms of the size of the payment in relation to their income, and eventual full payment of their loan.

The experience of Mexico demonstrates how this policy can be effective. The adoption of the double-indexed mortgage in 1984 made it possible to eliminate subsidies for borrowers resulting from negative real interest rates. It also contributed to a resurgence in bank lending and the end of portfolio requirements imposed by the government. The policy contributed to a significant and continuous increase in mortgage credit portfolios, with moderate default levels. Toward the end of 1993, the value of these portfolios was six times greater in real terms than the balances at the end of 1987.[4]

As for accessibility for sectors with limited or no ability to pay, it must be said that since access to housing is a right of all the inhabitants of our countries, and since market mechanisms are not sufficient to profitably provide housing for all those who need it, authorities must design and apply mechanisms that can provide for total coverage.

Investment in housing often stagnates simply due to the fact that those who need housing cannot have access to it because they do not have enough purchasing power. Therefore, a key element for the viability of a housing policy and for effectively dealing with the problem of the housing deficit is the creation of an ability to pay among the poorest sectors who have an unmet housing demand. By the same token, the entry of the private financial sector into the financing of affordable low-income housing [*vivienda popular*] can only be expected to the extent that there are mechanisms that complement the ability to pay of the lowest income sectors. These mechanisms will contribute to increase the potential market of mortgage borrowers by reducing the amount of financing necessary to make up the price of the housing to be bought.

Direct subsidies to housing demand have demonstrated their usefulness in creating this ability to pay, and there are instructive experiences in several Latin American countries. Currently there are five Latin American countries—Chile, Costa Rica, Colombia, El Salvador and Uruguay—with regimes for direct subsidies to housing demand as an instrument to broaden accessibility to housing for sectors of the population with a limited ability to pay. It is no coincidence that Chile and Costa Rica are the two countries in the region that have already begun (as of two years ago) to reduce their accumulated housing deficit; that is, the annual production of housing is already exceeding the new demand generated by population growth.[5]

The utilization of a direct subsidy mechanism in the framework of a housing policy is based on the model in which the state plays a role as facilitator with housing construction and sales conducted by the private sector. State subsidies to the sectors of the population that have no ability to pay can create an environment of acceptable profitability and market allocation of resources, which can more effectively meet the needs of this group than the model in which the state intervenes as producer and financier. It is important to note that none of the countries with experience in the application of direct subsidies to the demand for housing has experienced significant inflation since their adoption.

The Latin American experience suggests that direct subsidies to the demand for housing must have a set of typical characteristics. First, they must take the form of one-time-only direct state grant without a restitution charge.[6] Also, the subsidy amounts must be publicly known and vary according to income level and housing values on a progressive basis; that is, the lower the level of income, the greater the subsidy. They also must be based on the utilization of clearly measurable resources (for example, of budgetary origin) and utilize transparent application, selection and adjudication procedures for distribution. Finally, it is important to place emphasis on a previous savings requirement, that is, savings that are methodically set aside, as a prerequisite for granting a subsidy. All of these characteristics will help prevent these mechanisms from distorting the profitable activity of the participants in the system and will make it possible to take advantage of the infrastructure that has been developed by the private sector in order to avoid duplication of costs.

NOTES

[1] See Jesús R. Boada, "El papel del sector privado en el financiamiento habitacional: un nuevo enfoque," in UNIAPRAVI, *La creación de sistemas de financiamiento habitacional viables en América Latina*, Lima: UNIAPRAVI, 1991, p. 66.

[2] See José M. Agudo, "Financiamiento habitacional e indizacion: el caso de Mexico," in Gerardo M. Gonzalez, ed., *Financiamiento habitacional e indizacion: experiencias y alternativas en América Latina*, Lima: UNIAPRAVI, 1993, pp. 123-124. Also see José Agudo and Manuel Campos, "Credit Recovery Through Payments Related to Borrower Income in Unstable Economies: The Mexican Experience, 1984-1989," in *Housing Policy Debate*, 3, 1, 1992.

[3] The basic criteria presented in what follows are based on the practical experiences of five Latin American countries—Chile, Colombia, Costa Rica, El Salvador and Mexico—whose housing and home financing policies, in the author's opinion, include critical elements that are useful for the rest of the countries.

[4] For a description of the cases of three important Mexican banks, see the contributions by Gerardo Concha, Ignacio Deschamps and Ernesto Gómez in Gerardo M. Gonzáles, ed., *Recuperación de créditos hipotecarios y fondos financieros de vivienda: experiencias latinoamericanas*, Lima: UNIAPRAVI, 1994, pp. 75-120.

[5] For a description and evaluation of these regimes of direct subsidy to housing demand, see Gerardo M. Gonzáles, ed., *Financiamiento habitacional y subsidios directos a la demanda: experiencias latinoamericanas*, Lima: UNIAPRAVI, forthcoming.

[6] This system can also work with leased housing. In Chile there is a legislative proposal to provide access to housing subsidies to renters who have not been able to accumulate the previous savings required. The subsidy would be paid out on a deferred basis as the renters accumulated the necessary savings.