Access to Credit, Terms of Housing Finance and Affordability of Housing

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INTRODUCTION

An important component of a shelter strategy is to devise mechanisms and legal and regulatory frameworks by which an adequate and steady flow of long-term financial resources can be mobilized from various sectors and channeled into shelter development. Availability, accessibility and quality of housing, land and related services depend heavily upon well-functioning housing finance systems. Development of housing finance constitutes a major building block of the enabling approach in the Global Shelter Strategy which strives for shelter for all, including low-income families.

Worldwide experience in housing finance development demonstrates that broad, market-based systems are the most effective vehicle through which to provide financial resources for shelter development. A fundamental problem facing governments, however, is that formal sector financial institutions seldom lend down market to serve the needs of low-income households. Low-income families are denied credit because their economic characteristics and financing needs are not compatible with the way financial institutions operate. For example, commercial lending institutions require that borrowers have a stable source of income out of which the principal and interest on loans can be paid according to the agreed terms; whereas income of self-employed households is not stable, regardless of its size. Lenders also look for collateral with a clear title, something that many low-income urban households do not have. In addition, financial institutions tend to think that low-income households are a bad risk, although there is no proven evidence for it.

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Very often governments try to address the problem of lack of access to credit for low-income households by creating specialized lending institutions. In so doing, most governments also provide capital or low-cost funds to special circuit housing finance institutions so that they will extend credit to low-income clientele at subsidized interest rates. Interest rate subsidies are justified on the social policy grounds that the low-income borrowers cannot afford to service the loans offered on commercial terms.

In the next section of this paper it is argued that such an approach is inefficient, inequitable and financially unsustainable; it should be replaced by measures making low-income households more bankable for financial institutions. The third section describes and presents an example of community-based housing finance programs as a promising modality for providing access to credit for the urban poor. In the final section it is pointed out that the problem of affordability of housing should better be addressed by tackling the various supply side constraints, supplemented with well-targeted subsidies separated from finance, rather than by providing affordable terms of housing finance.

HOUSING FINANCE, SUBSIDIES AND AFFORDABILITY OF HOUSING

The ultimate goal of housing policy for low-income households is to make housing available at affordable prices with the least possible distortion of the housing sector and the rest of the economy. Affordability of housing is determined by the price level or rent of the dwelling unit relative to household income; it is also affected by availability and terms of finance and government subsidies. Therefore, affordability of housing can be enhanced through improving access to and terms of mortgage credit, government subsidies and other measures which contribute to lowering the price of housing itself. We will discuss each option briefly.

Availability vs Terms of Housing Finance

The focus of housing finance policy should be placed on enhancing access to credit rather than offering more favorable terms of finance through interest rate subsidies. It makes sense to talk about the level of interest rate and other terms of housing finance only if credit is available in the first place. As long as lenders consider low-income households a bad risk and remain reluctant to do business with them, the issue of affordable interest rate becomes irrelevant.

In this context, the borrower's willingness to pay and the lender's perception of the borrower's creditworthiness are more appropriate concerns than affordability of housing loans. First, there is evidence indicating that low-income households are willing to pay the market interest rate and even more as long as funds can be disbursed fast when needed. This finding is not surprising in view of the fact that the only realistic alternative source of credit available for the urban poor is the private money lenders who charge interest at a much higher than market rate.

A good case in point is the Kupedes Program developed by Bank Rakayat Indonesia, a state-owned commercial bank. This lending program offers short-term loans up to three years of maturity at an annual interest rate of 32 percent, much higher than the market rate but much lower than what private money lenders charge. The rate is higher than the market rate to enable the lender to cover the higher administrative costs associated with handling small loans. Although housing loans represent a small portion of their total portfolio, this program suggests potential for a profitable market for housing finance for low-income households (PADCO 1994).

Borrowers' willingness to pay the market interest rate does not completely solve the problem of lack of access to credit, because lenders must be convinced that the borrowers are creditworthy. This will require financial discipline of low-income borrowers, as well as adjustments and adaptations on the lenders' side. Some studies demonstrate that it is indeed possible for formal housing finance institutions to serve the demand of low-income households if the former adapt to the needs of the latter (e.g., by collecting payments at the source, or increasing the frequency of payments for families with irregular income). Such techniques are especially useful if non-governmental organizations (NGOs) and community-based organizations (CBOs) serve as an intermediary or if peer pressure is used for supervision of loan payments among members of small-scale, multi-purpose mutual credit institutions, and if the program includes income generation activities (Lall 1991). More careful studies on this subject would be worthwhile.

Of course, housing loans can also be made more affordable through the use of innovative instruments and more flexible product design. Graduated payment mortgages(GPM) and dual-index mortgages (DIM) represent examples of innovative loan products. The GPM is a fixed-rate mortgage which makes it easier for a borrower to qualify for the loan by tilting the flow of monthly payments to reduce the initial burden. On the other hand, a DIM features indexation both to inflation to ensure that a positive real interest rate is paid to lenders and to the income profile of the borrowers so that affordability is maintained within a reasonable range.

Another example of a loan product with a flexible repayment arrangement is the Kupedes Program mentioned earlier, in which the payment schedule is tailored to fit the borrower's income stream over time (PADCO 1994). Flexibility in the use of borrowed funds according to the priorities set by borrowers is also a desirable feature. In the case of housing loans, borrowers should be allowed to spend the loan proceeds to purchase land, construction materials and labor, or upgrading or expanding the existing structure. Even better, housing loans could be packaged as a component of multi-purpose loans. The program of Kredit Triguna of Indonesia, described in the next section, is a good example.

Separating Subsidies From Finance

In virtually every country in the developed or developing part of the world, government housing policy has some form of subsidies for low-income households. There is no denying that subsidies are an integral part of a shelter strategy and a key component of the social safety net. The issue is finding the right modality of subsidies, not whether or not there should be subsidies at all.

Two points need to be made about subsidies: that they should be targeted and that they should be separated from housing finance systems. The first point is self-explanatory on equity grounds, and it suffices to add that the issue of targeting becomes even more critical as governments face tougher public sector budget constraints. The second point deserves further elaboration. Attempts to develop market-based housing finance systems in the former socialist economies in Eastern Europe have been hampered by the practice of mixing subsidies and finance (Buckley and Gurenko 1993).

As has already been mentioned, there are fundamental problems with the approach of relying on directed financial institutions offering subsidized loans. First, it reduces the supply of funds available for housing loans by discouraging the entry of potential players into the mortgage business. Commercial banks which must raise funds from savers by offering competitive returns cannot compete with specialized credit institutions which have access to low-cost funds provided by the central bank or which receive capital grants from the government. These hidden subsidies also hamper the development of the financial sector.

The directed credit system with interest rate subsidies is also not sustainable because those institutions can extend credit only as long as they receive subsidies. There are no private sector institutions to fill the gap when the government resources for subsidies are exhausted. Finally, the system is inequitable because benefits of interest rate subsidies end up in the hands of those belonging to the middle and upper income groups who can make downpayments for the houses financed by subsidized loans; whereas many other potential home buyers, especially those with low-to-moderate income, are altogether denied access to credit.

For both efficiency and equity reasons, therefore, it is desirable to separate subsidies from housing finance. On the finance side the cost of borrowing should equal the cost of resources and reflect their true opportunity cost. This will guarantee competitive returns to savers and hence allow funds to flow into the housing sector. It also will enable housing finance systems to operate on commercial terms with normal profits. The experience of the Government Housing Bank of Thailand and Housing Development Finance Corporation of India demonstrates that financial institutions can lend reasonably down market without government subsidies.

The ideal form of subsidies is one-time cash grants toward downpayment for home purchase, or rental allowance for a finite time period. Lump sum cash subsidies are efficient because they contribute to making housing more affordable without jeopardizing the viability of housing finance institutions or distorting the allocation of financial resources. Unlike interest rate subsidies, cash subsidies do not distort the consumer's choice between housing and other goods and services. In fact, the subsidies allow the recipients to select the dwelling units according to their own preferences rather than the criteria determined by lending institutions. Finally, cash subsidies provide greater transparency of the system.

Despite all the merits associated with cash subsidies, actual examples of their use are scant, even in developed countries, let alone in developing countries — with the exception of Chile (World Bank 1993, p.127). Starting in the 1995–96 fiscal year, the government of Indonesia has introduced a one-time lump-sum subsidy program to facilitate homeownership among the urban poor. Although the exact details are yet to be designed, it marks an important change in the government's policy stance on housing subsidies. Replacing interest subsidies with such lump-sum cash subsidies will encourage participation of the private sector in constructing and financing low-cost housing, as well as making housing affordable to low-income households.

Housing Supply and Affordability of Housing

The price of housing and hence its affordability is affected by various factors other than the terms of housing loans or subsidies. They include the efficiency of markets for land and other inputs to housing production, the competitiveness of the construction industry, the effectiveness of the housing delivery systems, and various government regulations on land use, building and basic service standards. All these factors influence the shape of the housing supply and hence the impact of increased demand upon the price and quantity of housing.

One implication of the above is that housing loans can become more affordable if housing itself becomes less expensive as a result of rationalizing the various supply side constraints. On the other hand, no housing finance mechanism will be of great relevance if housing is priced beyond the reach of home purchasers. For example, home purchase will be impossible even with the most efficient mortgage arrangements if a house costs the borrower 10 years' income. Therefore, housing finance systems should be strengthened simultaneously with the improvement of housing delivery systems. Otherwise, expanded credit for housing will increase housing prices and have only a limited impact on housing production and housing quality conditions.

There are many cases illustrating how these supply side constraints affect the efficiency of the housing delivery system, and hence the housing market outcome. Inappropriate supply of serviced land and unrealistically high service standards are just two examples (Hannah-Kim-Mills 1993, Renaud 1989, World Bank 1993; Cotton and Francyes 1994). The government has a critical role to play in enabling the markets to work by rationalizing land use regulations and standards on building and basic services, as well as by streamlining the procedures for granting building permits.

Another way of making housing more affordable for low-income households is to support the development of the rental sector. A well-functioning rental sector relieves pressure from potential home buyers and allows them to accumulate savings required to purchase homes later. Rental housing provides a viable long-term alternative for those who cannot afford to purchase their own homes or those who are not in a position to make a long-term commitment for housing.

The reality is that rental housing is not given due attention in many developing countries. Inadequate supply of rental housing in these countries leads to high and rapidly rising rents, which makes rental housing even less popular to the low-income households, and hence increases the pressure on the government to promote homeownership. Development of the private rental sector is frequently hindered by inadequate financing, rent control and difficulty in enforcing evictions on delinquent rent payers. These constraints need to be removed. Housing allowances for a finite time period can then be instituted to make rental housing affordable for the low-income target group.

COMMUNITY-BASED CREDIT PROGRAMS

Community-based, low-cost housing programs have been implemented quite successfully in some countries. The Build-Together Program of Namibia and Kredit Triguna (triple function credit) of Indonesia have been adopted as programs in their national housing strategies. Both programs share such key features as flexibility in housing options, design and standards, as well as major decisions being taken by participating communities and their members. One difference is that Kredit Triguna is offered only to groups, whereas individual loans are also provided under the Build-Together Program. Another difference is that Triguna has an explicit income generation component.

In the previous section it was stated that a market for low-income households could be formed if appropriate adjustments were made to make the urban poor more bankable. This section provides a detailed description of Kredit Triguna as a potentially promising modality of enhancing the perceived creditworthiness of low-income households by requiring them to organize into groups which assume collective repayment responsibilities.

Kredit Triguna provides a loan package to finance purchase of land, construction of housing and income generation activities according to the needs and priorities of the borrowers. The loan is only provided to a group or community under collective responsibilities taken in advance in lieu of collateral. Funds are disbursed in stages to facilitate incremental construction according to the needs and resource availability. Only 'low-cost housing' (RS) and 'very low-cost housing' (RSS) can be financed with Triguna.

As a community-based, low-cost housing program, Kredit Triguna has a few advantages. The first one is that it is based on a demand-oriented and people-centered approach. Members of the association participate in the design and implementation of the projects from the beginning. This approach could avoid mistakes which could arise when some external body tries to impose standards or design unacceptable to the consumers. Secondly, it could contribute to income generation at the community level, through loans to finance small enterprises or by promoting labor intensive construction techniques.

A negative feature of the current program is the heavy interest rate subsidy. In order to support the RSS portion of Kredit Triguna, the Central Bank provides 75 percent of the funds at a nominal annual interest rate of 3 percent. BTN (the State Savings Bank), the implementing agency, mobilizes the remaining 25 percent from its own sources. The source of its funding for loans to support RS comes from the Central Bank (50 percent of the total) with interest of 7 percent and from the Ministry of Finance at no interest (10 percent). BTN then onlends to communities at 8.5 percent for RSS, and 11 percent for RS. These rates are much lower than the market, which is about 18–22 percent p.a.

At the current level of operation, there does not appear to be a sustainability problem. The government is committed to contributing financial resources over a reasonable period of time into the future, and BTN was not able to disburse the allocated sum so far. The program could be a burden to the government if the program becomes much more popular and the number of participants increases in the future.

The point is that the current level of interest rate subsidy is unnecessary, because the real problem facing nonbankable people is lack of credit itself rather than the cost of credit. In fact, NGOs working with the groups of individuals participating in the program say that these people are willing to pay the market interest rate if money can be disbursed in a timely manner. Therefore, it may be more effective for government to focus on bridging the perceived gap by, for instance, providing guarantees to enable private as well as public sector credit institutions to extend loans to households lacking acceptable collateral. The current interest rate policy should be reviewed and the interest rate subsidy should be phased out in tandem with the increase of income of the participating households.

The second point is that housing could be made more affordable without the subsidy. It is claimed that the groups participating in the project were able to cut the construction cost by doing their own design as well as by hiring smaller subcontractors with lower overheads and profits than the large-scale commercial developers. On the other hand, implementation was substantially delayed due to the time-consuming procedure for obtaining building permits. Such delay led to increasing the cost of labor and building materials as well as creating a cash flow problem for the participants who had to pay both the monthly rent in their current housing and the downpayment for their new houses. In short, significant sums of money could be saved if the amount of red tape was reduced (according to an estimate, by as much as 35 percent). This is a much more efficient way of making housing affordable than the heavy interest subsidy.

As to implementation of the program beyond a pilot stage, there is a need to institutionalize it. In the pilot stage, the State Ministry of Housing has played a key role by providing technical assistance in designing and implementing the projects. However, the burden may become excessive as the number of eligible projects increases in the future. For this reason, it would be useful to prepare practical guidelines for the implementation of the program and to do some baseline research on the impact of the program. Also, for the sake of sustainability, local governments should be more engaged in facilitating the process. From the viewpoint of BTN, Triguna is seen as cumbersome to implement and imposing extra administrative cost, since it does not fit into their computerized loan management system. Some guidelines on the financial management of the product would be worthwhile to prepare.

A final point concerns the income generation component of Kredit Triguna. Obviously, the underlying cause of the low-income housing problem is poverty or the lack of stable income. Housing may not have the top priority in allocating limited financial resources available for low-income households. Consequently, the inclusion of the income generation component in the Triguna is very positive. In principle, the income generated from the activities financed by the loan could also enhance the ability of the borrowers to service the loan.

However, the impact of this component is unclear at this point. In pilot projects, most of the loans made available have been devoted to land purchase and housing construction leaving only a very small portion for income generating projects. This decision was made by the members of the group themselves, most of whom already have jobs or other sources of income. Although there is nothing wrong with this, one might wonder what is the potential for such a multi-purpose loan for improving the economic profile of the participants. There seems to be a role for "business consultants" to provide expert advice to the participants on more productive use of funds for income generating projects.

Although Kredit Triguna appears to hold promise in providing access to capital for low-income households, it is premature at this point to be overly confident about the initial success. Moreover, one should be reminded that Triguna was able to engage the formal financing sector by pooling nonbankable individuals into bankable groups, and by providing low-cost funds from the government. The very requirement that people should form groups may not be the ideal solution to the problem of individual nonbankability. Moreover, there is a potential management problem in that the project depends on the cohesiveness of the groups. Hopefully, the financial discipline obtained through the experience of servicing the debt will enhance the creditworthiness of individual participants.

SUMMARY AND CONCLUSIONS

This short paper sought to highlight some points relevant to policy discussions on improving housing finance for low-income households.

The first point was that the fundamental problem concerns not so much the terms of housing loans as the lack of access to credit itself. As long as lenders are reluctant to lend to low-income households, the question of affordability of terms of credit becomes meaningless. This obviously implies that attempts to channel subsidized loans through specialized credit institutions miss the point.

There is evidence indicating that low-income households are willing to pay the market interest rate and even more as long as funds can be disbursed in a timely manner. This suggests that interest subsidies are not necessary. Besides, subsidized loans end up reducing the size of the pool of resources available to finance housing for all households, including the urban poor, as well as quite frequently failing to reach the group targeted for subsidization.

The critical question, then, is what kind of adjustments are needed to enhance creditworthiness of the urban poor and to make them more bankable to financial institutions. An example of the community-based housing loan program was described as a promising avenue for improving access to credit for the urban poor. Kredit Triguna and other models of this type of program deserve more careful analyses.

Once credit for housing becomes available, efforts should be made to offer as wide a range of options as possible. Rental housing should be given greater support. Incremental improvement loans and multi-purpose loans should be promoted. Innovative instruments, such as graduated payment mortgages and dual-index mortgages, should be exploited to make housing finance more affordable.

However, housing finance systems should not be burdened to solve the affordability problem caused by irrational regulations and other supply side constraints. In order to maximize the contribution of housing finance to promoting home ownership and to improving housing conditions, it is equally important to rationalize the factor markets and regulations governing them. Facilitating the process of providing serviced land, streamlining the procedures to obtain building permits, setting realistic building and design standards, and making the construction industry more competitive are among the necessary measures.

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